The Law Society of Upper Canada

LICENSING Process

EXAMINATION STUDY MATERIALS 2012

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The Law Foundation of Ontario
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Licensing Process
The Law Society of Upper Canada
Osgoode Hall
130 Queen Street West
Toronto, Ontario
M5H 2N6
Telephone: (416) 947-3315
FAX: (416) 947-9070
www.lsuc.on.ca

List of Contributors

The Law Society of Upper Canada is grateful for the valuable contributions made in the preparation of these Examination Materials by the following people:

Donald Burke
Milly Chow
Kenneth J. Cohen
Barry Corbin
Joseph Grignano
Ian Hull
Joel Kadish
J. Milan Legris
David Little
Jeffrey Long
Paul Morassutti
Hartley Nathan
Bernard Roach
William A. Rowlands
Edward Sellers
Krista Yao

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Professional Responsibility

Chapter 1

Regulating the legal professions

1. The Law Society of Upper Canada

The Law Society of Upper Canada was established in 1797 as a self-governing or self-regulating body. The mandate of the Law Society is to govern the Ontario legal and paralegal professions in the "public interest." Only individuals who are competent and who comply with the Law Society's ethical code, expressed through relevant rules and by-laws, are permitted by the Law Society to practise law and/or provide legal services to the public.

To support its mandate, the Law Society's primary functions can be sorted into four main areas: (1) convocation and management; (2) education, licensing, and professional development; (3) professional regulation; and (4) support to paralegals, lawyers, and the public.

1.1 Convocation and management

As a self-governing body, the Law Society is run by a board of directors (*benchers*) elected by licensees of the Law Society. Benchers meet each month in a gathering called *Convocation* to deal with matters related to governing the legal and paralegal professions. Benchers may be lawyers, paralegals, or members of the public. Benchers also participate in special committees established by Convocation and hearing panels to decide on cases concerning the conduct and competence of lawyers and paralegals.

The head of the Law Society, the *Treasurer*, presides over Convocation and is elected by benchers entitled to vote in Convocation. The Chief Executive Officer (CEO), an employee of the Law Society, oversees the staff and the daily operations of the organization.

1.2 Education, licensing, and professional development

The Professional Development and Competence (PD&C) division of the Law Society provides education, practice resources, and support to lawyers and paralegals. To further the Law Society's mandate, PD&C's goal is to ensure that competent professionals serve the public. PD&C's responsibilities include the Licensing Process, Continuing Professional Development (CPD), and the provision of practice resources to lawyers and paralegals via the Great Library and the Practice Management Helpline (PMH). PD&C also oversees remedial programs aimed at identifying and correcting problems with competence, which include both spot audits and practice reviews.

1.3 Professional regulation

The Professional Regulation division fulfills the Law Society's obligation to govern lawyers and paralegals by resolving complaints (the Complaints Resolution department), investigating more serious complaints against lawyers or paralegals (the Investigations department), and conducting hearings to determine whether a paralegal or lawyer has engaged in unethical conduct that may result in disciplinary action (the Discipline department). Professional Regulation also provides trustee services and operates the Unclaimed Trust Fund.

1.4 Support to lawyers, paralegals, and the public

The Client Service Centre (CSC) is the face and voice of the Law Society. The CSC is made up of the Call Centre, which is the intake point for most inquiries the Law Society receives, and the administrative areas that handle lawyer and paralegal fees and annual filings, as well as any incoming complaints.

Communication and Public Affairs produces informative publications, deals with media inquiries, and manages the Law Society website. The Law Society's Equity Initiatives division provides resources regarding equity and diversity issues and provides model policies and programs to assist lawyers and paralegals to prevent discrimination and harassment.

2. Regulating the legal professions in the public interest

A profession requires extensive training and the study and mastery of specialized knowledge. Recognized professions are regulated by a governing body that oversees licensing, outlines ethical conduct, and holds the profession to its established standards.

Practising law or providing legal services to the public is a privilege and a responsibility. Lawyers are required to comply with the code of ethical behaviour set out by the *Rules of Professional Conduct* (*Rules*), and those who fail to meet their responsibilities are subject to the Law Society's complaints, investigation, and discipline process where the question of whether they should maintain the privilege to practise may be reviewed.

2.1 Terminology

For purposes of these materials, the phrase

- *lawyer* refers to a lawyer licensed by the Law Society;
- *legal practitioner* refers to a lawyer or paralegal licensed by the Law Society or a lawyer from another Canadian jurisdiction or both;
- *legal profession* refers to the occupation of practising law as a lawyer;
- *legal professions* refers to the occupations of providing legal services as a licensed paralegal and of practising law as a lawyer;
- *licensee* refers to either a lawyer or a paralegal licensed by the Law Society or both; and
- *paralegal* refers to a paralegal licensed by the Law Society.

Certain aspects outlined in these chapters are mandatory and others are not. The terms *shall* or *must* are used in those instances where compliance is mandated by either the by-laws made under the *Law Society Act* (*Act*) or the *Rules*. The term *should* and the phrase *should consider* indicate a recommendation. These terms refer to those practices or policies that are considered by the Law Society to be a reasonable goal for maintaining or enhancing practice management or client service. The term *may* and the phrase *may consider* convey discretion. Lawyers may or may not pursue these suggested policies or practices depending upon their particular circumstances, areas of practice, or clientele.

2.2 The Rules of Professional Conduct

Under the *Act*, the Law Society of Upper Canada has the right to make rules and regulations to govern the professional conduct of Ontario's lawyers and paralegals. Through their elected benchers, Ontario lawyers and paralegals determine what conduct is acceptable and what conduct is prohibited. The *Act* also gives the Law Society the ability to discipline those who do not adhere to the rules. Regulations include the by-laws under the *Act* and the *Rules*, which were adopted to govern the professional conduct of Ontario lawyers. There are six *Rules*, listed below:

- **Rule 1: Citation and Interpretation** defines the terms used in the *Rules* and provides some general standards for the legal profession, including the obligation to advise a client of any French language rights.
- **Rule 2: Relationship to Clients** discusses issues that relate to the lawyer-client relationship. These include competence, quality of service, confidentiality, conflicts of interest, withdrawal from representation, and preservation of client property. It also covers fees and billing issues and contains rules on fee splitting and referral fees.
- **Rule 3: The Practice of Law** covers topics related to running a law practice and includes the offering, marketing, and advertising of legal services, and responsibilities related to interprovincial law firms.
- **Rule 4: Relationship to the Administration of Justice** outlines how the lawyer should conduct himself or herself when acting as advocate and includes the lawyer's duties to the tribunal, agreements on guilty pleas, interviewing or communicating with witnesses giving testimony, the relationship with jurors, the lawyer as witness, the lawyer as mediator, and the security of court facilities.
- **Rule 5: Relationship to Students, Employees, And Others** outlines the lawyer's responsibilities regarding the supervision of non-licensed employees, articling students, harassment, and discrimination.
- **Rule 6: Relationship to the Society and Other Lawyers** deals with the lawyer's general duties of integrity, civility, courtesy, and good faith and outlines how lawyers must treat others. It includes the lawyer's obligations when engaging in outside interests, making public appearances or statements, or holding public office and also addresses undertakings. Rule 6 discusses the lawyer's duty to prevent unauthorized practice; to respond to the Society; and to report misconduct, criminal charges, or convictions. It also covers the obligations of the suspended lawyer and outlines the Law Society's disciplinary authority.

The *Rules* cannot cover every situation; they should be interpreted and applied with common sense and in a manner consistent with the public interest and the integrity of the legal profession. There may be circumstances where a lawyer's personal sense of what is right may conflict with what is outlined in the *Rules*; however, a lawyer is obliged to conform to the *Rules* regardless of whether the lawyer agrees with them. When faced with an ethical problem or question to be resolved, the Law Society recommends that the lawyer consider taking the steps outlined below:

(1) Identify the various ethical issues raised by the particular situation.

(2) Consider any governing law that may be relevant to the problem.

(3) Look to the specific rule in the *Rules*.

(4) Apply the situation to the rule to determine the lawyer's responsibilities and whether it is mandatory (i.e., you "shall" do something) or permissive (i.e., you "may" do something).

(5) Consider how to balance any competing duties.

(6) If you are uncertain of how to proceed, check the Practice Resources section of the Law Society's website, consult with a senior lawyer, or contact the Law Society's Practice Management Helpline for guidance.

(7) Keep a detailed written record of what steps you considered and took.

The *Rules* were created to ensure a high standard of behaviour for the protection and benefit of the public. Failure to comply with the *Rules* may prejudice a client's rights, demean the profession, and result in discipline by the Law Society.

2.3 Competence and professional development

The Law Society has developed various initiatives to assist lawyers and paralegals to maintain the competence required to serve the public. CPD seminars and materials provide lawyers and paralegals information on the law and practice management techniques and are offered in various formats. The PMH, a confidential telephone service, can assist lawyers and paralegals to properly apply Law Society rules and by-laws and offers practice management advice.

To monitor the competence of lawyers and paralegals, the Law Society operates the Spot Audit and Practice Review programs, both of which are remedial in nature. Spot audits assess compliance with the financial record keeping requirements outlined in By-Law 9, made under the *Act*, and auditors can provide guidance on the best practices for organizing and maintaining required records. Practice Review conducts focused practice reviews and practice management reviews, both of which evaluate the systems that a lawyer, paralegal, or firm has in place to allow each to serve the public effectively.

2.4 Complaints, investigations, and discipline

Complaints about a lawyer or paralegal must be sent to the Law Society in writing and are first reviewed to ensure that the issues outlined are within the Law Society's jurisdiction. If a complaint deals with an issue that can be resolved informally, Complaints Resolution will deal with the complaint. Serious allegations of misconduct, incapacity, or incompetence that are likely to result in discipline against the lawyer or paralegal are referred to Investigations.

Investigations may suggest the matter be resolved through some form of alternative dispute resolution (ADR) or may recommend that the lawyer or paralegal be referred to the Proceedings Authorization Committee (PAC) for disciplinary action. The PAC is made up of benchers who may authorize a hearing before a *hearing panel*, which is similar to but less formal than a court proceeding.

The hearing panel may decide to discipline the lawyer or paralegal by suspending or revoking his or her licence or ordering him or her to

- participate in CPD or professional training;
- restrict his or her practice to certain areas;
- provide legal services only under the supervision of another lawyer or paralegal;
- cooperate in a practice review;
- not maintain a trust account;
- refund to a client all or a portion of fees; and/or
- start or continue treatment or counselling.

Lawyers and paralegals may appeal any decision of the hearing panel to an *appeal panel* and may appeal the decision of an appeal panel to the Divisional Court. Hearing panels are also involved in "good character" hearings for lawyer and paralegal candidates enrolled in the Law Society's Licensing Process.

If the Law Society receives a complaint against a lawyer, the lawyer will be notified and given an opportunity to respond. Failure to respond promptly to any communication from the Law Society is a breach of the *Rules* and is also grounds for discipline. Lawyers should communicate and cooperate fully with any representative of the Law Society who contacts the lawyer regarding a complaint so that the issue can be resolved as quickly as possible. Most complaints are resolved without a formal discipline hearing. If the lawyer is disciplined, the hearing panel's decision will become part of the lawyer's record with the Law Society and will be made public.

2.5 Suspensions — administrative and disciplinary

When a lawyer or paralegal has acted contrary to the Law Society's rules and regulations or to the by-laws made under the *Act*, the Law Society may discipline that individual. Such discipline may include

- delivering a verbal or written reprimand;
- placing temporary or permanent restrictions on the individual's licence (e.g., via an undertaking);
- suspending the individual's licence;
- permitting the individual to give up his or her licence; and
- revoking the individual's licence.

Lawyers and paralegals suspended for failing to meet the required standard of conduct have been suspended for

disciplinary reasons. When a lawyer or paralegal is suspended as a result of discipline, the suspension may be for a defined period of time, or it may be indefinite and dependent on him or her completing other tasks prescribed by the Law Society's hearing panel. Lawyers and paralegals may also be suspended by the Law Society for *administrative* reasons. Administrative suspensions are automatic, and there is no hearing. They occur if the lawyer or paralegal fails to meet his or her administrative obligations to the Law Society, including the requirements to

- pay annual fees to the Law Society;
- pay the necessary professional insurance premiums or file the necessary forms with the professional liability carrier;
- complete and report on annual CPD hours; and
- file annual reports to the Law Society.

The specifics of these requirements are contained in By-Laws 5–6.1 and 8, made under the *Act*.

Unlike disciplinary suspensions, administrative suspensions are automatically lifted as soon as the suspended individual meets his or her administrative obligation to the Law Society. The lawyer or paralegal may also be required to pay an additional fee to have his or her licence reinstated.

While under suspension for any reason, the lawyer is prohibited from practising law or providing legal services or holding himself or herself out as someone who is entitled to do so. The suspended lawyer also has specific obligations to disclose his or her suspended status to prospective, existing, and former clients and to engage another lawyer to complete certain tasks related to any existing client's file. There are additional obligations if the lawyer is holding client funds or property in trust. These obligations are outlined in rr. 6.07(3)–(5) of the *Rules* and By-Laws 7.1 and 9, made under the *Act*.

Chapter 2
Professionalism

1. Standards of the legal profession — r. 1.03(1) and commentary

Though a lack of professionalism is easily recognized, it is often unclear what is required to be "professional." The professional lawyer practises law effectively with a positive attitude and approach to the work required. That lawyer takes responsibility for his or her actions, behaves appropriately in all situations, and is a role model for colleagues. Under the *Rules of Professional Conduct* (*Rules*), lawyers have a duty to be professional by upholding the standards and reputation of the legal profession. To fulfill this duty, lawyers must act with integrity, civility, courtesy, and good faith. Lawyers must also respect the diversity of the communities in which they practise law. These elements of professionalism are outlined further below.

2. Integrity and civility — r. 6.01(1) and commentary

Lawyers have a duty to practise law and fulfill their professional responsibilities to others with honour and integrity. A client who doubts the trustworthiness of a lawyer cannot fully benefit from that lawyer-client relationship regardless of the lawyer's competence. A lawyer who practises law without civility disrespects the legal process and all those who participate in that process. Because a lawyer's failure to act with integrity or civility may undermine public confidence in the legal profession and the justice system, lawyers must serve the public in a manner that inspires confidence and respect. A lawyer must act with integrity when dealing with all others. Where possible, even the appearance of impropriety should be avoided.

3. Courtesy and good faith — r. 6.03(1) and commentary

Further to the duty to act with civility and integrity, lawyers must show courtesy and good faith to all persons with whom they may interact while practising law. This includes clients, opposing parties, fellow lawyers, paralegals, support staff, tribunal officers, other employees of the judicial system, and representatives of the Law Society of Upper Canada. This obligation applies regardless of where the lawyer may be appearing, the degree of formality, and at what stage of the process the matter may be. A lawyer who is ill-mannered or acts in bad faith does a disservice to the client and may impair the lawyer's ability to perform the tasks required to complete the client's matter.

4. Lawyers and the Ontario Human Rights Code — r. 1.03

Because of the role the legal profession fulfills in the administration of justice, lawyers have a special responsibility to recognize the diversity of the public they serve. Lawyers must protect the dignity of individuals and must comply with the human rights laws of Ontario. The Ontario *Human Rights Code* (*Code*) gives every person equal rights and opportunities relating to matters such as jobs, housing, and services. The purpose of the *Code* is to prevent discrimination and harassment on the grounds of

- race, colour, or creed;
- citizenship, ancestry, place of origin, or ethnic origin;
- gender;
- maternity or parental status;
- sexual orientation;
- age;
- record of offences;
- marital or family status; and
- disability.

Individuals have the right to be free from discrimination or harassment when they use facilities or receive goods or services, such as legal services. Lawyers shall not engage in the harassment or discrimination of a colleague, a staff member, a client, or any other person. Lawyers must ensure that no person is denied service or receives inferior service due to discrimination or harassment and that their employment practices adhere to the *Code*. A lawyer's obligations regarding harassment and discrimination are outlined in both the *Rules* and the *Code*. Lawyers should review and become familiar with both to ensure they are meeting their legal and ethical obligations to others.

4.1 Discrimination — r. 5.04 and commentary

Discrimination is unfair treatment by another based on any of the grounds prohibited by the *Code*, such as race, gender, creed, sexual orientation, etc. It is the impact of the behaviour and not the intention behind it that determines whether the behaviour is discriminatory.

Lawyers shall not discriminate based on any of the *Code*'s grounds with respect to the employment of others or in dealings with clients, other licensees, or any other person.

For example, discrimination would include a lawyer's refusal to accept clients of a particular sexual orientation. It would also include conduct that may result in an adverse effect that is discriminatory, even though that was not the lawyer's intent (i.e., *adverse effect discrimination*). If the conduct adversely affects a group or individual protected by the *Code*, the lawyer may have a duty to accommodate. Depending on the situation, a failure to accommodate may amount to discrimination.

4.2 Harassment — r. 5.03 and commentary

A form of discrimination is *harassment*. Harassment means comments or actions that are unwelcome or that should be known to be unwelcome because they are discriminatory or offensive. Harassment is a "course of conduct"; it is a pattern of behaviour where more than one incident has occurred. However, even one incident may constitute harassment in cases of *sexual harassment*. Sexual harassment is defined as an incident or series of incidents involving unwelcome sexual advances, requests for sexual favours, or other verbal or physical conduct of a sexual nature when

- such conduct might reasonably be expected to cause insecurity, discomfort, offence, or humiliation to the recipient(s) of the conduct;
- giving in to such conduct is a condition for the supply of legal services by the lawyer, whether this condition was spoken or unspoken by the lawyer;
- giving in to such conduct is a condition of employment by the lawyer, whether this condition was explicit or implied by the lawyer;
- giving in to or rejecting such conduct affects the lawyer's employment decisions regarding the employee (which may include assigning file work to the employee, matters of promotion, raises in salary, job security, and employee benefits, among other things);
- such conduct is intended to or results in interference with an employee's work performance; or
- such conduct creates an uncomfortable, unfriendly, or unpleasant work environment.

Examples of behaviour considered as sexual harassment includes, but is not limited to,

- sexist jokes that cause embarrassment or offence, that are told or carried out after the speaker has been advised that they are embarrassing or offensive, or that are clearly embarrassing or offensive in nature;
- the display of sexually offensive material;
- the use of sexually degrading words to describe a person;
- the use of derogatory or degrading remarks directed at one's sex or sexual orientation;
- the use of sexually suggestive or obscene comments or gestures;
- unwelcome inquiries or comments about one's sex life;
- unwelcome sexual flirtations, advances, or propositions;
- leering;
- persistent unwanted contact or attention after the end of a consensual relationship;
- requests for sexual favours;
- unwanted touching;
- verbal abuse or threats; and
- sexual assault.

Sexual harassment can occur in the form of behaviour by men towards women, by men towards other men, by women towards other women, or by women towards men.

5. Model policies, discrimination, and harassment counsel

The Law Society's Equity Initiatives Department has developed a series of best practices and model policies to guide lawyers in promoting equity and diversity in all areas of their practice. Model policies cover practices relating to employment and the provision of services to clients. They include guides to developing business policies that address

- preventing and responding to workplace harassment and discrimination;
- promoting equity in the workplace;
- parental and pregnancy leaves and benefits;
- accommodation in the workplace and flexible work arrangements; and
- issues relating to creed and religious beliefs, to gender and sexual orientation, and to individuals with disabilities.

Equity Initiatives has also developed a professional development program to design and deliver education and training to licensees regarding the equity and diversity issues outlined above. Lawyers may contact the Law Society to discuss available training sessions, which may be offered as seminars, workshops, or informal meetings. Full information regarding these initiatives is available in the Equity and Diversity section of the Law Society's website at www.lsuc.on.ca .

The Law Society also provides the services of the Discrimination and Harassment Counsel (DHC) to anyone who may have experienced discrimination by a lawyer or paralegal, or within a firm. This service is funded by the Law Society but is completely independent of the Law Society. The service is free to the Ontario public, lawyers, and paralegals and is strictly confidential.

The DHC can provide advice and support and will review options with the individual using the service, which may include

- filing a complaint with the Law Society;
- filing a complaint with the Ontario Human Rights Commission; and
- allowing the DHC to mediate a resolution, if all parties agree.

More information is available on the DHC website at www.dhcounsel.on.ca/

Chapter 3
Who is the client

One of the lawyer's most important duties is the duty of service to his or her client. The duty of service includes the lawyer's responsibility to be competent, to maintain client confidentiality, to avoid conflicts of interest, and to continue to represent the client unless there is good cause to withdraw. Other responsibilities within the duty to serve the client relate to fees and billing clients and to handling clients' money and other property. Because most of the duties outlined in the *Rules of Professional Conduct* (*Rules*) are those that are owed to the client, a lawyer must always know who the client is.

1. Determining who is the client

Lawyers often have difficulty clearly distinguishing which organization, individual, or group of individuals is their client. The need to "identify the client" may vary depending on the context. For example, a lawyer

- must determine whether a lawyer-client relationship exists between the lawyer and the individual to determine to whom the lawyer owes client-related duties and from whom the lawyer will take instructions;
- must comply with the requirements of By-Law 7.1, made under the *Law Society Act*, by obtaining basic information about the client and by verifying the identity of the client (through the review of independent identity documents) when handling or instructing the client on the transfer of funds,
- should set out the client's name in an engagement letter or retainer agreement to identify who retained the lawyer to provide legal services; and
- should send a non-engagement letter that identifies to whom the lawyer will not be providing legal services (i.e., identifies who is not a client).

The lawyer must recognize when an individual or organization becomes a *prospective client* or *client*. A *prospective client* is a party that is likely to become a client. The prospective client contacts the lawyer or firm for the purpose of seeking legal services and may reveal confidential information necessary for the lawyer to determine if he or she may act (e.g., to ensure no conflict of interest exists) or for the prospective client to evaluate whether he or she would like to retain the lawyer or firm.

Regardless of whether the lawyer or firm is retained by the prospective client after this initial contact, the *lawyer-client relationship* is established when the prospective client has first contact with the lawyer or firm. The lawyer and the firm have the duty to protect the prospective client's confidential information and to avoid potential conflicts of interest that involve the prospective client. Both of these duties arise as soon as the prospective client has first contact with the lawyer or firm and continue indefinitely.

Once a lawyer agrees to act for a prospective client, the prospective client becomes a *client*. A retainer or an agreement for legal services may be created either formally or informally. Once the lawyer has agreed to provide legal services, the *lawyer-client retainer* has been established, and the lawyer has the additional duty to provide legal services competently, as discussed later in these materials.

Even when it is apparent what organization, individual, or group of individuals is the client, situations may arise during the retainer that create confusion as to who has proper authority to provide the lawyer with instructions on the client's matter. This may occur when the client brings a friend or family member who is not involved in the matter to meetings with the lawyer, when a third party pays for the lawyer's services, or when the lawyer represents more than one client in the same matter. The friend, family member, or third party may try to instruct or ask the lawyer to reveal information about the client. To ensure no misunderstanding about the involvement or authority of the third party as it relates to the client's matter, the lawyer should meet with the client privately to obtain direction as to how the lawyer should deal with the third party. The lawyer should also confirm in writing the client's directions concerning the third party and any subsequent changes to those directions.

If the third party is also a client (i.e., a joint retainer client) or if the third party is authorized to give instructions on behalf of the client, the lawyer may take instructions or reveal information. If not, the lawyer must confirm with the client whom the lawyer may speak with regarding the client's matter. The following are situations where it may be difficult to identify the client or to identify the party authorized to instruct the lawyer on the client's behalf.

1.1 Joint clients — rr. 2.04(6)–(10) and commentaries

A *joint retainer* is where the lawyer has been retained to represent two or more clients in the same matter. As with any retainer, the lawyer must clearly determine the clients to whom legal services will be provided to ensure

that the lawyer can fulfill his or her duties to those clients. Before a lawyer may accept joint clients, the lawyer must ensure that there are no conflicts of interest and must advise each party of all of the following:

- The lawyer has been asked to act for both or all parties.
- No information received about the matter from one joint client can be treated as confidential where the other joint clients are concerned (i.e., information provided by one joint client about the joint matter may not be withheld from the other joint clients).
- If a conflict develops between the joint clients that cannot be resolved, the lawyer cannot continue to act for both or all of them and may have to withdraw completely.

A lawyer may represent the clients jointly if all parties give consent in writing after being informed of the above. If there are differing degrees of knowledge, vulnerability, or authority among the clients, the lawyer should consider suggesting that they obtain independent legal advice before agreeing to the joint retainer.

Regardless of whether the lawyer receives the clients' consent to act in a joint retainer, the lawyer must not do so where it is likely that the clients will disagree on an issue or where the clients' interests or rights may diverge during the retainer. If a conflict arises after establishing the joint retainer and that conflict cannot be resolved, the lawyer must not continue to act. The lawyer must immediately advise the joint clients that the lawyer must withdraw from representing them, unless the joint clients previously agreed that the lawyer may continue to act for one or some of the clients in the event of such a conflict.

When a lawyer accepts more than one client in a matter, the lawyer must also be clear as to who will be providing the lawyer with instructions regarding the matter. To ensure there is no misunderstanding, the lawyer should discuss whether one, some, or all of the joint retainer clients will give instructions. This should be confirmed in writing either in the retainer agreement or retainer letter.

1.2 Authorized representatives — r. 2.02(6) and commentary

Establishing who the client is and who will provide instructions may be difficult where a client representative is involved. If asked to provide legal services to an individual who lacks legal capacity to give instructions or enter into binding relationships, the lawyer must determine who the individual's lawfully authorized representative is (e.g., a litigation guardian, an attorney acting under a power of attorney, or a trustee acting on behalf of a beneficiary). The lawyer must then confirm with that representative whether the lawyer is retained to act for the individual lacking capacity, for the representative, or for both. The lawyer must be clear as to which individual will be providing instructions on the client's matter and should confirm this in writing.

If the lawyer is acting for both the individual and the individual's authorized representative in the same matter, the lawyer must comply with the *Rules* regarding joint retainers, as previously outlined. Whether or not a lawfully authorized representative has been appointed for a client under a disability, the lawyer must comply with the *Rules* regarding clients under a disability.

1.3 Client is an organization — r. 2.02(1.1) and commentary

When acting for an organization, the lawyer should determine which officers, directors, shareholders, employees, or agents of the organization may properly give instructions on the organization's behalf. This should be confirmed in writing via a retainer agreement or engagement letter. To ensure no misunderstanding, any subsequent changes to those authorized to give instructions should also be confirmed in writing. The lawyer should confirm with the agents (i.e., those properly authorized to instruct on the organization's behalf) that the lawyer acts for the organization and not for the individuals who act as its instructing agents.

If the lawyer is retained to act for both an organization and any officer, director, shareholder, employee, or agent of the organization in the same matter, the lawyer must determine whether a conflict exists that would prevent the lawyer from acting for both the corporation and the individual. If not, the lawyer may act for both but must also comply with the joint retainer rule.

1.4 Limited scope clients – rr. 2.02(6.1)–(6.3) and commentary and commentary r. 2.01(1)

A *limited scope retainer* is where the lawyer is retained by a client to provide limited legal service in relation to the client's matter (e.g., prepare a demand letter or provide a second opinion), including limited legal representation for only part of the client's matter (e.g., to negotiate a settlement), by agreement with the client. Prior to agreeing to assist the client in a limited scope retainer, the lawyer must advise the client honestly and candidly about the nature, extent, and scope of the services that he or she can provide and whether those services can be provided within the financial means of the client. The lawyer must also document the limited terms of engagement. Limited scope retainer clients are still owed the same duties of competence, confidentiality, and avoidance of potential conflicts of interest. Thus, when acting in a limited scope retainer, the lawyer must

ensure that the client and any related parties are included in the lawyer's conflicts checking system.

1.5 Firm clients — r. 1.02 and commentary

The *Rules* define client as including "a client of the law firm of which the lawyer is a partner or associate, whether or not the lawyer handles the client's work." This means that the clients of a lawyer's partner or associate in the same firm are also the lawyer's clients, and vice versa. The duties owed to one client of the firm are owed to all clients of the firm. The lawyer must avoid conflicts that exist or may arise regarding other clients of the firm, and every lawyer at the firm owes the duty of confidentiality to all other clients of the firm.

Each time the firm deals with a prospective client or is retained by a new client, every lawyer and staff member of the firm should be notified of the clients and of the related and instructing parties in that matter. Proper file and office management systems, especially firm-wide conflicts checking systems, should be used to ensure there is no unintended breach of duty owed to a firm client.

1.6 Phantom clients

The term *phantom client* refers to an individual who believes that he or she is represented by a lawyer and that his or her rights are being protected by that lawyer, even though he or she did not formally retain or even meet with the lawyer. Phantom clients arise when a lawyer does not make it clear that the lawyer has not been retained to provide legal services. The lawyer is unaware that the individual believes that he or she is a client to whom certain duties must be fulfilled and that these duties exist. These may include the duty to maintain confidentiality and to avoid acting where any conflicts of interest are concerned.

Because the lawyer-client relationship may be established when a prospective client first contacts a lawyer or a law firm for legal services, there is a risk of acquiring phantom clients at any time. To avoid the danger of acquiring a phantom client, lawyers should be careful when dealing with individuals who

- consult with the lawyer on a matter but do not clearly indicate whether they want to hire the lawyer or pursue the matter;
- are third parties that accompany the lawyer's client and are present during the client's consultation with the lawyer (e.g., a friend, family member, or business associate);
- are third parties who know of the lawyer through the client and on whose behalf the client may be retaining the lawyer but who have never met with the lawyer (e.g., a friend, family member, or business associate); and
- speak to the lawyer casually or socially about a limited issue outside of the lawyer's office.

To avoid the problem of phantom clients, lawyers should clearly establish when they have or have not been retained to provide legal services. Lawyers should clearly communicate what role they will fulfill for the client and should

- confirm in writing whether they will act for a client who has consulted with them and refer to any limitation periods (i.e., in a retainer agreement and engagement or non-engagement letter);
- inform third parties who attend meetings with a client that they do not represent them and represent the client only;
- discourage clients from requesting legal advice for third parties or from relaying information that the lawyer has provided to the client; and
- avoid discussing legal matters outside the working environment or any working relationships.

In addition to the risk of a third party misunderstanding the nature of his or her relationship with the lawyer (i.e., the third party believes that he or she is an individual client or in a joint retainer with the actual client), third-party involvement may give rise to a conflict of interest. The lawyer must be alert to avoid all conflicts, regardless of their source, as discussed in detail elsewhere in these materials.

1.7 Unrepresented parties — r. 2.04(14) and commentary

Lawyers have a special obligation when representing a client in a matter where another party is not represented. The lawyer must

- urge the unrepresented person to obtain independent legal representation;
- ensure that the unrepresented person understands that his or her interests will not be protected by the lawyer; and
- make it clear to the unrepresented person that the lawyer is acting only in the interests of his or her client and that any comments may be biased towards his or her client.

If an unrepresented person requests that the lawyer also advise or act on his or her behalf in the same matter, the lawyer is prohibited from representing parties on more than one side of a dispute. Even where the parties' interests seem to be aligned, the lawyer must evaluate whether representing both would pose a potential or actual conflict of interest, and if the lawyer is permitted to act for the unrepresented party and the existing client in the same matter, the lawyer must comply with the

provisions of the joint retainer rule, as previously outlined. When dealing with an unrepresented party who refuses to obtain his or her own legal representation, the lawyer should confirm this in a letter to the unrepresented party.

2. Client identification and verification requirements — By-Law 7.1, Part III

By-Law 7.1 outlines client identification and verification requirements for lawyers. These requirements were created to enhance the protection of the public by assisting lawyers to prevent money laundering and potentially fraudulent or criminal activities. For purposes of these requirements, *identification* refers to the basic information the lawyer needs to obtain from his or her client and relevant third parties when retained to provide legal services, such as the client's or third party's name and address. For purposes of the by-law, a third party refers to an individual or organization that directs or instructs the client, or has the authority to direct or instruct the client. *Verification* refers to the additional steps the lawyer must take to confirm the identity of the client and any third parties, in circumstances as outlined below. The by-law requires that lawyers keep a record of any identifying information obtained and copies of verification documents, and mandates the retention periods for both. It is the lawyer's responsibility to first determine if client or third party identification is required, to ascertain if identity verification is also mandatory, and to obtain and retain relevant information and documents related to these matters.

2.1 When identification required

When retained to provide legal services, the by-law requires the lawyer to identify his or her client(s) and any third party. However, there are exceptions, which are outlined in the by-law. If the exceptions do not apply, the lawyer must identify the client(s) and any relevant third parties as required by the by-law.

2.2 Identifying information

When required to identify the client(s) and/or third party, the lawyer must obtain and keep a record of certain information. The required information differs depending on whether the client or third party is an individual or an organization. If the client or any third party is an individual, the lawyer must obtain and keep a record of the individual's name, home address and phone number, business address and phone number (if applicable), and the individual's occupation(s).

If the client(s) and/or third party is an organization, the lawyer must obtain and keep a record of the organization's full name and business address and phone number (if any). In addition, the lawyer must also obtain and keep a record of the name, position, and contact information of all individuals authorized to provide instructions on behalf of the organization. If the organization is not a financial institution, government body, or public company, the lawyer must also obtain information regarding the type of business or activities of the organization, the organization's incorporation or business number, and where it was issued, if applicable.

2.3 When verification of identity required

To comply with the by-law, a lawyer must verify the identity of his or her client(s) and any third party for whom the client acts if the lawyer acts for or gives instructions on behalf of the client or third party regarding the receipt, payment, or transfer of funds. However, there are exceptions for certain licensees, certain funds, and certain clients or third parties, which are outlined in the by-law.

If none of the exemptions apply, the lawyer must verify the identity of the client(s) and any third party in the manner and time frame required by the by-law. The period for verifying identity differs on whether the client or third party is an individual or an organization.

If the client is an individual, the lawyer must verify his or her identity before or when the lawyer engages or gives instructions in respect of the receipt, payment, or transfer of funds. If acting for an organization, the lawyer has 60 days to verify its identity, beginning from the time the lawyer engages in or gives instructions or acts on behalf of the organization to receive, pay, or transfer funds. However, the lawyer must verify the identity of the individual providing instructions on behalf of the corporation before or when the lawyer engages in the funds transfer activity.

2.4 Verifying identity

The lawyer may use whatever he or she reasonably considers reliable, independent source documents, data, or information to verify identity. The type of source documentation will differ depending on the nature of the client and the specific situation, and the by-law lists examples of source documents.

To verify the identity of an individual, a lawyer must look at reliable, independent source documents, but has the discretion to determine what source documents he or she wishes and is legally entitled to use for this purpose. Examples provided in the by-law include a government-issued driver's licence, passport, or birth certificate that is valid and has not expired. The lawyer may review as many independent source documents as is necessary to confirm an individual's identity.

To verify the identity of an organization that is a corporation or an organization created or registered under federal or provincial law, the lawyer may obtain written confirmation of its existence from a government registry. This confirmation should also include the name and address of the organization and, where applicable, the names of its directors. In this regard, the lawyer could obtain a certificate of corporate status, a corporate profile report, and/or an annual filing of the corporation.

If the organization is a trust, partnership, or an association, the lawyer will need to obtain some sort of formal record that confirms its existence as an organization. This could include a copy of the trust, partnership agreement, or articles of association. It might also include the Harmonized Sales Tax registration information or information relating to the organization's business licence.

If the lawyer is required to verify the identity of an organization, the lawyer must also take two additional steps: the lawyer must verify the identity of the individuals who provide instructions with respect to the matter on behalf of the organization and must make reasonable efforts to obtain

- the name and occupation(s) of each director of the organization unless the organization is a securities dealer; and
- the name, address, and occupation(s) of each person who owns 25% or more of the organization or of the shares of the organization.

The by-law also contains special provisions for verifying identity when the client or a relevant third party cannot meet with the lawyer in person. If the client or third party is within Canada, the lawyer may accept the attestation of a commissioner of oaths or a person designated in s. 23(9) of By-Law 7.1 regarding the verification of identity. An attestation means that the commissioner of oaths or designated person looking at the document will have to provide the lawyer with a legible photocopy of the document that they have signed and on which they have included their name, profession, and address and have identified the type and number of the identification document provided by the client. If the client or third party is outside of Canada, the lawyer may use an agent for verification of identity as long as the agent has agreed in advance in writing to the specific steps to be taken on the lawyer's behalf to verify identity and to provide the lawyer with the information the agent obtains.

2.5 Client identification and verification records

When a lawyer determines that he or she must identify the client(s) or a third party, the lawyer must retain a record of the identifying information obtained and copies of documents received. In these situations, the lawyer must obtain a copy of every document used for verification, including a copy of every document used by an agent who has undertaken to verify the identity of a client or third party outside of Canada on behalf of the lawyer. The records must be kept for the longer of

- the duration of the professional relationship with the client and for as long as is necessary and so long as is necessary to provide service to the client; and
- six years following the completion of the work for which the lawyer was retained.

2.6 Withdrawal obligations

The by-law also outlines circumstances where the lawyer may be obligated to withdraw during the course of identifying or verifying the identity of a client or third party. If the lawyer knows or ought to know that he or she is or would be assisting the client in something illegal or dishonest, the lawyer has a duty to refuse to act for the client in that matter. The duty applies whether the lawyer's suspicions are aroused during the identification and verification process or at any time during the retainer. Withdrawal from representation is discussed later in these materials.

Chapter 4
Competence

Most clients enlist the help of a legal representative because they do not have the knowledge or skill to deal with the legal system on their own. As a member of the legal profession, a lawyer is perceived as knowledgeable, skilled, and capable in the practice of law. A client who retains a lawyer is entitled to assume that the lawyer is able to adequately dispense with the client's legal matter in the way that the client desires.

A lawyer who is incompetent fails to serve the client, discredits the legal profession, and taints the reputation of the justice system in the eyes of the public. In addition to damaging the lawyer's own reputation and business, incompetence may also impact those of the lawyer's partners and associates. Therefore, it is important that lawyers understand, meet, and maintain the standards for competence set out in s. 41 of the *Law Society Act* and the *Rules of Professional Conduct* (*Rules*).

1. Required standard of competence — rr. 2.01(1)–(2) and commentaries

A lawyer shall perform the services undertaken on a client's behalf to the standards of a competent lawyer. A lawyer should not take on a client matter if the lawyer does not feel competent to handle the matter or cannot become competent to handle the matter without undue delay, risk, or cost to the client. If a lawyer is or later discovers that he or she is not competent to complete a task for the client, the lawyer should either refuse to act for the client or should obtain the client's consent to retain, consult, or collaborate with a lawyer who is competent to complete that task.

2. The competent lawyer — r. 2.01(1)

A *competent* lawyer is one who has and applies the relevant skills, attributes, and values appropriate to each matter undertaken on a client's behalf. Though the *Rules* do not require a standard of perfection, they do require the lawyer to meet minimum standards relating to six areas of competence: knowledge, skills, judgment, client service and communication, practice management, and professional development. Under the *Rules*, a lawyer who fails to meet the minimum standards of professional competence may be subject to disciplinary action.

2.1 Knowledge

To practise competently, the lawyer must know both the general legal principles and procedures and the substantive law and procedures for any particular area of law. If the lawyer cannot learn the legal principles and rules of procedure relating to an unfamiliar area of law without undue delay or additional expense to the client, the lawyer should refuse to represent the client in that matter. The competent lawyer is aware of the limits of his or her knowledge and will consider this when deciding whether to accept a client's matter.

In addition to general legal knowledge, the lawyer must have adequate knowledge about the client's matter to be able to properly advise or represent the client. A competent lawyer accomplishes this by effectively

- investigating facts;
- identifying issues;
- ascertaining client objectives;
- considering possible options; and
- developing and advising clients on appropriate courses of action.

Depending on the matter and the client, the lawyer may be required to confirm information provided by the client or to learn additional facts that may not be within the client's knowledge. The competent lawyer will ensure that he or she has gathered, reviewed, and considered all necessary information before providing any opinion or advice as to a course of action that would most likely meet the client's goals. The lawyer must then take the necessary steps to meet the client's chosen course of action so that the lawyer can work to meet the client's goal. Though a matter may seem familiar, each client matter is unique.

2.2 Skills

To meet the client's objective, a lawyer may be required to use many skills, including

- legal research;
- analysis;
- application of the law to the relevant facts;
- writing and drafting;
- negotiation;
- mediation;
- arbitration;
- advocacy; and
- problem-solving.

By accepting a client's matter, a lawyer effectively affirms that he or she has the skills to properly complete the

tasks required for the matter. When deciding whether to represent a client, the competent lawyer will consider what tasks have to be completed and whether the lawyer has the skills to perform them.

2.3 Judgment

Lawyers must apply intellectual capacity, deliberation, and judgment to all functions. When representing clients or performing any professional service, the competent lawyer applies

- *intellectual capacity*: by using the lawyer's ability to understand (legal concepts, issues, and facts) and reason, and by applying these in a logical manner to the client's cause;
- *deliberation*: by giving careful thought and consideration to the matters the lawyer handles; and
- *judgment*: by using the lawyer's ability to make reasoned decisions when providing practical recommendations and advice to the client about his or her particular matter.

In "complying in letter and in spirit with the *Rules of Professional Conduct*," lawyers are also required to apply appropriate judgment to their own conduct. The competent lawyer knows the *Rules*, knows why each rule is important, and uses this knowledge and understanding to guide his or her conduct.

2.4 Client service and communication

Adequately serving the client's interest and properly communicating with the client is an important part of competence. Lawyers must represent clients in a conscientious, diligent, and cost-effective manner and must keep the client informed regarding his or her matter, through all stages of the matter and concerning all aspects of the matter. Lawyers should make use of the various tools and methods available that will allow them to communicate with the client in an efficient and timely manner and should discuss with the client any drawbacks or risks associated with a particular method for communication (e.g., when using email or a cellular phone).

Many of the client complaints made against lawyers result from the client's perception that the lawyer did not do what the client expected. Often, such complaints are an indication that the lawyer failed to manage the client's expectations about what tasks would be performed for the client, when they would be completed, and at what cost.

Lawyers should ensure they understand what the client expects, both at the beginning of and throughout the retainer, since client expectations may change as the matter proceeds. If the client's expectations change or if it becomes impossible for the lawyer to meet the client's original expectations, the lawyer must discuss this with the client and obtain confirming or new instructions, as the case may be. Any new or different instructions should be obtained or confirmed in writing. The lawyer should also explain to the client under what circumstances the lawyer may not be able to follow the client's instructions (i.e., if the instructions would cause the lawyer to violate the *Rules*).

To avoid difficulties in the lawyer-client relationship, the lawyer should discuss with the client all aspects of the retainer. The competent lawyer ensures the client is informed of and agrees to the terms of the professional relationship and confirms these terms in a written retainer agreement or letter that addresses the

- specific legal services the client will receive from the lawyer;
- specific results the lawyer is likely to achieve for the client;
- costs associated with achieving those goals; and
- time required to complete the legal services and meet those goals.

2.5 Practice management

Another important part of competence is practice management. Lawyers should use available systems, technologies, or methods to make sure their practices operate in a manner that helps them serve clients well, in a timely manner, and at a reasonable cost. Competent practice management requires that the lawyer effectively manage his or her

- *staff* via workplace policies and business procedures;
- *time* via planning and reminder systems and time docketing systems;
- *finances* via billing procedures, money handling policies, and record keeping systems; and
- *client information* via filing, organizational, and storage systems, including conflicts checking systems.

2.6 Professional development — adapting to change

Lawyers must remain competent by ensuring that their knowledge of the law and applicable procedures is current and that they continue to have the required skill level to meet client needs. Lawyers must pursue professional development to ensure their abilities remain at the required level of competence while adapting to changing requirements, legislation, rules, standards, techniques, and practices. The competent lawyer

recognizes that maintaining and enhancing competence is an ongoing cycle of assessment, education or training, and reassessment. This obligation to maintain competence assists lawyers to better serve their clients and to avoid potential complaints and claims. Annual requirements for continuing professional development activities, which are effective January 2011, are outlined in By-Law 6.1 under the *Law Society Act*.

Chapter 5
Confidentiality

To adequately advise and serve the client, the lawyer must have all the information relevant to the client's matter. For the client to freely provide any information, whether relevant or not, the client must be satisfied that the lawyer will keep that information confidential and only use it for the client's benefit. A lawyer cannot effectively serve the client unless there is full and free communication between them. The lawyer's duty of confidentiality, and of loyalty, is essential for open communication between lawyer and client throughout the professional relationship.

1. Confidentiality versus privilege — r. 2.03(1) and commentary

Though the term *privilege* is often used to refer to a lawyer's duty of confidentiality, the duty of confidentiality must be distinguished from lawyer-client privilege. Privilege is an evidentiary rule of law that refers to the legal right of an individual to withhold information from an opposing party, a court, a tribunal, and investigations, including law enforcement officials.

The duty of confidentiality is an ethical one and is much broader. It covers all information obtained by a lawyer during the course of and for the purpose of the retainer, whether directly from the client or from some other source, and applies regardless of whether others may share the knowledge. The source of the information and its intended use are not relevant for determining whether information is confidential, though these are elements of privilege.

Privileged information, i.e., information or communications protected in law, is simply a subset of "all information concerning the business and affairs of the client acquired in the course of the professional relationship." All privileged information is also confidential information.

2. The duty of confidentiality — r. 2.03(1) and commentary

The duty of confidentiality requires lawyers to, at all times, hold in strict confidence all information concerning the business and affairs of the client acquired in the course of the professional relationship. Lawyers must keep all information they acquire about the client private whether the information seems private or is known to others.

However, the duty of confidentiality is not absolute. Lawyers must disclose confidential information if required by law and may disclose confidential information in the limited circumstances provided by the *Rules of Professional Conduct* (*Rules*). To fulfill the obligation of confidentiality, lawyers must understand what information is confidential, when the duty of confidentiality begins, and to whom the duty of confidentiality is owed.

2.1 Information that must be protected

Lawyers must protect all information concerning the business and affairs of the client acquired during the professional relationship regardless of the source of that information. It includes information recorded in any form, such as paper or electronic documents, emails, or video or audio recordings. It also includes the client's papers and property. It includes information that may not seem relevant to the matter for which the lawyer was retained.

Unless the lawyer is authorized by the client to do so or the situation requires it, the lawyer should not reveal a client's identity or that the client consulted with or retained the lawyer. However, there are many situations where the lawyer is required to reveal the identity of a client to advance the client's matter, such as filing the necessary documents to bring or defend a claim.

2.2 When the duty arises and how long it endures

The duty to protect confidential information begins when the lawyer's professional relationship with the client begins. The lawyer-client relationship arises as soon as a prospective client first contacts the lawyer or firm and provides confidential information, even before the lawyer has consulted with a prospective client. In addition to the client, lawyers owe a duty of confidentiality to prospective clients, even if they are never retained.

The duty of confidentiality is perpetual. It continues after the professional relationship ends regardless of why the relationship ended or whether differences exist between the lawyer and the client. It continues unchanged even if the client or former client dies. A lawyer must protect client information at all times and for all time unless the client consents to the disclosure or the lawyer is otherwise permitted or required to disclose the information.

2.3 Duty to all clients, owed by all members of the firm

Lawyers owe the duty of confidentiality to every client without exception. The lawyer and all other members of a firm, including support staff, owe the duty of confidentiality to every client. This includes prospective clients, current clients, and former clients of the lawyer or firm. Lawyers must ensure their employees and anyone involved with the client's matter understand and abide by the duty of confidentiality set out in the *Rules*. The lawyer is ultimately responsible if someone employed by him or her discloses confidential information without authorization or cause.

3. Disclosure, with client authority — r. 2.03(1) and commentary

A lawyer must not reveal confidential information unless the client authorizes the disclosure or the client's authority to disclose the information is implied by the circumstances of the retainer. For example, where a lawyer has been hired to act for a client in an application before a tribunal, the lawyer has the client's authority to disclose the information required by the prescribed application form. The client's authority is implied because the lawyer was retained to do all that was necessary to bring the application before the tribunal.

Even where the client's authority is implied (e.g., to disclose confidential information to a third-party expert to obtain his or her opinion), it may be prudent for the lawyer to confirm the disclosure in the retainer agreement with or engagement letter to the client. Where the client's authority was not previously implied and the client authorizes the disclosure of specific confidential information, the lawyer should confirm this by separate, subsequent document.

4. Disclosure, justified or permitted without client authority

There are situations where lawyers must or may reveal confidential client information without the client's authority. Lawyers must disclose confidential information when required by law (i.e., justified disclosure) and are permitted, but not required, to disclose information where it will allow them to prevent death or serious bodily harm, defend against certain allegations or claims, or establish or collect their fees. The conditions that must be satisfied in these situations are set out in the *Rules*.

4.1 Justified disclosure, legally required — r. 2.03(2)

The duty of confidentiality under the *Rules* does not supersede the law. Lawyers must disclose confidential information if required by law. For example, a lawyer must disclose information if a judge presiding over a court of competent jurisdiction orders the lawyer to do so. However, the lawyer must provide no more information than he or she was ordered to reveal and, if appropriate, should consider and be prepared to raise the issue of privilege.

When faced with a subpoena, court order, or some other demand to divulge or allow access to confidential client information, lawyers should first determine whether there is a legal obligation to disclose any information. If unsure, he or she should seek legal advice from a lawyer experienced in the relevant area of law (e.g., criminal law if served with a police search warrant or tax law if faced with a demand for information from the Canada Revenue Agency) who may advise on privilege. Where a legal obligation to disclose confidential information does exist, the lawyer

- must comply with the statute, court order, or subpoena that compels the disclosure of confidential information (subject to the obligation to assert privilege on the client's behalf);
- must reveal only what is legally mandated by the statute, court order, or subpoena;
- if asked to disclose information that is privileged, must assert privilege on the client's behalf;
- if asked to disclose information that may be privileged, should consider seeking the advice of another lawyer or retaining another lawyer to make submissions to the court on the issue of privilege; and
- should advise the client of the legal obligation to disclose the information, what information must be revealed, and the justifying statute, court order, or subpoena.

Where the lawyer has confirmed that there is <u>no</u> legal obligation to disclose confidential information, he or she may not comply with the demand or request without client consent. The lawyer

- must decline to disclose the information;
- must inform the client of the request or demand for disclosure and advise the client on privilege and the legal consequences of disclosure;
- must obtain the client's consent and instructions to disclose or withhold information;
- should obtain these instructions in writing or confirm them in writing;
- if the client cannot be located or refuses to provide instructions regarding disclosure, should assert privilege on the client's behalf; and
- should note in the client file the request or demand for information and the client's response.

4.2 Permitted disclosure, to prevent serious harm — r. 2.03(3)

Lawyers may disclose confidential information if the disclosure is necessary to prevent death or serious bodily or psychological harm to an individual or a group of individuals. Before disclosing any information, the lawyer must have reasonable grounds for believing that there is an imminent risk of harm to an identified person or persons, including the client, and that the disclosure is required to and will prevent that harm from occurring. The lawyer may then choose to disclose the limited information that is needed to prevent the harm and, where feasible (i.e., if time permits and there is an appropriate venue), should obtain a court order allowing the disclosure. The rule is permissive and not mandatory.

For disclosure to be justified, the lawyer must use his or her judgment regarding each element of the rule. The lawyer must believe and not just suspect that the harm against specified person(s) will happen in the near future. The lawyer must also believe that the disclosure is necessary to prevent the harm. The rule does not permit disclosure for harm that has already occurred nor for situations where no particular individual(s) can be identified as being at risk. The rule does not permit disclosure to prevent illegal or criminal conduct unless that conduct involves death or serious bodily or psychological harm. The lawyer's belief must be based upon grounds that would cause any reasonable person to come to the same belief.

4.3 Permitted disclosure, to defend against allegations — r. 2.03(4)

Lawyers are permitted to disclose confidential information in circumstances where a claim is made against them or their employees and the confidential information must be revealed in order to defend against those allegations. In these situations, disclosure is only permitted if it is alleged that the lawyer or lawyer's associates or employees are

- guilty of a criminal offence involving a client's affairs;
- civilly liable with respect to a client matter involving a client's affairs; or
- guilty of malpractice or misconduct.

Disclosure is limited to what is required to respond to the allegations and no more.

4.4 Permitted disclosure, to establish or collect fees — r. 2.03(5)

Lawyers may disclose confidential information to establish or collect their fees as long as no more information is revealed than is required to do so. If the documents necessary to allow a lawyer to enforce or collect payment contain confidential information, the lawyer must remove or block out that information before disclosing those documents.

5. Other obligations arising from confidential client information

There are cases where confidential information a lawyer receives during the relationship with the client triggers other obligations. Though these obligations are covered elsewhere in the *Rules* and in these materials, they are also subject to the confidentiality rule and have been included here.

5.1 "Whistle blowing" — commentary, r. 2.03(3), and rr. 2.02(5.1)–(5.2)

The lawyer's duty of confidentiality does not differ when the client is an organization, and it is unchanged whether the lawyer is retained as an outside legal representative or employed in-house by the organization. The duty of confidentiality is owed to the organization itself and not to any officer, employee, or agent communicating on behalf of the organization unless the lawyer has been retained to act in a joint retainer with the organization and the individual. In that event, the rules regarding joint retainers and confidentiality apply.

There are additional obligations when the organization is engaged or intends to engage in unethical activity, which the lawyer may discover after receiving confidential information. The lawyer must advise those responsible for the organization about the wrongful conduct and that the conduct must stop or be avoided. If the lawyer cannot convince the organization to abandon the wrongful conduct, the lawyer may be forced to withdraw from representation.

Unless permitted or justified by the *Rules* to do so, a lawyer must <u>not</u> disclose to the authorities or any outside party the corporate client's intended or actual misconduct regardless of whether the organization engages in, continues, or ceases the unethical activity.

5.2 Security of court facilities — r. 4.06(3) and commentary

If a lawyer receives information that leads the lawyer to reasonably believe that a dangerous situation is likely to develop at a court facility, the lawyer must notify the local police force. Because the lawyer is still bound by the confidentiality rule, the lawyer cannot disclose any confidential client information without the client's consent. However, the lawyer must disclose whatever information the lawyer can to prevent the dangerous situation from occurring. Where possible, the lawyer should suggest solutions, such as added security at the

court. To protect client confidentiality, a lawyer may consider providing this tip to the court facility anonymously or through another lawyer or agent.

Where possible, the lawyer should also notify other lawyers who are known to be involved in proceedings at the court facility where the dangerous situation is likely to develop. In addition to warning a colleague, such notice may allow him or her to suggest security measures that do not interfere with an accused's or party's right to a fair trial.

5.3 Duty to report misconduct — r. 6.01(3) and commentary

When a lawyer is retained by a client who has dealt with another lawyer or paralegal, professionally or personally, the lawyer may learn information about the other licensee from the client. If the lawyer discovers that another licensee was or is engaged in misconduct as outlined in this rule, the lawyer is required to report it to the Law Society of Upper Canada. However, in doing so the lawyer cannot breach client confidentiality. The lawyer must obtain the client's consent to provide details regarding the client or must report the misconduct to the Law Society in a way that does not require confidential client information.

6. Prohibited use or disclosure of client information — commentary, r. 2.03(6)

A lawyer's duty of loyalty to a client prohibits the lawyer from using any client information for a purpose other than serving that client in accordance with the terms of the retainer. During the professional relationship and after the retainer has ended, lawyers must not use information from one client to disadvantage that client, to serve another party, or for their own benefit.

6.1 Literary works — r. 2.03(6)

A lawyer who engages in literary works is prohibited from disclosing confidential client information unless that client or former client consents to the disclosure. This applies to writings and publications of any kind and in any medium, including a script, article, speech, online journal, or lawyer's autobiography or memoirs. The rule applies regardless of whether the professional relationship has ended and is not affected by the length of time since the retainer concluded.

6.2 Discussions in public — commentary, r. 2.03(1)

Lawyers should apply common sense where client information is concerned. Lawyers should never gossip about a client or discuss client matters where the discussion may be overheard or intercepted. Casual conversations regarding clients at social events or even with members of the same firm should be avoided. Lawyers should not discuss client matters over a cellular telephone in public. They should not leave client documents on a receptionist's desk in view of others. These "leaks" of information may have unintended results: the client may be identified or opposite parties may learn information that can be used against the client. Even in cases where the client cannot be identified, the respect of the public for the legal profession may be lessened as a result of overhearing a lawyer "talk shop" in public.

Chapter 6
Conflicts of interest

A *conflict of interest* or a *conflicting interest* is anything that may have a harmful effect on the lawyer's ability to fulfill the lawyer's obligations to the client. It is an interest, financial or otherwise, that

- is likely to adversely affect a lawyer's judgment on behalf of a client or prospective client;
- is likely to adversely affect a lawyer's loyalty to a client or prospective client; or
- a lawyer may be prompted to prefer over the interests of the client or prospective client

The competing interest that causes the conflict may be the lawyer's professional duty to another client, to a tribunal, or to another party. Or a conflict may arise because the lawyer is tempted to prefer his or her own interests. Because conflicts of interest may prejudice the client or impair the lawyer's ability to properly serve the client, lawyers have a duty to all clients to avoid actual and potential conflicts of interest. This duty extends to prospective clients, current clients, and former clients of the lawyer or law firm.

1. Recognizing conflicts of interests

To avoid a conflict or potential conflict of interest, the lawyer must first recognize circumstances that may present a conflicting interest or later give rise to one. Because a conflict of interest can result from competing or incompatible duties to various parties during the various stages of the professional relationship, it may be difficult for a lawyer to contemplate all possible sources of conflict at every possible turn. Many conflicts arise from the lawyer's duty to maintain confidentiality or the lawyer's duty of loyalty, but conflicting interests may also include the lawyer's personal or financial interests.

Because the duty of confidentiality is perpetual, so is the duty to avoid conflicts of interest that may arise from having confidential information. For example, a conflict may arise when the lawyer has information from one client that is relevant to another client's or prospective client's matter. The lawyer owes a duty to one client not to reveal the information but owes a duty to the other client or prospective client to disclose the information. Because the lawyer cannot fulfill both duties, the lawyer is in a conflict of interest.

However, not all conflicts arise because of the lawyer's duty to protect confidential information. Conflicts may arise because of the lawyer's self interest, financial, personal, or otherwise, or may result from the lawyer's actual or perceived duty of loyalty. The lawyer must remain loyal to the client as long as the matter for which the lawyer was retained continues. Depending on the matter and the personality and expectations of the individual client, this duty of loyalty may endure long after the professional relationship has ended. Regardless of why a conflict has arisen, the lawyer must always consider his or her duty of loyalty. Because the duty of loyalty derives from the lawyer's fiduciary duty to put the client's interest before all others, it is broader and more pervasive and must be considered in all cases.

Because these arise from the lawyer's relationship with the client, a lawyer evaluating a conflict of interest must always consider the client. The duty to avoid conflicts of interest extends to all clients, including

- prospective clients who contacted the lawyer or law firm for purposes of obtaining legal advice;
- current clients who are represented by the lawyer or partners or associates of the law firm; and
- former clients who were represented by the lawyer or partners or associates of the law firm.

Where there are others who are involved or associated with the client in the client's matter, or other third parties, the lawyer's duty to avoid conflicts of interest may extend to those individuals as well. Third parties or persons involved or associated with clients may include the client's spouse, family members, business associates, or employees of any related companies. Because the interests of a third party may not be aligned with those of the client or could be affected by the outcome of the client's matter, the lawyer must be alert to and avoid any conflicts that exist or may arise from third-party involvement. For example, where the third party instructs the lawyer on the client's behalf or assists the client by translating the lawyer's advice, the lawyer must consider whether the third party has an interest in the client's matter. Where the third party's interests conflict with those of the lawyer's client, the lawyer should advise the client of this and decline to deal with the third party regarding the client's matter. If the client insists upon the third party's involvement, the lawyer may be forced to decline the retainer.

2. Avoiding conflicts of interest — rr. 2.04(1)–(3) and commentaries

Lawyers have a general duty to avoid being involved in a conflict of interest. A lawyer must not act or continue to

act in a matter where there is or is likely to be a conflicting interest. Where a conflict arises that cannot be resolved, this may mean that the lawyer is required to decline a retainer from a prospective client or withdraw from a client's ongoing matter. A lawyer must evaluate whether a conflict of interest exists or may develop for every client and every matter that he or she accepts, considering the duties to the client and any outside, personal, or financial interests that may compete with those duties. At each stage of the matter, from the first contact with a prospective client to after the retainer has ended, the lawyer must re-evaluate whether a conflict of interest has developed or may arise.

3. Dealing with a conflict of interest

Though a lawyer has the general duty to avoid actual and potential conflicts of interest, there are situations where the lawyer may be permitted to act or continue to act in a matter despite the conflict. Where the *Rules of Professional Conduct* (*Rules*) permit a lawyer to act or continue to act, the lawyer must obtain the client's informed consent to do so. Depending on the circumstances, in addition to client consent, the lawyer may also be required to

- obtain the informed consent of persons involved or associated with the client in a matter;
- suggest that the client receive independent legal advice;
- insist that the client receive independent legal advice; or
- urge the client to obtain independent legal representation.

However, it should be noted that even where the *Rules* permit the lawyer to obtain the client's informed consent to act, it may not be prudent for the lawyer to do so. There are also situations where the lawyer is prohibited from acting or continuing to act when a conflict exists or has developed and the lawyer may be forced to withdraw from representing the client.

3.1 Informed consent — r. 2.04(3) and commentary

The *Rules* outline situations where, even though a conflict of interest exists, the lawyer is permitted to obtain the *informed consent* of the client and other relevant persons, where applicable, to act or continue to act in a matter. To obtain informed consent, the lawyer must disclose all pertinent information regarding the conflict of interest to the prospective client or client and other relevant persons and then must obtain their consent to act or continue to act in the matter. Under r. 1.02, consent must be written or recorded in writing, preferably in a retainer agreement signed by the client or in a confirmation letter to the client.

A situation may arise where it is impossible for a lawyer to make full disclosure to a prospective client to obtain his or her consent to act in a matter where there is a conflict. This may happen when the details regarding the conflict involve another client or former client and the lawyer is precluded from revealing the information because it is confidential. In this circumstance, the lawyer must advise the prospective client that there is a conflict of interest and that the lawyer cannot accept the retainer.

3.2 Independent legal advice, independent legal representation

There are situations where the client's informed and written consent is not sufficient to allow the lawyer to accept or continue with a matter. In some circumstances, the client must receive advice from an independent legal advisor regarding the matter or transaction before the lawyer may proceed. An independent legal advisor has no connection to the client's matter, associated parties, or lawyer. He or she is unbiased and objective and does not have a conflict of interest. An independent legal advisor is another lawyer or other legal representative who can provide the client with *independent legal advice*. In circumstances where the lawyer is prohibited from acting for a client or prospective client, the lawyer must suggest that the individual obtain his or her own *independent legal representation*. The retained lawyer or paralegal, if appropriate, must be objective and have no conflicting interest with regard to the matter.

3.3 Refuse to act, withdraw from representation — rr. 2.04(2)–(3)

In some cases, the existence of a conflict of interest may require the lawyer to decline the retainer at the outset or to terminate the retainer and withdraw from representing the client at a later time.

For example, the lawyer must refuse to act when he or she is asked to represent more than one side of a dispute. Because the parties are on opposing sides and have contrary interests, the lawyer would be in a conflict of interest because of his or her duty to maintain confidential information and to remain loyal to each client in the matter. The lawyer cannot fully represent one client's interests while fully representing the opposite interests of the other side in the dispute. The lawyer is prohibited from acting for both of them in the matter, even if both sides of the dispute wish to consent.

Similarly, a lawyer may be forced to withdraw during the retainer because a conflict of interest has arisen. For

example, a client who insists that a lawyer take or continue in a course of conduct that would be inconsistent with his or her duties to a tribunal under the *Rules* may be creating a conflict of interest that cannot be resolved. If the lawyer cannot convince the client to abandon those instructions, the conflict of interest remains, and the lawyer must withdraw. If, however, the lawyer is able to persuade the client to provide different instructions that do not conflict with the lawyer's other duties, the conflict has been removed, and the lawyer can continue to act.

4. Acting against clients — rr. 2.04(4)–(5) and commentaries

The *Rules* prohibit a lawyer and his or her partners or associates from acting against clients unless certain criteria are met. This applies equally to prospective, current, and former clients of the individual lawyer or law firm, as well as persons involved or associated with the client in his or her matter. These are potential conflicts of interest that arise both from the lawyer's duty to maintain confidential information and the duty to remain loyal to the client (and those associated with the client). Even where the issue of confidential information does not exist or is not relevant, the lawyer must consider the duty of loyalty.

4.1 Same or related matters

A lawyer and his or her partners and associates may not act against a client or those involved with the client in the same matter or a related matter, unless the client and those involved with the client consent. For example, a lawyer retained by a client for a particular matter who is later discharged by the client cannot act for another party in the same matter or a related matter, unless the original client and those others involved agree. Likewise, if a prospective client consults with a lawyer regarding a matter but does not retain the lawyer, the lawyer must not act against that prospective client in the same or related matter, unless the prospective client consents.

4.2 New matters

A lawyer and his or her partners or associates may not act against a former client in a new matter if they have confidential information from the first retainer that is relevant to the new matter. However, there are exceptions:

- The lawyer may act against the former client or against those involved with the client in a new matter if the former client and all those involved consent to the lawyer acting against him or her.
- The lawyer's partner or associate may act against the former client in a new matter if the former client consents to the partner or associate acting against him or her.
- The lawyer's partner or associate may act against the former client in a new matter if the law firm establishes that it is in the interests of justice for the partner or associate to act against that client, considering the factors outlined in r. 2.04(5)(b) of the *Rules*.

Where the confidential information obtained from the original matter is not relevant to the new matter, the lawyer and his or her partners or associates may act in the new matter against a client or those who were involved with the client in the original matter.

5. Joint retainers — rr. 2.04(6)–(10) and commentaries

A lawyer may be asked to represent more than one client in a matter, where the interests of those clients are the same or are somehow aligned. Acting for joint clients or acting in a joint retainer places the lawyer in a potential conflict of interest: the lawyer must remain loyal and devoted to all joint clients equally; and if the interests of the joint clients diverge during the course of the retainer, the lawyer may not be able to serve all the joint clients because of conflicting interests. To act in joint retainer, the lawyer must

- advise the joint clients of the nature of a joint retainer, confidentiality in a joint retainer, and conflicts of interest that may arise in a joint retainer;
- in certain circumstances, recommend that the joint client(s) obtain independent legal advice prior to entering into the joint retainer;
- obtain each joint client's written consent to enter into the joint retainer; and
- deal with contentious issues that arise during the joint retainer, which may result in withdrawal.

Though the *Rules* may allow a lawyer to act for more than one client in a matter, there are circumstances where the lawyer should not do so. Before agreeing to accept a joint retainer, the lawyer must carefully evaluate the circumstance and any possible developments. If it is likely that the clients will disagree on some aspects of the matter or if the clients' concerns, rights, interests, or obligations will differ as the matter proceeds, the lawyer must avoid the potential conflict of interest and decline the joint retainer.

5.1 Advice to joint clients, informed consent

The lawyer must discuss with joint clients all issues that may arise during the joint retainer. Before accepting a joint retainer, the lawyer must advise all prospective joint clients of all of the following:

- The lawyer has been asked to act for both or all of them.
- No information regarding the matter received from one joint client may be kept confidential from the other joint client(s).
- If a conflict develops that cannot be resolved by the joint clients, the lawyer cannot continue to act for both or all of them and may have to withdraw from the joint retainer completely.

Once the lawyer has advised the prospective joint clients of the above, if they are content to have the lawyer act for them in a joint retainer, the lawyer must obtain their written consent to act. However, there are circumstances where the above advice is not sufficient for the joint client(s) to provide their informed consent to the joint retainer and independent legal advice must be discussed.

The lawyer has an additional obligation if the lawyer has a continuing relationship with a client who wants to retain the lawyer jointly with another new client. Before agreeing to act in a joint retainer for the ongoing client and the new client in a matter, the lawyer must advise the new client of the continuing relationship and must recommend that the new client obtain independent legal advice about the joint retainer. The lawyer should also consider recommending independent legal advice to a prospective joint client where he or she is not sophisticated or is vulnerable. This will ensure that the individual's consent to the joint retainer is informed, genuine, and uncoerced.

5.2 Contentious issues, withdrawal

Where a controversial issue arises among some or all of the clients in a joint retainer, the lawyer is prohibited from advising on the issue. He or she must refer the clients to other lawyers unless two conditions are met: the contentious issue does not require legal advice, and the clients are sophisticated and, therefore, capable of dealing with the issue outside of the joint retainer. If so, the clients may settle the contentious issue by direct negotiation with each other, and the lawyer may continue to act in the joint retainer. However, the lawyer is permitted to advise one of the joint clients about the contentious issue if all the joint clients agreed to this arrangement upon entering into the joint retainer.

Where the contentious issue that arose between joint clients cannot be resolved and results in conflicting interests between them, the lawyer must withdraw his or her services from the joint retainer. The lawyer cannot continue to act for any of the joint clients, unless they agreed otherwise at the outset of the joint retainer. The lawyer must arrange an interview with all joint clients to advise them that the lawyer must terminate the retainer. The lawyer must try to minimize the expense and prejudice to the clients and do all that can reasonably be done to help each client find a new lawyer to look after his or her matter.

6. Joint retainers in estate and real estate matters

The *Rules* provide additional guidance regarding joint retainers as they occur in certain estate and real estate matters. Typically, these are retainers in which the joint clients share a primary common interest (e.g., the successful transfer of title in real property from the vendor client to the purchaser client) but may have differing secondary interests that may or may not affect the joint retainer. Specifically, the *Rules* advise when these joint retainers are prohibited and any exceptions to that prohibition.

6.1 Joint wills for spouses or partners — commentary, r. 2.04(6)

A lawyer who receives instructions from spouses or partners as defined in the *Substitute Decisions Act* to prepare one or more wills for them based on their shared understanding of what is to be in each will should treat the matter as a joint retainer and comply with r. 2.04(6). At the outset of the initial joint retainer, the lawyer should advise the spouses or partners that if one of them subsequently were to communicate new instructions about his or her will (e.g., to change or revoke the will), both of the following would occur:

- The subsequent communication would be treated as a request for a new retainer and not as part of the joint retainer.
- In accordance with r. 2.03, the lawyer would be obliged to hold the subsequent communication in strict confidence and not disclose it to the other spouse or partner.

The lawyer should also advise the spouses or partners that the lawyer would have a duty to decline the new retainer to change or revoke the will unless they were no longer in a relationship (i.e., the spouses or partners had annulled their marriage, divorced, or permanently ended their conjugal or close personal relationship), as outlined in the commentary; the other spouse or partner had died; or the other spouse or partner was informed of the subsequent communication and consented to the lawyer acting on the new instructions.

6.2 Acting for borrower and lender — rr. 2.04(6.1), (8.1)–(8.2), (11)–(12), and commentaries

A lawyer and his or her partners or associates are prohibited from representing both the borrower and lender in a mortgage or loan transaction, unless any of the following are true:

- The lawyer practises in a remote location where there are no other lawyers that either party could conveniently retain for the mortgage or loan transaction.
- The lender is selling real property to the borrower, and the mortgage represents part of the purchase price (vendor take-back mortgage situation).
- The lender is a bank, trust company, insurance company, credit union, or finance company that lends money in the ordinary course of business.
- The consideration for the mortgage or loan does not exceed $50,000.
- The lender and borrower are not at "arm's length" as defined in the *Income Tax Act* (Canada).

If none of these exceptions applies, the lawyer or law firm cannot enter into the joint retainer. Where a lawyer determines that one of these limited, defined circumstances applies and the lawyer intends to accept the retainer, the lawyer must comply with all the other provisions of the joint retainer rule in r. 2.04(6).

Before the advance or release of mortgage or loan funds, the lawyer who acts jointly for both borrower and lender must disclose to them in writing all material information relevant to the transaction. What is material should be determined objectively and includes any facts that a reasonable borrower or lender might consider relevant. This duty to disclose arises even if neither joint client asks for the information.

A lawyer who agrees to act for both lender and borrower in a mortgage transaction must remember that the lawyer's obligations to these joint clients are the same as in any other joint retainer. Should a borrower demand that the lawyer not disclose relevant information to the lender or insist in providing instructions that conflict with the lawyer's duties to the lender, the lawyer may be forced to withdraw from acting in the mortgage transaction.

Depending on the type of lending client, the lawyer for borrower and lender may not be required to fulfill the general advice and informed consent requirements prior to accepting the joint retainer. Where the lending client is a bank, trust company, insurance company, credit union, or finance company that lends money in the ordinary course of business, the lending client's consent to act is deemed to exist upon the lawyer's receipt of written instructions from the lending client, and the lawyer is not required to

- advise the lending client of the nature of a joint retainer, confidentiality in a joint retainer, and conflicts of interest that may arise in a joint retainer;
- if the borrower is a continuing client, recommend that the lending client obtain independent legal advice prior to entering into the joint retainer; and
- obtain or confirm in writing the lending client's consent to enter into the joint retainer unless the lending client so requires this.

This is intended to simplify the advice and consent process between lawyer and institutional lender clients, who are generally sophisticated and provide their acknowledgment and consent to the joint retainer in the documentation for the transaction (e.g., mortgage loan instructions). However, the lawyer must still fulfill these obligations to the borrower client in the joint retainer.

6.3 Acting for transferor and transferee — r. 2.04.1

The *Rules* require that there be two lawyers for transfers of title, one for the transferor (vendor) and one for the transferee (purchaser). Unlike the prohibition against acting for both borrower and lender, the lawyers may practise in the same law firm as long as the general rules on the avoidance of conflicts of interest are observed. There are also exceptions to the two-lawyer rule. Provided that there is no violation of r. 2.04, one lawyer may represent both transferee and transferor in a transfer to real property if any of the following is true:

- The transfer is one where the transferee and transferor are "related persons" as defined in s. 251 of the *Income Tax Act* (Canada).
- The lawyer practises law in a remote location where there are no other lawyers that neither the transferee nor transferor could retain for the transfer without undue inconvenience.
- The *Land Registration Reform Act* permits the lawyer to sign the transfer on behalf of the transferor and transferee (e.g., transfers where the transferor and transferee are the same and the transfer is being made to effect a change in legal tenure or to effect a severance of land, etc.).

Even if the lawyer is permitted to act for both parties and the clients consent, a lawyer should avoid acting for more than one client when it is likely that a contentious issue will arise or their interests, rights, or obligations will diverge as the matter progresses. The probability of a conflict of interest arising between a purchaser and vendor in a real estate transaction is high. The interests of each of these clients will likely differ, and the advice the lawyer would give to each would likely not be the same and may even conflict. If an unexpected conflict between the parties were to arise on the date of closing and the lawyer is forced to withdraw, there may be insufficient time for each of them to retain separate lawyers, and their rights may be prejudiced. All of these

potential issues should be considered prior to accepting the retainer.

7. Short-term, limited legal services — rr. 2.04(15)–(19) and commentary

To properly serve the public interest and the administration of justice, the *Rules* provide a modification in the standard for conflicts of interest for lawyers participating in the court-based, brief services programs offered by Pro Bono Law Ontario (PBLO). The standard was adjusted to facilitate convenient access to justice by those self-represented litigants in need of the immediate services offered within these programs.

The modification permits a lawyer to provide to a client *pro bono*, summary legal services through PBLO programs, unless the lawyer knows or learns of a conflict of interest that would prevent him or her from acting. The lawyer is only disqualified from acting if the lawyer has actual knowledge of a conflict of interest between the *pro bono* client and an existing or former client of the lawyer, the lawyer's firm, or PBLO. For example, a lawyer would be precluded from assisting a *pro bono* client where the lawyer knows that the client's interests are directly adverse to those of a current client of the lawyer's firm, or where the *pro bono* client provides the lawyer with confidential information relevant to another client whose interests are adverse. Where there is a disqualifying conflict of interest, the lawyer must decline or cease to act for the *pro bono* client and is prohibited from requesting that client's waiver of the conflict.

For the modified conflicts standards to apply, there must be the expectation by the lawyer and the *pro bono* client that the lawyer will not continue to act as legal representative in the matter beyond the short-term, limited legal services provided within a recognized PBLO program. To ensure no misunderstanding, r. 2.04(19) requires the lawyer providing short-term, limited legal services to

- before providing legal services, ensure that he or she has appropriately disclosed to the *pro bono* client the limited nature of the legal services to be provided; and
- determine whether the *pro bono* client may require additional legal services beyond the short-term, limited legal services and, if required or advisable, encourage the client to seek further legal assistance.

8. Transfers between law firms — r. 2.05

The duty to protect confidential information may also lead to a conflict of interest when a lawyer transfers from one law firm to another. The rule regarding conflicts from transfers between law firms applies where the transferring lawyer or the new firm knows at the time of the transfer or later learns of all of the following:

- The new and former firms act for different clients in the same or a related matter.
- The interests of those clients in that matter conflict.
- The transferring lawyer actually possesses relevant confidential information about that matter.

The risk is that confidential information about a client or former client from the lawyer's previous firm may be revealed to lawyers at the new firm and used against that client. The *Rules* set out the steps that must be taken to avoid this disclosure, which also may allow the new firm to continue to represent its own client. If the requirements of the *Rules* cannot be satisfied, the new firm must withdraw from representing its client.

The rule applies equally to articling students transferring between law firms and lawyers transferring to or from government service or an in-house counsel position, but does not extend to internal transfers where the lawyer remains with the same employer. The rule does not apply to a lawyer employed by the federal, a provincial, or a territorial Attorney General or Department of Justice who continues with that employer after transferring from one of its departments, ministries, or agencies to another.

8.1 Law firm disqualification

Where the transferring lawyer (or articling student) actually possesses relevant confidential information regarding the former client that may prejudice the former client if it were disclosed to a member of the new firm, the new firm must withdraw from representing its client, unless either of the following occurs:

- The former client consents to the new firm's continued representation of its client.
- The new law firm establishes that it is in the interests of justice to act in the matter, considering the factors outlined in r. 2.05(4)(b) of the *Rules*.

If the client does not consent and the firm cannot establish that its continued representation of its client is in the interests of justice (i.e., in response to a challenge before a tribunal of competent jurisdiction), the new firm is forced to withdraw from representing its client.

Where the transferring lawyer (or articling student) actually possesses relevant information regarding the former client that is <u>not</u> confidential but that may still prejudice the former client if it were disclosed to a member of the new firm, all of the following must occur:

- The transferring lawyer must execute an affidavit or a solemn declaration that the information he or she possesses is relevant but not confidential.

- The new law firm must notify its client and the former client (through his or her lawyer, if represented in the matter) of the situation arising from the transfer and the new firm's intended action under this rule, providing to each of them a copy of the affidavit or solemn declaration executed by the transferring lawyer.

Where the information the transferring lawyer possesses is relevant but not confidential, the new firm is not immediately forced to withdraw from representing its client. The new law firm may choose to withdraw or to continue to act in its client's matter. The notification the new firm must provide offers the new firm's client the opportunity to terminate the retainer and puts the former client of the previous firm on notice should the former client wish to apply to a tribunal of competent jurisdiction for a determination as to whether the information the transferring lawyer possesses is actually confidential and should disqualify the new firm from continuing to act in the matter.

8.2 Transferring lawyer disqualification

Unless the former client consents, a transferring lawyer shall not

- disclose any confidential information respecting the former client; or
- participate in any manner in the new law firm's representation of its client in that matter.

This means that regardless of why the new law firm is able to continue in its representation of its client (i.e., because the relevant information the transferring lawyer has is not confidential, the former client consents, or to do so is in the interests of justice), the transferring lawyer may only be involved if the former client consents. It also means that, unless the former client consents, the transferring lawyer who possesses relevant confidential information must not disclose it to anyone regardless of whether the new firm is able to continue in its representation of its client or is disqualified.

Further, unless the former client consents, no member of the new law firm may discuss with the transferring lawyer

- the new law firm's representation of its client in that matter; or
- the former law firm's representation of the former client in the matter.

The commentary to r. 2.05 contains guidelines for insulating or screening the transferring lawyer to ensure that the disclosure of confidential information is avoided.

8.3 Due diligence, determination of compliance

A lawyer is required to exercise due diligence to ensure that each partner, associate, and employee of the lawyer's firm, both lawyer and non-lawyer, complies with the rule regarding conflicts from transfers between law firms and does not disclose confidential information of clients of the firm and confidential information of clients of another firm in which that person has worked.

Anyone who has an interest or represents a party in a matter referred to in the rule regarding conflicts from lawyers transferring between firms may apply to a tribunal of competent jurisdiction for a determination of any aspect of the rule. For example, applications may be made by the new firm or its client, the former firm or its client, the transferring lawyer, and any other persons or groups that may have an interest.

9. Doing business with a client — r. 2.06

Because the relationship between a lawyer and client is a fiduciary one in which the lawyer must put the client's interests before his or her own, the lawyer must not act for a client when the lawyer's own financial interests conflict with those of the client. Thus, lawyers should not enter into a business transaction with a client, apart from the business of providing the client legal advice and representation. To do so may complicate the lawyer's fiduciary duty and duties regarding confidentiality and conflicts of interest since the client who enters into a secondary business relationship with the lawyer may still expect to receive the lawyer's professional advice and guidance regarding this.

9.1 Investment by client where lawyer has an interest

Before a client enters into a transaction with the lawyer or with a corporation or other entity that is not publicly traded in which the lawyer an interest, financial or otherwise, the lawyer must

- disclose and explain to the client the nature of any existing or potential conflict of interest as it relates to the transaction;
- recommend that the client obtain independent legal representation for the transaction and require the client to obtain independent legal advice; and
- obtain the client's written consent to proceed with the transaction.

The *Rules* also stipulate that the independent legal advice must be confirmed by way of a written certificate, a copy of which must be signed by the client and provided to the lawyer who wishes to transact business with the client. The lawyer is precluded from proceeding with the

transaction if the client refuses to obtain, at a minimum, independent legal advice. However, where the transaction is one in which the client will pay for the lawyer's legal services by a transfer of shares, independent legal advice is not required but should be recommended before the lawyer accepts the retainer. In any circumstance, if the lawyer opts not to disclose a conflict or cannot do so without breaching confidentiality, the lawyer must decline to act for the client.

9.2 Borrowing from and lending to clients

A lawyer is prohibited from borrowing money from a client unless the client is

- a lending institution, financial institution, or insurance or trust company;
- any similar corporation whose business includes lending money to members of the public; or
- a related person as defined by the *Income Tax Act* (Canada) and the lawyer can discharge the onus of proving that the client's interests were fully protected by the nature of the case and by independent legal advice or independent legal representation.

To preserve and protect the client's interests, a lawyer must require the client to obtain independent legal representation where money is borrowed from the client by

- a lawyer's spouse; or
- a corporation, syndicate, or partnership in which the lawyer, the lawyer's spouse, or both of them have a direct or indirect substantial interest.

Though the *Rules* do not prohibit a lawyer from loaning money to a client, to do so may cause a conflict of interest (i.e., the lawyer's financial interest versus the client's interests), particularly if the loan goes into default either during or after the retainer. Therefore, the client must be informed of the potential conflict of interest and encouraged to obtain independent legal advice on the loan prior to advancing funds. The terms of any such loan should be clear and reduced to writing.

9.3 Lawyers in loan or mortgage transactions

A lawyer in private practice in Ontario is prohibited from engaging in certain mortgage or loan transactions that involve clients, investors, and other persons. The lawyer shall not directly or indirectly

- except with the lawyer's usual skill, competence, and integrity, sell or arrange for clients or other persons mortgages or loans;
- arrange or recommend that a client or other person participate as an investor in a syndicated mortgage or loan where the lawyer is an investor, unless the lawyer can demonstrate that the client or other person had independent legal advice regarding the investment; or
- hold a syndicated mortgage or loan in trust for investor clients unless each investor client receives a complete reporting letter on the transaction, a copy of the duplicate registered mortgage or security instrument, and a trust declaration signed by the person in whose name the mortgage or security instrument is registered.

As stated in the rule, "indirectly" means through a corporation, syndicate, partnership, trust, or other entity in which the lawyer or a related person has a financial interest, but does not apply to an ownership interest of less than 5% of a corporation or of some other entity offering any class of securities to the public. A lawyer is prohibited from advertising or promoting individual or joint investments by clients or other persons with money to lend in any mortgage in which the lawyer has a direct or indirect financial interest.

Where a lawyer sells or arranges mortgages or loans for clients or other persons (with the appropriate skill, competence, and integrity), the lawyer must disclose in writing to each client or individual the priority of the mortgage and all other information relevant to the transaction that the lawyer is aware of and that would pose a concern to a proposed investor.

The commentary to the rule outlines acceptable mortgage or loan transactions related to the practice of law that the lawyer may engage in. These include the introduction of borrowers to lenders, the collection of mortgage or loan payments on a client's behalf, the lawyer's personal investment in mortgages or loans, and the lawyer's involvement in a mortgage or loan as an executor, administrator, committee, or trustee of a trust.

9.4 Guarantees by lawyer

Lawyers are prohibited from providing a personal guarantee or any security for debts where the client is a borrower or lender. However, there are three exceptions. The lawyer may give a personal guarantee in any of the following situations:

(1) The lender is directly or indirectly providing funds solely for the lawyer or the lawyer's spouse, parent, or child, and the lender is a
  - lending institution or financial institution;
  - insurance company or trust corporation; or
  - any similar institution whose business includes lending money to members of the public.

(2) The transaction is for the benefit of a non-profit or charitable institution where the lawyer is asked

individually or as a member or supporter of the institution, to provide a guarantee.

(3) The lawyer has entered into a business venture with a client, the lender requires personal guarantees from all participants in the venture, and both of the following have occurred:

– The lawyer has complied with the requirements of the *Rules* regarding the avoidance of conflicts of interest.

– The lender and the venture participants who are or were clients of the lawyer have obtained independent legal representation regarding the business venture.

Before agreeing to personally guarantee any debt involving clients, lawyers should carefully review the *Rules* to ensure they meet their professional obligations.

10. Other conflicts of interest

Conflicts may also arise because of the lawyer's personal or other interests. Though these conflicts or potential conflicts are equally important as those arising from the lawyer's financial interests, duty of confidentiality, or duty of loyalty, they are often more difficult to anticipate and avoid.

10.1 Personal relationships — commentary, r. 2.04(3)

Though a lawyer is not precluded from acting for a friend or relative, *pro bono* or otherwise, the existing personal relationship may impair the lawyer's professional judgment. If the lawyer cannot fulfill the obligation to provide objective and disinterested advice because of personal feelings or history, the lawyer should decline to make that individual a client. At any social or family gathering, the lawyer should avoid discussing legal issues or should ensure that the information he or she provides is understood to be information only and not mistaken as legal advice.

The potential for a conflict also exists when a lawyer has a sexual or intimate relationship with a client. Problems may arise because emotional or psychological influences can affect the lawyer's ability to consider only the client's interests, which should be separate and apart from the lawyer's own. The commentary to the rule outlines some of the issues the lawyer should consider to evaluate whether the lawyer should represent such a client, including the client's vulnerability and whether the personal relationship will affect what information is considered confidential or covered by privilege or may require the lawyer to act as a witness in the proceedings. Lawyers should avoid acting for persons to whom they have close emotional ties if they are unable to remain impartial.

10.2 Affiliations and multi-discipline practices (MDPs) — rr. 2.04(10.1)–(10.3) and commentary, r. 2.04(13)

The ordinary conflicts rules apply equally to affiliations. A lawyer in an affiliation must check for conflicts as if the legal practice and that of the affiliated entity were one, where services are provided jointly to a client by the firm and the affiliated entity. Because of the risk of conflict, the lawyer who offers legal services jointly with an affiliated entity has special obligations. Before accepting a retainer to provide joint services, the lawyer in the affiliation must disclose to the client

- any risk to confidentiality or privilege because of the involvement of the affiliated entity, including circumstances where non-lawyers provide services in the lawyer's office;
- the role the lawyer has in providing legal and non-legal services or both;
- any financial, economic, or other arrangements between the lawyer and the affiliated entity that may affect the independence of the lawyer's representation of the client (i.e., potential conflicts of interest), including whether the lawyer shares in the affiliated entity's revenues, profits, or cash flows; and
- agreements between the lawyer and the affiliated entity that may affect the independence of the lawyer's representation of the client (i.e., potential conflicts of interest), including referral agreements.

After making such disclosure, the lawyer must obtain the client's consent to act. Consent must be written or confirmed in writing.

Lawyers who practise law through a multi-discipline practice or a multi-discipline partnership must ensure that non-licensee partners and associates abide by the rules regarding conflicts of interest since they apply to the legal practice and to the other non-legal business of the practice. This means that the lawyers and non-licensee partners and associates must avoid or deal with conflicts as they relate to all clients, whether the client consults the practice for a legal or non-legal matter or both.

10.3 Outside interests and public office — rr. 6.04–6.05

As discussed elsewhere in these materials, the *Rules* recognize that lawyers may engage in outside interests that may or may not be related to the practice of law, including an involvement in public office as an elected or appointed official. Whatever the outside interest, lawyers must guard against allowing these outside interests to interfere or conflict with their duties to clients or to others. Where there is a possibility of a conflict between the activities of the outside interest and the duties of the

lawyer, the lawyer must avoid the conflict. The lawyer may do so by disengaging from the outside interest, declining to act for the client, or where appropriate, obtaining the client's informed consent to act. The nature of the outside interest, the client retainer, and the conflict will dictate what options are available to avoid the conflict.

10.4 Unrepresented persons — r. 2.04(14)

As discussed previously in these materials, lawyers have a special responsibility when acting for a client where an opposing or other party is unrepresented in the matter. The lawyer must urge the unrepresented person to obtain independent legal representation. The lawyer must also ensure that the unrepresented person understands that his or her interests are not protected by the lawyer and that the lawyer is acting only in the interest of the lawyer's own client. The purpose of this rule is to ensure that the unrepresented party does not misunderstand that the lawyer is acting for him or her, which allows the lawyer to avoid any potential conflict or the appearance of conflict that could otherwise arise from this misunderstanding.

11. Conflicts checking systems

Conflicts of interest may arise at any time. To fulfill their responsibilities regarding conflicts, lawyers should use and maintain an up-to-date firm database against which all names (e.g., client, prospective clients, and adverse and associated parties) are checked. Every time a prospective client or person contacts or consults with the firm, all names and matter information should be recorded in the database. The lawyer should perform a preliminary conflicts check before the initial consultation with the prospective client and before any confidential information is provided. The lawyer should check again after the initial consultation and before accepting the retainer. This should be done whether or not the prospective client actually retains the firm for further services. Another conflicts check should be made each time a new person becomes involved in the matter or whenever a new lawyer joins the firm. More information on conflicts checking systems can be found in the Practice Management chapter of these materials.

Chapter 7
Duty to the client

The *Rules of Professional Conduct* (*Rules*) outline the lawyer's professional responsibilities to many parties: the client, other lawyers and paralegals, the Law Society of Upper Canada, and the administration of justice itself. Though it may be affected by duties to other parties, one of the most important responsibilities is the duty to the lawyer's client. These client-related duties, discussed elsewhere in these materials, include the obligation to

- provide competent service to the client;
- safeguard confidential client information;
- avoid conflicts of interest;
- charge fair and reasonable fees for services;
- withdraw from representation under certain circumstances; and
- manage the client relationship and client expectations through proper communication.

This chapter will focus on the additional duties to the client, which include the

- obligation to appropriately advise the client;
- special duties that relate to title insurance and mortgage transactions; and
- responsibility to protect client funds and property.

1. The lawyer as fiduciary

The lawyer-client relationship is

- a fiduciary relationship, a relationship of trust, in which the lawyer acts on behalf of and in confidence for the client;
- an agency relationship in which the lawyer is agent for the client;
- a business or contractual relationship where the lawyer and client have entered into an agreement for legal services; and
- a professional relationship where the lawyer's dealings with the client are subject to the *Rules*.

Though each of these relationships is essential, the most important duties to the client arise from the lawyer's role as the client's *fiduciary*. A fiduciary is one who does and must act for another person with total trust, good faith, and honesty and has the complete confidence and trust of that other person. As fiduciary, the lawyer must put the needs of the client before the lawyer's own. Because the lawyer-client relationship exists for the benefit of the client, lawyers must ensure that they meet the minimum standard of care expected of them. Generally, the standard of care requires the lawyer to

- be honest and candid with the client in order to provide the client with full disclosure of any information that is relevant to the client's matter;
- protect the client's information in order to keep client information confidential; and
- place the client's interests before those of the lawyer or others in order to avoid conflicts of interest.

2. Duties when advising clients

The *Rules* further expand on the minimum standard of care expected of the lawyer as fiduciary. Duties that the lawyer must fulfill when advising clients, which are detailed in this section, relate to

- honesty and candour;
- encouraging compromise or settlement;
- abstaining from threatening criminal proceedings;
- refraining from assisting or encouraging a client in any dishonesty, fraud, crime, or illegal conduct;
- acting appropriately with clients under a disability;
- properly handling medical-legal reports;
- advice on title insurance in real estate conveyancing;
- reporting on mortgage transactions;
- errors and omissions; and
- official language rights.

2.1 Honesty and candour — rr. 2.02(1)–(1.1) and commentary

The lawyer must be honest and candid when advising clients, whether the client is an individual or an organization, or a joint or a prospective client. The lawyer must provide the client with the lawyer's true opinion regarding the options, possible outcomes, or risks of the matter so the client is able to make informed decisions and give appropriate instructions. Lawyers should be wary of providing assurances to the client or of guaranteeing an outcome when advising the client. The lawyer must also be honest with the client when the client's expectations about the matter are unreasonable or cannot be performed under the law. Honesty and candour are essential if the client is to trust the lawyer's judgment and fully benefit from the professional relationship.

2.2 Settlement and ADR — rr. 2.02(2)–(3)

Lawyers must encourage compromise or settlement of a dispute if settlement is reasonably possible. Receipt of an offer to settle is an important stage in a matter or proceeding, and the lawyer must present all settlement offers to the client as soon as possible for discussion and decision. A lawyer must not accept or reject an offer without advising the client on the suitability of the offer and obtaining the client's clear and informed instructions. To avoid any misunderstanding, lawyers should confirm those client instructions in writing.

Lawyers must also consider the use of alternative dispute resolution (ADR) for every dispute and must inform the client of ADR options, if appropriate. If the client instructs the lawyer to take steps to pursue an ADR option, the lawyer must do so.

2.3 Threatening criminal proceedings — r. 2.02(4)

A lawyer is not permitted to use threats or promises regarding criminal or quasi-criminal charges to gain an advantage in the client's negotiations in a civil matter. A client who suggests or requests that the lawyer use this tactic must be advised that the lawyer cannot comply with the client's wishes.

2.4 Dishonesty, fraud, etc., by client — rr. 2.02(5)–(5.2) and commentaries

When advising a client, the lawyer must not knowingly assist in or encourage any dishonesty, fraud, crime, or illegal conduct by the client, whether or not it is directly related to the legal services the lawyer was retained to provide to the client. Lawyers are also prohibited from instructing the client on how to violate the law and avoid punishment whether or not that was the client's intent. For example, it would be inappropriate for a lawyer to offer to continue to hold client funds in trust after the services to the client have been completed or to assist the client in concealing the funds from a third party or an external authority.

Lawyers must not ignore the warning signs that may indicate dishonesty of the client. Lawyers should take all reasonable measures to avoid becoming the tool or dupe of a corrupt client or associates of the client and should be alert to avoid being misled or used to further a client's illegal or dishonest actions. For example, a lawyer is prohibited from accepting funds that were gained through illegal means and should not hold stolen property or any other evidence of a crime.

The lawyer has special obligations when the proposed or actual misconduct involves a client that is an organization. A lawyer who learns that the institutional client is acting or intends to act dishonestly, fraudulently, criminally, or illegally with respect to the matter for which the lawyer was retained or employed is required to advise those responsible for the organization about the wrongful conduct and that the conduct must stop. The lawyer must

- advise the person who gives instructions to the lawyer and the organization's chief legal officer that the conduct is or was fraudulent (dishonest, criminal, or illegal) and should be avoided or stopped;
- if the conduct persists, advise progressively the next highest persons or groups, ultimately including the board of directors that the conduct is or was fraudulent (dishonest, criminal, or illegal) and should be avoided or stopped; and
- if the wrongful conduct continues despite the lawyer's advice, withdraw from acting for the organization in that matter in accordance with r. 2.09 of the *Rules*.

These reporting and withdrawal obligations apply equally to lawyers in private practice as well as those employed in-house. In circumstances where a lawyer employed in-house must withdraw because the corporate client or employer refuses to abandon a course of illegal conduct, the lawyer may have to resign from his or her position of employment.

2.5 Client under a disability — r. 2.02(6) and commentary

Lawyers have a special obligation to ensure that the needs of a client under a disability are being met. This includes the need for the lawyer to have a normal business relationship with the client even if the client's ability to make decisions is impaired because of minority, physical health, mental disability, functional disability (e.g., illiteracy), or some other reason. Lawyers must be sensitive to the individual needs of the client. Where a lawyer suspects that a client may not have capacity to give instructions, he or she should make efforts to confirm the client's capability (e.g., by obtaining a medical opinion from the client's treating physician, upon the client's consent). If the client no longer has the legal capacity to provide instructions, the lawyer must also be prepared to take steps to have a lawfully authorized representative appointed for the client, such as a litigation guardian, to protect the client's interests.

2.6 Medical-legal reports — rr. 2.02(7)–(9) and commentary

As part of the legal services that are provided to the client, the lawyer may need to obtain a report from an expert. Because a medical-legal report may contain information sensitive to the client, lawyers have special

responsibilities where such reports are concerned. After an expert has been hired but before the expert prepares a written report, the lawyer should discuss the expert's findings and conclusions with the expert to determine if they will advance the client's cause. If the findings do not, subject to any legal requirements, the lawyer may decide not to obtain a written report. A written report should not be ordered unless the client has instructed the lawyer and the lawyer has obtained the client's written consent to do so.

Because lawyers must be honest and candid with the client, a lawyer cannot follow the instructions of the report writer to withhold a medical-legal report from the client. If a physician or health professional provides the lawyer with a medical-legal report on the condition that it is not to be shown to the client, the lawyer must return the report immediately without making a copy unless the client has given the lawyer advance instructions to accept the report on this condition.

If the lawyer receives a medical-legal report that contains opinions or findings that might cause harm or injury to the client if disclosed to the client, the lawyer must try to protect the client by persuading the client not to review the report. If the client insists, the lawyer must produce the report for the client to review. Where the client insists on reviewing such a report, the lawyer must also recommend that the client do so at the office of the physician or health professional who prepared the report so that the client will have the benefit of the physician's or health professional's expertise and advice regarding the contents of the report.

2.7 Title insurance — rr. 2.02(10)–(13) and commentaries

Conveyancing is the transfer of title of property from one person to another or the granting of an encumbrance such as a mortgage or a lien. Title insurance is an insurance policy that protects residential or commercial property owners and their lenders against losses related to the property's title or ownership. A lawyer who advises clients about a real estate conveyance is required to advise that title insurance is not mandatory in Ontario and that there are other options available to protect the client's interests in a real estate transaction. Although title insurance is intended to protect a client against title risks, it is not a substitute for the lawyer's competent service.

When advising the client on how to minimize the risks in a particular transaction, the lawyer

- must assess all reasonable options to assure title;
- should recognize when title insurance may be an appropriate option;
- must be fully informed regarding a particular insurance product before recommending it to a client;
- should discuss with the client the advantages, conditions, and limitations of coverage options available;
- if discussing LAWPRO's TitlePLUS® program, must fully disclose the relationship between the legal profession, the Law Society, and the Lawyers' Professional Indemnity Company (LAWPRO).

A lawyer is prohibited from receiving any direct or indirect compensation from a title insurer, agent, or intermediary for recommending a particular product and must also disclose to the client that the lawyer is not receiving any such compensation.

2.8 Reporting on mortgage transactions — r. 2.02(14)–(15)

There are special obligations for the lawyer who represents a lender where the loan is secured by a mortgage on real property. The lawyer is required to provide to the lender the duplicate registered mortgage and a final report on the transaction within 60 days of the registration of the mortgage or within some other time period as instructed by the lender. This time frame, 6o days or otherwise, applies even if the lawyer paid funds to satisfy one or more prior encumbrances to ensure the priority of the mortgage as instructed and the lawyer has obtained an undertaking to register a discharge of the encumbrance(s) but the discharge remains unregistered.

2.9 Errors and omissions — r. 6.09

A lawyer must also fulfill specific duties to the client when the lawyer makes an error or fails to do something that he or she should have done. If a lawyer does or fails to do something that may involve a breach of the *Rules*, the lawyer must disclose the error or omission to the client and do all that can reasonably be done to correct it. If the lawyer learns that the error or omission is or may be damaging to the client's matter and cannot be readily corrected, the lawyer must

- promptly inform the client of the error or omission, while being careful not to prejudice any rights either the client or the lawyer may have under an insurance, client's protection, or indemnity plan or otherwise;
- recommend that the client get legal advice elsewhere to discuss any rights of claim the client may have against the lawyer; and
- advise the client that in the circumstances, the lawyer may no longer be able to provide legal services to the client.

The need for the lawyer to withdraw from representing the client may result from the lawyer being put in a potential conflict of interest, where the lawyer might be tempted to prefer his or her own interests regarding the mistake over those of the client in the original matter. Lawyers cannot continue to act in a matter where there is or is likely to be a conflict of interest unless, after adequate disclosure, the client consents.

The lawyer must also promptly notify the professional liability insurer of any circumstances that might reasonably give rise to a claim against the lawyer so that the client's insurance protection will not be prejudiced.

2.10 Official language rights — commentary, r. 1.03

When dealing with French-speaking clients, lawyers have a special responsibility to inform clients of their French language rights relating to the matter. Where applicable, lawyers must advise clients of their rights under

- s. 19(1) of the *Constitution Act, 1982* on the use of French or English in any court established by Parliament;
- s. 530 of the *Criminal Code* on an accused's right to a trial before a court that speaks the official language of Canada that is the language of the accused;
- s. 126 of the *Courts of Justice Act* that requires that a proceeding in which the client is a party be conducted as a bilingual (English and French) proceeding; and
- s. 5(1) of the *French Language Services Act* for services in French from Ontario government agencies and legislative institutions.

3. Duties regarding client property — r. 2.07 and commentaries

Lawyers may be required to receive, hold, and deliver property belonging to a client as part of the retainer. As a fiduciary, the lawyer has an obligation to care for clients' property as a careful and prudent owner would when dealing with like property. The lawyer must

(1) promptly notify the client when the lawyer receives any money or other property of the client unless the lawyer is satisfied that the client is already aware of this;

(2) clearly label the client's property and place it in safekeeping that can clearly be identified as different and separate from the lawyer's property;

(3) maintain required records to identify and track client property that is in the lawyer's custody;

(4) promptly account for client property that is in the lawyer's custody and deliver it to the client upon the client's request; and

(5) apply to a tribunal of competent jurisdiction for direction if the lawyer is unsure of the proper person to receive a client's property.

In addition to the above, when an external authority seizes or attempts to seize client property held by the lawyer, the lawyer should be alert to claim privilege on the client's behalf. An example of an external authority is the Canada Revenue Agency (CRA). Lawyers should be familiar with the nature of the client's privilege and with relevant statutory provisions that may be found in the *Income Tax Act* (Canada) and other legislation.

Under the *Rules*, the term *client property* covers a wide range of items such as money or other valuables, physical items, and information. By-Law 9 under the *Law Society Act* sets out the specific requirements regarding the handling of clients' money and other property, as well as record keeping requirements.

3.1 Client property

Lawyers may be asked to safeguard client assets or items that have value, monetary or otherwise. Client property in the lawyer's possession, including original client documents held by the lawyer for the client (e.g., original wills, power of attorney documents, trust deeds, or share certificates), must be stored in a secure manner and location befitting the property, such as a safety deposit box or a fireproof safe. Lawyers must keep track of any property held for the client and must be able to account for or deliver the property upon the client's request. A lawyer should only hold client property that is the subject of the legal services the lawyer is providing to the client. For example, it would be appropriate for a lawyer representing a client in the transfer of shares to hold the share certificates in trust. A lawyer should not hold client property that is unrelated to the retainer.

Valuable property (i.e., property with monetary value) cannot be sold or negotiated by the lawyer unless the client has given instructions to do so, which instructions should be written or confirmed in writing. By-Law 9 requires lawyers to record valuable client property in their care. This *valuable property record* documents assets other than client money, and as a minimum, the record must show

- the name of the property owner(s);
- a description of the property;
- the date the property came into the lawyer's possession or control;
- the name of the person who had control of the property immediately before the lawyer took possession;
- the value of the property;

- the date that the property was delivered or transferred to or on the direction of the owner(s); and
- the name of the person who received the property.

The record should include items such as

- stocks, bonds, or other securities in bearer form;
- jewellery, paintings, furs, collector's items, or any saleable valuables;
- any property that a lawyer can convert to cash, on his or her own authority; and
- mortgages, transfers, or other instruments registered in the lawyer's name in trust (includes mortgages or other investment securities held in trust by a corporation or other business entity controlled by the lawyer, a firm of lawyers, and/or the spouse(s) of the lawyer(s)).

Though a lawyer may be asked to hold other client items that have value to the client but no monetary value, the valuable property record should not include items that cannot be sold or negotiated by the lawyer. The valuable property record should not include wills, power of attorney documents, deeds of title, securities registered in the client's name, corporate records or seals, etc. Lawyers should maintain a list of these properties, but this list must be separate from the valuable property record. Also, the valuable property record should not include any client trust moneys since lawyers should record these in their financial accounting records. These would include term deposits, deposit receipts, savings accounts, or similar deposit accounts maintained for individual clients at chartered banks or registered trust companies.

3.2 Client money

As part of the retainer, a lawyer may receive, hold, or disburse client funds on behalf of a client. These may include

- funds received by the lawyer from an opposing or other party that belong to the client;
- funds received by the lawyer from the client that belong to the opposing or another party;
- money provided to the lawyer for payment of disbursements that will be incurred on behalf of the client by the lawyer; or
- money provided to the lawyer by the client or a third party to secure legal services or as a deposit for fees that will be charged for these services (i.e., a *money retainer*).

Lawyers have a duty to preserve the money they hold on a client's behalf. Lawyers must keep track of these client funds and must be able to account for them upon request by the client. Any money received and held by the lawyer for the client must be deposited into a designated *trust account* and must be kept separate from the lawyer's own funds. A lawyer who operates any type of trust account must meet the minimum record keeping requirements as outlined in By-Law 9. If the lawyer does not receive or hold client money in trust, the lawyer does not need to open a trust account. The lawyer must still meet the record keeping requirements outlined in By-Law 9 that apply to the operation of the lawyer's business or *general account*.

3.3 Client file

The duty to preserve client property also applies to the documents that a client may provide to the lawyer or that the lawyer may create or collect for the client's benefit during the professional relationship. Lawyers should keep the client's papers and other property out of sight and out of reach of those not entitled to see them and should promptly return them to the client at the end of the retainer.

To determine what documents to return to the client, the lawyer must determine which documents belong to the client. Documents in existence before the client retained the lawyer that were provided by the client belong to the client. Generally, documents created during the retainer that were prepared as part of the service provided to the client belong to the client. Normally, documents to be returned to the client include

- originals of all documents prepared or collected for the client;
- copies of all other documents prepared or collected for which the client has paid;
- copies of letters requested and received by the lawyer and paid for by the client;
- copies of letters from the lawyer to third parties;
- letters received by the lawyer from third parties;
- originals of letters from the lawyer to the client (presumably these would have already been sent to the client in the course of the retainer);
- copies of case law;
- briefs;
- memorandums of law where the client paid for the preparation;
- trial preparation documents, trial briefs, document books, and trial books;
- discovery and trial transcripts;
- vouchers and receipts for disbursements the lawyer made on the client's behalf;
- experts' reports;
- photographs or other items of evidence; and
- data storage media containing information that belongs to the client (e.g., DVD, CD, etc.).

Documents that belong to the lawyer do not need to be returned to the client at the end of the engagement. These include documents that came into existence during the retainer that the lawyer was under no duty to prepare, were not prepared for the client's benefit, and for which the client cannot be regarded as being liable to pay. Examples of such documents include the lawyer's time dockets, internal memorandums, accounting records, working notes, and copies of any client documents made for the lawyer's benefit and at the lawyer's expense.

If the client requests copies of these documents, the lawyer may choose to provide copies at the lawyer's discretion and may discuss the cost of photocopying them directly with the client. Lawyers should also consider retaining copies of client documents, at their own cost, to defend against complaints or claims that may be made against them. Lawyers must not charge clients for these copies since they are for the benefit of the lawyer, not the client.

Chapter 8
Fees and disbursements

Once retained for a particular matter, the lawyer should discuss with the client two essential terms of the engagement: the scope of the legal services to be provided and the costs of those services. In discussing scope, the lawyer should set out which services will be provided to the client and which services will not be provided. In discussing costs, the lawyer should discuss the amount of fees and disbursements that will likely be charged to the client and whether a money retainer will be required.

Lawyers should ensure that the client clearly understands what the lawyer is expected to accomplish and at what cost. Too often, misunderstandings about fees and financial matters result in disputes over legal bills and complaints from unhappy clients. These disputes reflect badly on the legal profession and the general administration of justice. Rule 2.08 of the *Rules of Professional Conduct* (*Rules*) outlines the lawyer's obligations regarding fees and disbursements.

1. Retainers

In the context of providing legal services, the word *retainer* may mean

- the act of retaining a lawyer to provide legal services or the professional engagement (a *retainer*);
- the contract that outlines the legal services the lawyer will provide to the client (a *retainer agreement*); or
- an initial fee or deposit paid to the lawyer in advance to secure the lawyer's services in the near future, against which future fees and disbursements will be charged (a *monetary* or *money retainer*).

Whenever it is practical to do so, the lawyer should obtain a money retainer from the client at the beginning of the professional relationship. The money retainer must be deposited into the lawyer's trust account. As the lawyer works on the client matter and after the lawyer has properly billed and delivered an account to the client for services rendered, the lawyer may pay the account from the money retainer held in trust. Disbursements and expenses paid on behalf of the client to others are also paid from the money retainer and may be paid directly from trust if the client has instructed the lawyer to do so.

When determining the amount of the money retainer the client should provide, the lawyer should consider the circumstances of each matter. These include the amount of time and tasks that will be required and the urgency of the matter. Many of the factors the lawyer should consider when determining the amount of the money retainer are the same as those for deciding whether a fee is fair and reasonable, which are discussed later in this chapter. There are also certain circumstances where a money retainer may not be appropriate, for example, where the client and lawyer have entered into a contingency fee agreement. Contingency fees are also discussed in detail later in this chapter.

The client should be advised at the outset if and when further money retainers will be required as the matter progresses and the original money retainer is used to pay fees and disbursements. Lawyers should also consider their obligation to continue to represent the client, in some situations, even if the client has not paid the lawyer's accounts. Lawyers cannot withdraw for non-payment where serious prejudice to the client would result. If the lawyer has obtained a money retainer in advance, the lawyer may be able to avoid these situations.

2. Fees and disbursements

Clients pay *fees* for the legal services the lawyer provides to them. Fees may be billed in various ways, and lawyers should select a method that best suits the circumstances and the client. Common fee types include

- an *hourly rate*, charging for the actual time spent on the client matter;
- a *block*, *fixed*, or *flat fee*, charging a fixed amount for performing a particular task or tasks regardless of the time spent on the matter;
- *fees by stages*, charging for a matter, which is broken down into stages, and giving an estimate as to the fee for each stage or step in the matter; and
- *contingency fees*, where part or all of the fee depends on the successful completion of the matter.

A *disbursement* refers to any expense that the lawyer pays on behalf of the client for which the lawyer is entitled to be reimbursed by the client. Lawyers cannot charge clients more than the actual cost of the disbursement and are not permitted to make a profit from disbursements. Common disbursements include charges for

- research;
- mileage;
- mailing or sending documents by courier;

- photocopying or faxing documents, and long distance calls; and
- administrative and filing fees related to the client matter.

As stated in the *Rules*, lawyers may only charge or accept an amount for a fee or disbursement that is fair, is reasonable, and has been disclosed to the client in a timely fashion.

2.1 Fair and reasonable — rr. 2.08(1), (5), and commentary, r. 2.08(2)

To determine what is fair and reasonable for fees, the lawyer must consider

- the time and effort required and spent on the matter;
- the difficulty and importance of the matter;
- whether special skill or service was required and provided;
- the amount involved or the value of the subject matter;
- the results obtained for the client;
- fees authorized by statute or regulation; and
- special circumstances (e.g., loss of other business to accept the retainer, delay in payment by the client, uncertainty of reward, or urgency of the matter).

When acting for two or more clients (i.e., in a *joint retainer*), the fees and disbursements must be divided equitably between the joint clients, unless the clients agree to a different arrangement. The division of fees between the joint clients should be shown clearly on the statement of account provided to each client.

Where warranted, lawyers are encouraged to provide legal services *pro bono*. Where a client or prospective client of limited means is unable to obtain legal services or representation, lawyers should consider reducing or waiving the fees they would normally charge to serve the greater good.

2.2 Timely disclosure to client, cost estimates — r. 2.08(1) and commentary, r. 2.08(2)

The *Rules* require lawyers to disclose to clients the charges for fees and disbursements in a "timely fashion." Though what is considered timely may depend on the individual client and his or her matter, at a minimum, a lawyer should initially discuss charges for fees and disbursements at the outset of the retainer. Whenever possible, the lawyer should provide the client with an estimate of the expected fees and disbursements to complete the client's matter or to bring it to a particular stage. To ensure there is no misunderstanding, this information should be provided or confirmed in writing. This can be done in a retainer agreement signed by the client or in a retainer or engagement letter prepared by the lawyer and delivered to the client.

If unexpected developments in the client's matter arise and result in costs that are higher than the lawyer's original estimate to the client, the lawyer should immediately inform the client of the reason for the increased fees, additional disbursements, or other costs and should provide a revised estimate, all of which should be confirmed in writing. The client may then instruct the lawyer based on this new information, which should also be confirmed in writing. One method to manage the client's expectations during the retainer and to ensure timely disclosure of fees is to provide the client with interim statements of account.

2.3 No hidden fees — commentary, r. 2.08(2)

Further to the lawyer's fiduciary duty to the client, a lawyer cannot withhold from the client any financial dealings in his or her matter. A lawyer is prohibited from accepting payment or compensation from anyone other than the client in the matter unless the client is informed and consents in writing. Such payments that must not be hidden from the client include

- a fee;
- a reward;
- costs;
- a commission;
- interest;
- a rebate;
- an agency or forwarding allowance; or
- any other compensation related to the lawyer's employment by the client.

2.4 Interest on overdue accounts — r. 2.08(2)

Lawyers must not charge a client interest on an overdue account except as permitted by s. 33 of the *Solicitors Act* or as otherwise permitted by law. This includes interest on unpaid fees, charges, or disbursements. Clients should be informed in writing of the potential for interest charges, the rate that will be charged (in accordance with the *Solicitors Act*), and when the interest will apply. Lawyers should consider including this information in their initial retainer letter or agreement and, as required by the *Solicitors Act*, must include it on any interim or final accounts delivered to the client.

2.5 Written confirmation — commentary, r. 2.08(2)

Lawyers should confirm their billing method in writing for both fees and disbursements via

- a written retainer agreement signed by the client;
- a retainer or engagement letter from the lawyer; or
- a confirming memo to the client (sent by mail, email, or fax).

The written confirmation should set out the scope of the legal services to be provided and describe how fees, expenses, and interest will be charged. It should also address when and how payment from the client must be received for outstanding accounts and the need for further money retainers, if appropriate. Lawyers should ensure that the terms for each engagement are appropriate for each individual client's matter.

Where appropriate, the lawyer should also include details regarding the receipt of client settlement funds. If the client has agreed that the lawyer may pay himself or herself from the client's settlement money received in trust, this should be clearly confirmed in writing to ensure no misunderstanding. As discussed below, payment from those funds can only be made after the lawyer has rendered the services and delivered an account in accordance with the Law Society of Upper Canada rules and by-laws.

If a lawyer does not accept a client's matter, the lawyer should confirm this by sending the client a non-engagement letter.

2.6 Statement of account — r. 2.08(4)

Whether interim or final, a statement of account or bill delivered to the client must clearly and separately detail the amounts the lawyer has charged for fees and disbursements and should also include the Harmonized Sales Tax (HST) and any interest charges. The amount for fees will be calculated based on the fee type and rate the lawyer and client have agreed to, and disbursements will be passed directly on to the client. The HST applies to fees and some disbursements, as outlined by Canada Revenue Agency (CRA) guidelines, and should be listed as a separate line on the bill. Clients in a joint retainer must receive separate statements of account outlining each of the above.

To preserve the lawyer's rights regarding the recovery of fees, disbursements, or other charges from a client, the lawyer must comply with s. 2(1) of the *Solicitors Act*, which requires a lawyer's bill to be "subscribed with the proper hand" of the lawyer. The lawyer should sign every statement of account to confirm that it was reviewed by the lawyer before it was sent to the client.

If a client disagrees with the amount charged by the lawyer on an interim or final statement of account, the lawyer should make efforts to discuss the matter openly and calmly with the client to resolve the dispute. The lawyer should promptly explain any charges questioned by the client and should inform the client about the right to have the account assessed under the *Solicitors Act*. Often client complaints about fees can be resolved by considering the client's perspective and dealing with the client in a polite and respectful manner. Civility and professionalism must govern all discussions, including discussions relating to fee disputes with clients.

2.7 Appropriation of funds from trust — r. 2.08(10)

When a lawyer receives funds to be held on the client's behalf, including a money retainer, those funds must be deposited into a trust account. Lawyers shall not appropriate client funds held in trust for or on account of fees except as permitted by By-Law 9 under the *Law Society Act*. A lawyer is only permitted to withdraw from the trust account

- money properly required for payment to a client or to a person on behalf of a client;
- money required to reimburse the lawyer for money properly paid on behalf of a client or for expenses properly incurred on behalf of a client;
- money properly required for or toward payment of fees for services performed by the lawyer for which a bill or statement of accounts has been sent;
- money that is directly transferred into another trust account and held on behalf of a client; or
- money that, under this by-law, should not have been paid into a trust account but was mistakenly paid into a trust account.

Lawyers may pay themselves for fees out of client funds held in trust (i.e., if a money retainer was provided by the client and deposited into the trust account) only if

- the lawyer has completed the work;
- the lawyer has delivered (i.e., not just filed) a bill or statement of account to the client; and
- there are sufficient funds in trust for that client available for the payment of the lawyer's fees.

In any other circumstance, paying oneself for fees from the client's money held in trust is misappropriation of trust moneys and a form of professional misconduct.

Disbursements can be paid directly from trust upon the client's instruction or consent since they are expenses incurred on the client's behalf. Lawyers should not withdraw funds from trust to pay themselves for fees or reimburse themselves for disbursements if the money is earmarked for some other purpose. For example,

settlement funds provided to the lawyer by the client in anticipation of payment to a third party or proceeds from the sale of property that the lawyer has agreed to hold until certain conditions are met have been earmarked for another purpose.

3. Division of fees and referral fees — rr. 2.08(6)–(8) and commentary

The *division of fees* (or *fee splitting*) occurs when a lawyer shares or divides his or her fee for legal services, paid by the client, with another individual. *Referral fees* are fees paid by a lawyer to another individual for referring a client to the lawyer. Fee splitting and referral fees are permitted between and among lawyers and paralegals under specific circumstances.

Lawyers or paralegals who are not at the same firm may divide between them the fees for a matter if

- the fees are split relative to the work done and the responsibilities of each of them; and
- the client is informed and consents to the division of fees.

Where a lawyer refers a client to another lawyer or a paralegal, the lawyer may accept (and the other legal representative may pay) a referral fee if

- the referral was not because of a conflict of interest;
- the referral was because of the receiving legal representative's expertise and ability;
- the fee is reasonable and does not increase the total amount of the fee charged to the client; and
- the client is informed and consents to the payment of the referral fee.

Lawyers should note that this rule does not prohibit an arrangement respecting the purchase and sale of a law practice. Where the consideration payable to a lawyer includes a percentage of revenues generated from the practice sold, that lawyer is still permitted to receive such payments.

3.1 Prohibition against non-licensees — rr. 2.08(6)–(8) and commentary

Lawyers are prohibited from sharing, splitting, or dividing fees for legal services with anyone who is neither a lawyer nor a paralegal. Lawyers are also prohibited from paying any financial or other reward to someone who is not a lawyer or paralegal (i.e., a non-licensee) for the referral of client matters. For example, a lawyer may not pay an acquaintance, friend, or family member for referring a client. A lawyer may receive such a financial or other reward from a non-licensee for the referral of a client to that non-licensee; however, to fulfill the lawyer's fiduciary duty to avoid hidden fees, the lawyer must obtain the client's informed consent before he or she can accept the reward. This does not apply to a referral fee or compensation from a title insurer. Under r. 2.02(11), a lawyer is prohibited from accepting such a fee from a title insurer.

3.2 Exceptions for non-licensees — r. 2.08(9) and commentary

There are exceptions to the prohibition against referral fees and fee splitting with non-licensees. The prohibition does not apply to the sharing of fees, cash flows, or profits

- among the lawyer and non-licensee partners of a multi-discipline practice where the partnership agreement provides for this; and
- by the lawyers of an interprovincial law firm or a law partnership of Ontario and non-Canadian lawyers who otherwise comply with this rule.

However, all the other conditions outlined in rr. 2.08(6)–(7) of the *Rules*, including client consent, must also be met.

Lawyers must note that there is no such exception for affiliations. An affiliation is different from a multi-discipline practice (as outlined in By-Law 7, made under the *Law Society Act*), an interprovincial law partnership, or a partnership between Ontario lawyers and foreign lawyers. An affiliated entity is not permitted to share in the lawyer's revenues, cash flows, or profits, either directly or indirectly.

4. Contingency fees and contingency fee agreements — r. 2.08(3) and commentary

A *contingency fee* is a fee that is paid if and when a particular result in the client's matter is achieved. The *Rules* permit a lawyer to enter into a *written* contingency fee agreement that states that the lawyer's fee, either in whole or in part, may depend on the successful completion of the client's matter. However, contingency fee arrangements are not permitted in family, criminal, or quasi-criminal matters. To determine the appropriate percentage (or other basis) of the contingency fee, lawyers should consider

- the likelihood of success;
- the nature and complexity of the claim;
- the expense and risk of pursuing the matter;
- the amount of the expected recovery;
- who may receive an award of costs; and
- the amount of costs that may be awarded.

Regardless of what factors were used to determine the percentage that was agreed to by the lawyer and the client, the ultimate fee must still be fair and reasonable.

In accordance with the *Solicitor's Act* and its regulations, a contingency fee agreement must be

- in writing;
- titled "Contingency Fee Retainer Agreement";
- dated; and
- signed by both the client(s) and the lawyer, with signatures verified by a witness.

Where the arrangement requires the client to provide a money retainer to be used for disbursements and only the lawyer's fee will be contingent upon the outcome of the matter, this should be clearly documented and explained to the client.

The contingency fee agreement must be clear on how the fee will be calculated and must contain the terms outlined in the *Solicitor's Act* and related regulations, as they apply. The agreement must not limit the client's ability to make a decision to discontinue or settle the claim, or to end the retainer with the lawyer. A copy of the signed and dated agreement must be provided to the client, and a copy retained by the lawyer.

In addition to the fee payable under the contingency fee agreement, the lawyer and client may agree that any amount arising as a result of an award of costs or costs obtained as a part of a settlement is to be paid to the lawyer. However, under the *Solicitor's Act*, such an agreement must receive judicial approval. In such circumstances, after considering all relevant factors, a smaller percentage of the award than would otherwise be agreed to for the contingency fee is generally appropriate.

Lawyers must take extra care when considering a contingency fee agreement with a client who is under a disability or is vulnerable. A vulnerable client could be one who has difficulty communicating with or understanding the lawyer, someone who may have limited life experience or education, or someone whose emotional state is being affected by his or her legal matter. This extra care is required to ensure that the client understands the arrangement to which he or she is consenting and that the consent is genuine, informed, and uncoerced.

5. Securing payment for legal services

The best way to ensure payment for legal services is for the lawyer to ask the client to initially provide a money retainer in an amount appropriate to cover the anticipated legal fees and disbursements for the client's matter. However, there may be circumstances where it is not feasible or possible to obtain a money retainer and the lawyer wishes to secure payment by some other means, including

- holding and registering a mortgage against the client's real property, per s. 35 of the *Solicitors Act*;
- obtaining a charging order on the client's property recovered or preserved by the lawyer's instrumentality, per s. 34 of the *Solicitors Act*; or
- asserting a common-law solicitor's lien on the client's property (e.g., the client's file) already in the lawyer's possession.

Even where the law permits any of the above, the lawyer may be limited in exercising these rights by other factors. For example, the lawyer may not assert a lien on the client's file for non-payment if doing so may prejudice the client's ongoing matter. In each circumstance, the lawyer should evaluate whether the security is appropriate.

Chapter 9
Managing the client relationship

Lawyers should adopt business policies and risk management practices to help them meet client needs and fulfill their professional duties to the client. The lawyer must manage the client relationship and the client's expectations throughout all stages of the retainer.

1. Managing the stages of the client relationship

Managing the client relationship is in the best interest of both the lawyer and the client. To successfully manage their responsibilities to clients, lawyers should plan for each of the following stages in the relationship:

- initial client or case screening;
- non-engagement or engagement;
- implementation; and
- disengagement.

1.1 Initial screening stage

The purpose of client or case screening is to determine whether the lawyer can assist the client with his or her matter. The lawyer should determine whether he or she is competent to act, whether he or she can complete the tasks required in a timely manner, and whether there are any conflicts of interest. Lawyers should also be aware of signs that indicate the prospective client may be difficult to manage, as discussed later in this chapter. Prior to agreeing to act for potentially difficult clients, lawyers should ensure that they are willing and able to serve the client despite any expected difficulties.

The initial screening should be used to

- learn how the client heard about the lawyer—tracking the source of clients can assist in marketing efforts later;
- obtain identifying information about the prospective client in accordance with By-Law 7.1;
- assess the client's demeanour to help the lawyer determine if the lawyer can work effectively and cooperatively with the client;
- evaluate whether there are any potential conflicts of interest and whether the client can waive those conflicts—this should be done prior to obtaining any confidential information from the prospective client;
- determine whether the lawyer has the required level of knowledge or skill to handle the matter without undue expense or delay to the client—lawyers should consider the tasks they must complete to serve the prospective client;
- confirm that the lawyer has time available to meet the deadlines imposed by the client and the nature of the matter;
- discuss with the client the potential cost of the matter, the client's ability to pay, and the lawyer's option to withdraw for non-payment of fees;
- evaluate whether the client's expectations are achievable;
- learn whether the client has been assisted previously by another lawyer or a paralegal and, if so, confirm that the former legal representative was discharged or has withdrawn; and
- avoid accepting clients whose conduct or objectives are dishonest or unlawful.

These factors will assist a lawyer in choosing whether to accept or decline the retainer. Information gathered at the screening should be recorded in a memo to the file, and a file should be opened even if the lawyer does not provide further services to the prospective client after the initial screening. If the lawyer declines a matter, he or she may refer the client to another lawyer or a paralegal, as appropriate, or suggest resources that the client may use to find another legal representative.

1.2 Engagement or non-engagement stage

Once the client has been screened, the lawyer must decide whether to accept or decline the retainer. If the lawyer declines the engagement for legal services or the client chooses not to retain the lawyer, the non-engagement should be confirmed in writing by way of a non-engagement letter. Though the lawyer will not be providing legal services to the individual beyond those that may have been provided during the initial consultation, that individual is or was a client for the purposes of the consultation, and his or her information must be included in the lawyer's conflicts checking system.

A *non-engagement letter* should

- include the date of the interview or consultation;
- clearly confirm that the lawyer is not retained for the matter discussed in the consultation;
- explain the reason for declining the retainer (e.g., lawyer is not available, client unable to pay retainer, or conflict of interest);

- refer to any applicable statute of limitation or other relevant deadline and urge immediate action, if appropriate;
- not include any opinion or advice regarding the matter unless careful research to support an opinion has been completed;
- recommend that the prospective client(s) seek other legal representation;
- list any documentation or other property provided during the consultation that is being returned to the individual;
- be sent via registered mail to confirm delivery and receipt; and
- be copied and retained in the lawyer's file.

If the lawyer accepts the retainer, the terms of the engagement should be confirmed in writing either by way of a retainer agreement or a letter of engagement. Two basic terms to include in any retainer agreement or letter are the scope and costs of legal services to be provided. Depending on the nature of the matter and the individual client, lawyers may want to include other terms. Confirming the terms of the engagement in writing reduces the risk of misunderstanding between lawyer and client.

An *engagement letter* or *retainer agreement* should

- clearly identify the client(s) by using proper legal names;
- explain that there is no confidentiality between the clients if the lawyer is acting for more than one client in a joint retainer;
- outline other issues regarding confidential information (e.g., disclosure to a third-party expert to obtain his or her opinion);
- confirm the client's goals and the suggested strategy to meet those goals;
- outline the scope of representation and set out specific limits (i.e., a limited scope retainer);
- specify what the lawyer requires from the client (e.g., information, documents, actions, etc.) for the representation;
- describe the key steps in the representation;
- identify any additional staff members that will be involved and what functions they will perform;
- provide an estimated time for the key steps and completion of the matter;
- set out the method and frequency with which the lawyer will communicate with the client;
- clearly outline the type and amount of fees the lawyer will charge (e.g., hourly rate, flat rate, etc.) and whether the fees may change in the future;
- clearly outline potential disbursements and indicate whether the client is responsible for paying these directly or the lawyer will pay them and later bill the client for reimbursement (e.g., third-party experts, accountants, actuaries, valuators, other advisors);
- indicate whether a money retainer is required and when it needs to be replenished;
- set out if and how often the lawyer will provide the client with interim bills, what they will include, and when the client can expect the final bill;
- indicate consequences of late payment, including interest to be charged on overdue accounts in accordance with the *Solicitors Act*;
- indicate consequences of non-payment of fees, including withdrawal of services;
- outline other circumstances under the *Rules of Professional Conduct* (*Rules*) where the lawyer may withdraw from representation;
- outline consequences if the lawyer cannot obtain adequate instructions to complete the tasks for which the lawyer was retained;
- discuss ownership of file contents and work product, transfer of files, and the file destruction policy in the event the retainer is ended by the client or by the lawyer;
- specify that any changes to the terms of the letter or agreement must be in writing; and
- clearly state that the engagement does not begin until the letter or agreement is signed by the client and returned to the lawyer and any applicable money retainer has been paid.

The language and meaning of the engagement letter or retainer agreement must be clear, and lawyers should review the terms of the engagement with the client to ensure that there is no misunderstanding.

Though a lawyer should use an engagement letter or retainer agreement for every matter, the lawyer is required to document the terms of engagement when acting in a limited scope retainer. Once the lawyer has advised the client about the nature, extent, and scope of the services that he or she can provide (and whether those services can be provided within the financial means of the client), the lawyer must confirm the services in writing and give the client a copy of the written document when practicable to do so.

1.3 Implementation stage

Once retained, the lawyer must competently carry out the services that the lawyer was hired to provide to the client. The lawyer must serve the client in a conscientious, diligent, and cost-effective manner. The lawyer must keep the client informed regarding his or her matter, through all stages of the matter and concerning all aspects of the matter. Because the client's needs and goals may change as the matter proceeds, lawyers must

continue to work and communicate with the client to review and adjust the strategy to meet those changing needs and goals. If the terms of the initial engagement change, a letter to the client should confirm those changes. Where the changes to the scope of the retainer or the terms of the lawyer's representation of the client are significant, these should be documented in a new retainer agreement. This will help the lawyer to document when the changes became effective and to avoid misunderstanding by the client.

Any new or different instructions from the client should also be obtained or confirmed in writing. As well, the lawyer must explain to the client any limitations regarding the client's instructions. For example, the lawyer should make it clear to the client that the lawyer cannot accept or act on client instructions that would cause the lawyer to violate any of the *Rules*.

If a lawyer later discovers that he or she lacks the competence to fulfill the retainer, the lawyer must obtain the client's written consent to retain, consult, or collaborate with another lawyer who is competent for the task. To ensure that the client provides informed consent, the lawyer must also advise the client of any anticipated increase in cost that might result from this arrangement.

1.4 Disengagement stage

Eventually the retainer will end, either because the matter is complete or because the client or lawyer terminated the retainer before completion. Although the client has the right to end the retainer at will, the lawyer does not. The *Rules* set out circumstances where the lawyer must end the engagement or may choose to do so.

The lawyer should record in the file and confirm with the client in writing why the retainer came to an end. Such letters to the client may be known as a *closing* or *reporting letter* or a *disengagement* or *termination letter*. Where the retainer has ended because the matter is complete, the letter should

- confirm that the particular matter was completed;
- detail the steps that were taken to complete the matter;
- specify any additional steps to be taken by the client in the future to protect his or her interests regarding the completed matter;
- inquire whether the client requires any further assistance from the lawyer if any new developments occur;
- include the return of client documents and remind the client of the lawyer's destruction policy regarding the client file (as outlined in the retainer agreement or engagement letter);
- include the final account and provide a trust statement reconciling funds received and dispersed, if appropriate; and
- thank the client for the opportunity to work on the matter.

Where the lawyer was retained only to provide limited services to the client, the lawyer should provide the client with a similar letter that confirms that the terms of the limited scope retainer have been completed and reminds the client of the steps that may still need to be taken in the client's matter but for which the lawyer was not retained.

If the client or the lawyer ended the retainer before the matter was completed or before the lawyer could complete the tasks required to fulfill the retainer, the letter should

- confirm why the relationship is ending;
- address any final or outstanding account; and
- remind the client of important deadlines or limitation periods and unfinished activities so that the client is aware of the status of the matter and can avoid prejudicing his or her interests.

As in the case of a non-engagement letter, the lawyer should confirm receipt of the disengagement letter by the client. This may be done by delivering the letter by registered mail or process server, or by having the client sign an acknowledgement of receipt of the letter if the letter is given to the client in person.

2. Managing client expectations

Many client complaints result from a failure to meet client expectations as to service, rather than dissatisfaction with the results obtained for the client by the lawyer. A client's service expectations may relate to a variety of things, such as how long it will take to achieve legal results, how quickly the lawyer will return the client's calls, and the cost of the legal services the lawyer will provide. Client expectations may change as the matter progresses or as new developments arise. The lawyer must keep the client informed of all developments throughout the retainer, both negative and positive. To manage the client's expectations regarding the cost of legal services being provided, the lawyer should consider providing the client with interim bills.

The lawyer must also monitor the client's expectations and the lawyer's ability to meet those expectations. If the client's expectations are unreasonable or if the lawyer cannot meet the client's reasonable expectations, this should be discussed and resolved with the client. Subject to the *Rules* on withdrawal from representation, the lawyer may have to end the engagement if the lawyer can no longer serve the client as the client requires.

2.1 What do clients want?

To meet the client's expectations, the lawyer must first determine what those are. Though the client's needs and wants will vary with the client and the matter, common expectations voiced by clients include

- the specific legal services the client will receive from the lawyer;
- the specific results the lawyer is likely to achieve for the client;
- the costs associated with achieving those goals; and
- the time required to complete the legal services and achieve the results.

Even if the client does not specifically ask about the above, these issues should be addressed by the lawyer and should be confirmed in the engagement letter or retainer agreement provided to the client.

Clients may have unspoken expectations, which are equally as important. Most clients expect the lawyer to

- be available to the client;
- listen to the client;
- ask for the client's opinion;
- acknowledge the client's concerns;
- speak *to* the client, not *at* the client;
- keep the client informed;
- treat the client as a person, rather than as a file; and
- care about the client and not just the matter.

These aspects of client service and communication are also components of competence under the *Rules*. Lawyers should realize that successfully completing the legal tasks associated with the client matter is not always enough to satisfy the client. Difficulty in the lawyer-client relationship can develop if the lawyer and client do not agree on what they expect of each other or if these expectations were not discussed at the beginning of the retainer.

2.2 Difficult clients

Some clients can be more challenging than others. Knowing how to recognize and deal with such clients can put the lawyer in a better position to avoid or manage a difficult relationship. Lawyers should be alert for indicators that a client may be difficult:

- The client has a pressing emergency or a "life or death" matter; if the client cannot give sufficient lead-time to do the work properly, consider declining the matter and confirm this in writing.
- The client has already been through a number of legal representatives and has been dissatisfied with each one.
- The client wants to barter for the lawyer's services, offering inducements such as work or benefits for handling the client's case.
- The client thinks he or she knows the legal process better than the lawyer.
- The client has unrealistic expectations (e.g., taking estimates as guarantees, becoming overly irritated with delay, and constantly complaining).
- The client demands that the lawyer set aside all other cases to handle the client's matter.
- The client makes unrealistic demands of the lawyer and his or her staff.
- The client is clearly motivated by malice and has instituted proceedings solely for the purpose of injuring the other party.

Lawyers are encouraged to provide legal services to clients who need it, whether or not they are difficult. If a lawyer chooses to represent a client who later becomes difficult, the lawyer should encourage realistic client expectations and manage the unpleasant relationship as best as possible. To do so, the lawyer may address issues directly with the client, involve another lawyer or a paralegal, as appropriate, or evaluate whether another legal representative would better serve the client.

Once a lawyer agrees to act for a difficult client, the lawyer must fulfill all client-related duties, regardless of how challenging the relationship may be. Though a lawyer may withdraw after the retainer is established where there has been a loss of confidence between the client and the lawyer, the fact that a client is or has become difficult to deal with may not be reason enough to end the engagement.

2.3 Client communication

Effective client communication is essential for a successful lawyer-client relationship. Lawyers must communicate with clients in a timely and effective manner that is appropriate to the age and abilities of the client. This may include using plain language to explain an issue or ensuring that a letter to a visually impaired client is printed in a large font or that the services of an interpreter or translator are used. Lawyers must be sensitive to the communication needs of their individual clients since each client may require a different approach or strategy. The lawyer must consider the client's

- age;
- education;
- physical health;
- mental health;
- functional ability;
- communication style;

- level of understanding or sophistication; and
- ability to make decisions or provide instructions.

Where the lawyer has a client with a disability, the lawyer may need to adjust the manner in which he or she communicates with the client, depending on the client's abilities. The lawyer has the duty to provide the same level of service to the client, regardless of ability.

Lawyers should use various methods to communicate with the client and at the beginning of the retainer should discuss with the client

- the method of preferred contact and related details (e.g., telephone, facsimile, email, mail, courier, priority post, or office or home visits);
- the drawbacks or risks associated with a particular method of communication;
- the frequency with which the lawyer will update the client on the matter going forward;
- the method used to update the client (e.g., sending client copies of correspondence, court documents, or memos to the client file); and
- the average time for the lawyer to respond to calls, emails, letters, or other communications.

It is the lawyer's responsibility to ensure that what is communicated to the client is understood by the client. Where information being shared is sensitive, complicated, or important to the client's ability to provide instructions, the lawyer should consider confirming this information in writing.

Chapter 10
Withdrawal from representation

Once a lawyer has been retained, the client may end the lawyer-client relationship any time and for any reason, while the lawyer cannot. A lawyer may only withdraw from representing a client

- for good cause; and
- upon notice to the client, appropriate to the client's circumstances.

The lawyer must have a legitimate reason to withdraw. The amount of time or advance warning and the way in which the lawyer informs the client of the intention to stop acting for the client depend upon the type of matter, the individual client, and the client's needs and expectations.

Rule 2.09 of the *Rules of Professional Conduct* (*Rules*) deals with the lawyer's obligations relating to withdrawal of services and sets out situations where the lawyer

- may choose to withdraw (i.e., *optional withdrawal*);
- must withdraw (i.e., *mandatory withdrawal*); and
- must comply with special rules (i.e., *withdrawal from criminal cases*).

1. Good cause, notice appropriate to the circumstance — r. 2.09(1)

Whether a lawyer has good cause for withdrawal will depend on many factors, including

- the nature and stage of the matter;
- the relationship with the client;
- the lawyer's expertise and experience; and
- any harm or prejudice to the client that may result from the withdrawal.

Appropriate notice of the intent to withdraw will also vary. The rules of the court or tribunal may outline what steps the lawyer must take to properly withdraw. When no specific timelines or provisions are set out, the lawyer should protect the client's interests to the best of the lawyer's ability and not abandon the client at a critical stage of a matter or when it may disadvantage the client. The client should have adequate time to retain another legal representative to continue with the matter and should be able to continue without losing any advantages or rights already obtained by the original lawyer during the original lawyer's representation.

To ensure that the lawyer and the client are clear as to when the lawyer may or must end the relationship, the lawyer should explain to the client at the beginning of the retainer

- when the lawyer may or must withdraw from representing the client;
- that the client's documents will be provided or returned to the client when the matter or retainer is completed or the lawyer withdraws; and
- which documents in the client file belong to the lawyer and will be kept by the lawyer when the matter or retainer is completed or the lawyer withdraws.

To ensure the client understands these details, the lawyer should consider including them in the engagement letter or retainer agreement.

2. Optional withdrawal

Where there is good cause to do so, a lawyer is permitted to withdraw from representing the client if the lawyer can give the client reasonable notice of the withdrawal and the withdrawal will not prejudice the client's matter. The lawyer is not required to withdraw but may choose to do so as long as he or she follows the direction of the tribunal and the specific rules regarding withdrawal from criminal proceedings. The *Rules* provide that a lawyer may choose to withdraw from representing a client where

- there has been a serious loss of confidence between the lawyer and the client; or
- the client does not pay the lawyer's fees and no serious prejudice to the client would result.

2.1 Serious loss of confidence — r. 2.09(2) and commentary

Subject to any direction of the tribunal or rules relating to withdrawal in criminal matters, a serious loss of confidence between the lawyer and client may be good cause for the lawyer to withdraw. A *serious loss of confidence* means that the trust between the lawyer and client has diminished such that it becomes very difficult for the lawyer to properly serve the client and for them to have a functional lawyer-client relationship.

For example, a serious loss of confidence may result when the client deceives the lawyer. If the client is not truthful, the lawyer may not have all the information needed to effectively represent the client. Another example is where the client refuses to accept and act on the lawyer's advice on an important point. A lawyer who continues to represent a client who will not take the

lawyer's professional advice may no longer be acting in the client's best interest. Any benefit of the lawyer's advice will be lost to the client or greatly reduced.

Even when faced with a serious loss of confidence, the lawyer must never threaten to withdraw legal services to force the client to make a quick decision on a difficult question or matter. As in all withdrawal cases, the lawyer must give the client notice appropriate to the circumstances.

2.2 Non-payment of fees — r. 2.09(3)

A lawyer may withdraw from representing a client for non-payment of fees if no serious prejudice would result from the withdrawal. Where immediate withdrawal would harm the client's interests, the lawyer must continue to act for the client competently and diligently even if the fees remain unpaid. Once the risk of prejudice has passed, the lawyer may then withdraw for non-payment of fees.

Where there is no risk of prejudice to the client's matter, the lawyer must first notify the client that payment of outstanding fees is required and that failure to remit payment within a reasonable and defined time will result in the lawyer ending the retainer. The notice must be reasonable; it must give the client enough advance warning and should be in writing. Withdrawal of services for non-payment is subject to any direction of the court or tribunal, where it applies. If the matter relates to a criminal matter, lawyers must comply with special rules relating to withdrawal in the types of cases discussed below.

3. Withdrawal from criminal proceedings

A lawyer may withdraw from acting for a client in a criminal matter if the lawyer has good cause, the withdrawal will not prejudice the client, and the lawyer complies with the special provisions in the *Rules* that relate to these types of matters. Whether a lawyer will be permitted to withdraw depends upon the interval between

- *the withdrawal*: the time, day, or date when the lawyer intends to stop acting for the client; and
- *the trial*: the time, day, or date the client's trial begins.

Generally, the amount of time between withdrawal and trial must be enough to allow the client to hire another lawyer or paralegal, as appropriate, and to allow that new legal representative enough time to prepare for the trial. What is considered a sufficient interval will vary with the level of knowledge and expertise required of the new legal representative and the type, stage, and complexity of the matter, among other factors. Where the interval is not sufficient, if possible, the trial should be adjourned to allow the client to obtain proper representation and for full preparation.

3.1 Withdrawal permitted — r. 2.09(4) and commentary

Where no prejudice would result, a lawyer acting in a criminal matter may withdraw for non-payment of fees or some other good cause if the interval between the withdrawal and the trial of the matter is enough to allow the client to retain other representation and to allow the other legal representative enough time to prepare for trial. Prior to withdrawing, the lawyer must also

- notify the client, preferably in writing, of the intent to withdraw and the reason for the withdrawal;
- provide an account to the client for all moneys received for fees and disbursements;
- notify the Crown counsel or prosecutor in writing of the withdrawal; and
- notify the clerk or the registrar of the court in writing of the withdrawal if the lawyer is on the record as acting for the accused.

While the *Rules* do not require the lawyer to make an application to the court to be removed as the client's legal representative, most rules of court do (e.g., rules and any practice directions). The lawyer must consult the rules of the court to determine the appropriate process that must be followed. As in every case, the lawyer must not tell the court or prosecutor the reasons for withdrawal unless the disclosure is justified in accordance with the *Rules*. This is important in situations where the lawyer has withdrawn due to a loss of confidence between the lawyer and the client or due to a conflict of interest involving other clients.

3.2 Withdrawal not permitted — r. 2.09(5)

If the interval between the trial date and the intended withdrawal is insufficient to allow the client to retain other legal representation or to allow a new legal representative to prepare for trial, a lawyer acting in a criminal matter may <u>not</u> withdraw for non-payment of fees. The lawyer may seek to adjourn the trial to give the client or the new lawyer or paralegal more time to prepare and to create the interval needed to permit the withdrawal, as long as the adjournment does not prejudice the client.

3.3 Withdrawal with permission of trial judge — r. 2.09(6) and commentary

If the interval between the trial date and the intended withdrawal is not sufficient to allow the client to retain other legal representation or to allow a new legal representative to prepare for trial, a lawyer acting in a

criminal matter may only withdraw for good cause other than non-payment of fees with the permission of the court. The lawyer may seek to adjourn the trial to give the client or the new lawyer or paralegal more time to prepare and to obtain permission for the withdrawal, as long as the adjournment does not prejudice the client. A court application to withdraw should be made as promptly as possible to minimize the disruption and inconvenience to the administration of justice. If the court agrees to the adjournment but does not grant permission for the withdrawal, the lawyer must continue to act.

4. Mandatory withdrawal — r. 2.09(7) and commentary

Circumstances may also arise where the lawyer is required to withdraw from representing a client regardless of whether the lawyer and the client both wish to continue with the retainer. Subject to the special rules about criminal proceedings and the direction of the tribunal, the lawyer must withdraw from representing a client in any of the following circumstances:

- The client has discharged the lawyer, regardless of the reason the client has done so.
- The client has instructed the lawyer to do something inconsistent with the lawyer's duty to the tribunal and, following an explanation by the lawyer, the client persists in such instructions.
- The client is guilty of dishonourable conduct in the proceeding or is taking a position solely to harass or maliciously injure another.
- It becomes clear that the lawyer's continued employment will lead to a breach of the *Rules*.
- The lawyer is required to withdraw because of dishonesty, fraud, etc., by an organizational client, pursuant to rr. 2.02(5.1)–(5.2).
- The lawyer is not competent to handle the matter.

Depending on the circumstances, failure to withdraw in compliance with the *Rules* may be considered professional misconduct.

5. Manner of withdrawal — rr. 2.09(8)–(9) and commentary

When a lawyer withdraws from representing a client, for whatever reason, the lawyer is obligated to do all that can reasonably be done to assist in the smooth transfer of the matter to the successor legal practitioner (i.e., a lawyer licensed in Ontario or another Canadian jurisdiction or a licensed paralegal).

When a lawyer withdraws or is discharged by the client, the lawyer must

- deliver all papers and property to which the client is entitled to the client or as per the client's orders;
- give the client all information that may be required in connection with the case or matter;
- account for all funds of the client that the lawyer has or previously held, including the refund of moneys not earned by the lawyer during the representation;
- promptly render an account for outstanding fees and disbursements; and
- cooperate with the successor legal practitioner to minimize expense and avoid prejudice to the client.

The obligation to deliver papers and property to the client is subject to the lawyer's right of lien. Where the lawyer may be able to assert a solicitor's lien for unpaid fees and disbursements, the lawyer should consider the effect of its enforcement upon the client's position. The lawyer should not enforce the lien if to do so would prejudice materially the client's position in any uncompleted matter.

It should be noted that a lawyer's obligations do not change when withdrawal results because the lawyer is leaving a firm or because a law firm is dissolving. In such cases, most clients will prefer to continue the professional relationship with the lawyer that they considered to be in charge of their business before the departure or dismantling of the firm, regardless of where that lawyer continues to practice law. However, the final decision rests with the client, and the lawyers who are no longer retained by that client must comply with the manner-of-withdrawal obligations outlined above.

5.1 Confidentiality upon withdrawal — r. 2.03(1) and commentary

As mentioned previously in these materials, the duty of confidentiality continues indefinitely after the lawyer's relationship with the client ends, even if differences have arisen between them. Upon withdrawal, the lawyer must not disclose any information regarding the client obtained during the professional relationship unless the client consents or disclosure is mandated or justified according to r. 2.03 of the *Rules*. Accordingly, the lawyer must not reveal the reason for withdrawal to the successor legal practitioner, opposing parties, or court or tribunal.

5.2 Written confirmation

If a lawyer's services are terminated while the client's matter is ongoing and the client requests that the matter be transferred to a new legal practitioner, the lawyer should confirm in writing his or her withdrawal from representation. The lawyer should obtain a direction signed by the client for the transfer of the client file to the successor legal practitioner. If the file is to be delivered to

the client personally, the lawyer should obtain the client's written acknowledgement that the client has received the file from the lawyer. Where the client also requests copies of documents from the client file that belong to the lawyer (i.e., documents that came to exist during the retainer that the lawyer was under no duty to prepare or were not prepared for the client's benefit and for which the client was not liable to pay), the lawyer may choose to provide these and may discuss the cost of photocopying them directly with the client.

6. Duties of successor lawyer — r. 2.09(10) and commentary

A lawyer who is contacted by a prospective client who was represented by another lawyer or paralegal has obligations as the *successor lawyer*. Before accepting the retainer, the successor lawyer must ensure that the client's former legal representative has withdrawn, agrees to withdraw, or was discharged by the client. It may be appropriate for the successor lawyer to urge the client to settle any accounts outstanding to the former representative, especially if the former representative withdrew for good cause or was discharged arbitrarily. However, if a trial or hearing is approaching or in progress, or if the client would otherwise be prejudiced, an outstanding account should not interfere with the successor lawyer's representation of the client.

Chapter 11
Duty to others

Though the lawyer's first duty is to the client, lawyers have concurrent duties to others. These may be related to the administration of justice, to other individuals licensed by the Law Society of Upper Canada, to the legal professions at large, or to the Law Society itself.

1. Duty to the Law Society

Both lawyers and paralegals have the privilege of providing legal services to the public because they have met the Law Society's competence and professional responsibility requirements. In accepting a licence to practise law or provide legal services, they have also agreed to submit to the Law Society's authority to govern their conduct. Lawyers must fulfill certain duties to the Law Society so that it can effectively and efficiently carry out its mandate to govern the legal professions in the public interest. Much of the lawyer's duty to the Law Society focuses on measures to protect the public from inappropriate lawyer and paralegal conduct. The lawyer's duties to the Law Society include the obligation to

- respond promptly to the Law Society;
- assist the Law Society in preventing the unauthorized practise of law or provision of legal services;
- obtain the Law Society's permission to work with or employ a person who is no longer authorized to practise law or provide legal services;
- cease practising law when the lawyer's licence is suspended or otherwise restricted by the Law Society or via the lawyer's undertaking; and
- submit to the disciplinary authority of the Law Society.

1.1 Responding promptly — r. 6.02

Lawyers must reply promptly to all communications from the Law Society regardless of the topic. Failure to respond promptly to the Law Society is a breach of the *Rules of Professional Conduct* (*Rules*) and is grounds for disciplinary action by the Law Society. For example, a lawyer who fails to respond to a Law Society inquiry about a complaint may be disciplined by the Law Society for failure to respond promptly, regardless of the merits or outcome of the original complaint. Complying with this obligation is often less time consuming than dealing with the consequences of failing to respond, such as a discipline hearing.

1.2 Unauthorized practice of law or provision of legal services — r. 6.07(1) and commentary

Unlicensed individuals who claim to practise law or provide legal services are not subject to the Law Society's competence or professional responsibility requirements, which exist to protect the public. Though an unauthorized person may seem to have technical skill or ability, the client who hires such an individual has none of the safeguards available to the clients of regulated legal service providers, including

- options for assessing or reviewing a lawyer's or paralegal's accounts;
- rules regarding the protection of confidential client information;
- rules regarding the protection of client funds and property, including the operation of trust accounts;
- professional liability insurance requirements; and
- the requirement to finance and maintain a compensation fund for clients who have been victimized by dishonest lawyers or paralegals.

Lawyers have a duty to assist the Law Society to prevent the unauthorized practice of law and the unauthorized provision of legal services in order to protect the public interest. A lawyer who suspects an unauthorized individual is practising law or providing legal services is obliged to advise the Law Society. A lawyer is similarly obliged to advise the Law Society if the lawyer learns that a paralegal is providing legal services outside the permitted scope of practice (i.e., both authorized proceedings and accepted activities related to those proceedings) as outlined in By-Law 4, made under the *Law Society Act*. Such activities would also be considered the unauthorized practice of law or provision of legal services.

1.3 Working with or employing unauthorized persons — r. 6.07(2)

The protections mentioned above are also not available to clients and lawyers who become victims of former lawyers or paralegals who may be employed by a firm. For this reason, a lawyer shall not share space or associate with, hire, or use the services of a lawyer or paralegal who is no longer licensed by the Law Society unless a committee of Convocation expressly approves it.

The rule applies whether the individual gave up his or her licence or the licence was revoked or suspended by the

Law Society. The rule is broad and prevents lawyers from hiring a former or suspended lawyer or paralegal in any capacity. It is meant to protect both the public and the employing lawyer from harm that may be done by an individual who is no longer licensed to practise law or provide legal services to the public but may be tempted to do so while working at a firm.

Because there is a danger that such an employee may provide legal services to clients in breach of this rule, the lawyer's duty to prevent unauthorized practice or provision of legal services is closely linked to the obligation to supervise the lawyer's employees. If a lawyer is a sole practitioner or operates a satellite office, the lawyer must ensure that all matters requiring legal skill and judgment are handled by a lawyer or paralegal, as appropriate. When working with or employing a paralegal, the lawyer has the additional obligation to ensure that paralegal is providing services within the scope of permitted practice as outlined in By-Law 4.

1.4 Licence suspended or restricted, undertaking not to practice law — rr. 6.07(3)–(5); By-Law 7.1, Part II; and By-Law 9, Part II.1

A lawyer whose licence to practise law has been suspended or restricted by the Law Society or by an undertaking must refrain from providing legal services that the lawyer is no longer entitled to offer. Whether a lawyer has provided the Law Society an undertaking to limit the services he or she provides or has undertaken not to practise law at all, the lawyer must comply with the terms of the undertaking.

A lawyer who has been suspended or who has given the Law Society an undertaking must not

- practise law or provide legal services; or
- hold themselves out as someone who is entitled to practise law or provide legal services.

A lawyer whose licence has been suspended, regardless of the reason why, also has specific obligations to disclose the lawyer's suspended status to prospective, existing, and former clients and to engage another lawyer to complete certain tasks related to any existing client's file. There are additional obligations if the lawyer is holding client funds or property in trust, which are outlined in By-Law 9.

1.5 Disciplinary authority — rr. 1.02, 6.11, and commentary

The Law Society has the authority to regulate and discipline every lawyer, whether or not the lawyer is acting in a professional capacity and in whatever jurisdiction the lawyer's activities take place. A lawyer may be disciplined by the Law Society for either professional misconduct or conduct unbecoming a lawyer. Both are prohibited by s. 33 of the *Law Society Act*. While professional misconduct relates to actions the lawyer may take in the course of the lawyer's practice, conduct unbecoming relates to actions the lawyer may take in his or her personal life.

Professional misconduct is defined in the *Rules* as conduct by a lawyer in his or her professional capacity "that tends to bring discredit upon the legal profession" and includes

- violating or attempting to violate any of the *Rules* or a requirement of the *Law Society Act*, its regulations, or its by-laws;
- knowingly assisting or inducing another legal practitioner (i.e., a lawyer licensed in Ontario or another Canadian jurisdiction or a licensed paralegal) to violate or attempt to violate any of the *Rules*, the *Paralegal Rules of Conduct*, or a requirement of the *Law Society Act*, its regulations, or its by-laws;
- knowingly assisting or inducing a non-licensee (i.e. non-paralegal or non-lawyer) partner or associate of a multi-discipline practice to violate or attempt to violate any of the *Rules* or a requirement of the *Law Society Act*, its regulations, or its by-laws;
- misappropriating or otherwise dealing dishonestly with a client or third party's money or property;
- engaging in conduct that is prejudicial to the administration of justice;
- stating or implying an ability to improperly influence a government agency or official; and
- knowingly assisting a judge or judicial officer in conduct that is a violation of applicable rules of judicial conduct or other law.

Conduct unbecoming a lawyer or *conduct unbecoming a barrister or solicitor* is also defined in the *Rules*, and refers to conduct in a lawyer's personal or private capacity "that tends to bring discredit upon the legal profession." For example, this includes

- committing a criminal act that reflects adversely on the lawyer's honesty, trustworthiness, or fitness as a lawyer;
- taking improper advantage of the vulnerability, youth, inexperience, lack of education, unsophistication, ill health, or unbusinesslike habits of another; or
- engaging in conduct involving dishonesty or conduct that undermines the administration of justice.

Generally, where a lawyer's conduct in a private or personal capacity does not bring into question his or her professional integrity, the Law Society will not review the

conduct. However, if a client's awareness of a lawyer's conduct would be likely to impair the client's trust in the lawyer, the Law Society may be justified in taking disciplinary action whether the conduct occurred in the lawyer's professional or personal sphere.

2. Duty to the legal profession

Public confidence in the legal profession as a whole may be eroded by an individual lawyer's irresponsible conduct. Accordingly, a lawyer has an obligation to the profession to conduct himself or herself in a way that inspires the confidence, respect, and trust of clients and the community. Duties to the profession specifically outlined in the *Rules* include the lawyer's obligation to

- report lawyer or paralegal misconduct;
- encourage clients to report lawyer or paralegal misconduct;
- report criminal charges or convictions; and
- report errors and omissions.

2.1 Reporting misconduct — r. 6.01(3) and commentary

Detecting and preventing misconduct at an early stage reduces the risk to clients and prevents damage to the reputation of the legal profession. Lawyers must assist the Law Society to protect the public and the profession by reporting misconduct of a serious nature. Unless it would be unlawful to do so or it would require the lawyer to divulge confidential client information, a lawyer must report to the Law Society

- the inappropriate removal or use of moneys from trust by a lawyer or paralegal;
- the abandonment of a law practice by a lawyer or a legal services practice by a paralegal;
- involvement in serious criminal activity related to a lawyer's or paralegal's practice;
- the mental instability of a lawyer or paralegal that is of such a serious nature that clients are likely to be severely prejudiced; or
- any other situation where a lawyer's or paralegal's clients are likely to be severely prejudiced.

It should be noted that this rule does not require or permit a lawyer to reveal confidential client information and, therefore, does not interfere with the lawyer's duty of confidentiality to the client. The lawyer's purpose for reporting must be motivated by an honest intention to protect the public and the reputation of the profession. It must not be used against another member of the profession for malice, spite, or a desire to harm another, or for some other hidden inappropriate purpose.

The obligation to report misconduct applies to the lawyer's own conduct and that of other individuals licensed by the Law Society. A lawyer who fails to report such conduct to the Law Society when the lawyer is aware of it is in violation of this rule and may be subject to discipline. If a lawyer is unsure as to whether the lawyer must report certain conduct, the lawyer should consider seeking the advice of the Law Society. The lawyer may do so by contacting the Law Society's Practice Management Helpline either directly or indirectly (e.g., through another lawyer or a paralegal).

2.2 Encouraging client to report dishonest conduct — rr. 6.01(4)–(7)

If a lawyer's client has a claim against an apparently dishonest lawyer or paralegal, the lawyer must try to persuade the client to report the facts to the Law Society before seeking private remedies against that dishonest legal representative. The lawyer should inform the client of the Law Society's compensation fund for clients who are victims of dishonest lawyers or paralegals. If the client refuses to report to the Law Society and wishes to pursue private remedies, the lawyer must take each of the steps outlined below:

(1) Obtain the client's written instructions to proceed with the client's private remedies without notice to the Law Society.

(2) Inform the client of the provisions of the *Criminal Code* (s. 141), where the client may be guilty of an indictable offence if the client assists a dishonest lawyer or paralegal in concealing his or her indictable offence in return for valuable consideration (money, materials, or something else that can be valued in money's worth).

(3) If the client wishes to pursue a private agreement with the apparently dishonest lawyer or paralegal, withdraw from representation if the agreement results in a violation of the *Criminal Code*.

2.3 Reporting criminal charges or convictions — r. 6.01(8) and commentary

As outlined in s. 2 of By-Law 8, made under the *Law Society Act*, lawyers and paralegals also have a duty to report themselves to the Law Society if charges have been laid against them pursuant to the *Criminal Code*, the *Controlled Drugs and Substances Act*, or the *Income Tax Act* (Canada). Both lawyers and paralegals must send written notification to the Law Society to advise of a charge made against them alleging that they committed

- an indictable offence under the *Criminal Code*;
- an offence under the *Controlled Drugs and Substances Act*;

- an offence under the *Income Tax Act* or under an Act of the legislature of a province or territory of Canada in respect of the income tax law of that province or territory, where the charge explicitly or implicitly alleges dishonesty on the part of the lawyer or paralegal or relates in any way to that individual's professional business;
- an offence under an Act of the legislature of a province or territory of Canada in respect of the securities law of the province or territory, where the charge explicitly or implicitly alleges dishonesty on the part of the lawyer or paralegal or relates in any way to that individual's professional business; or
- an offence under another Act of Parliament or under another Act of the legislature of a province or territory of Canada, where the charge explicitly or implicitly alleges dishonesty on the part of the lawyer or paralegal or relates in any way to that individual's professional business.

An *indictable offence* excludes an offence for which an offender is punishable only by summary conviction but includes

- an offence for which an offender may be prosecuted only by indictment; and
- an offence for which an offender may be prosecuted by indictment or is punishable by summary conviction at the instance of the prosecution.

Lawyers must also inform the Law Society in writing of the decision and the final result of any charge mentioned above. The lawyer must report a charge as soon as it is reasonably possible after he or she receives notice of the charge and must report the outcome of a charge as soon as reasonably possible after receiving notice of the disposition.

If the offence is being pursued by private prosecution and the charge against the lawyer is under s. 504 of the *Criminal Code* and refers to information other than the information referred to in s. 507(1) of the *Criminal Code*, the lawyer is only required to inform the Law Society of the charge and of its outcome if the charge results in a finding of guilt or conviction.

It should be noted that the by-law requires lawyers to self-report the above criminal charges or convictions. A lawyer is only required to report another lawyer or paralegal involved in criminal activity if it is related to the latter's practice such that it may prejudice the latter's clients.

2.4 Reporting errors and omissions — r. 6.09 and commentary

As outlined previously in these materials, a lawyer who realizes that an error or omission has occurred has a duty to advise the client of the error or omission, to recommend that the client obtain independent legal advice regarding any claim that may arise from the error or omission, and to advise that the lawyer may no longer be able to act for the client. When a lawyer discovers an error or omission, the lawyer has additional duties to the liability insurer for the legal profession, the Lawyers' Professional Indemnity Company (LAWPRO). The lawyer must

- subject to r. 2.03 regarding confidentiality, promptly give notice of any circumstance that the lawyer may reasonably expect to give rise to a claim to an insurer or another indemnitor (so that the client's protection from that source will not be prejudiced);
- where a claim of professional negligence is made against the lawyer, assist and cooperate with the insurer or other indemnitor as necessary to enable the claim to be dealt with promptly;
- if the lawyer is not indemnified or not fully indemnified for a client's error or omission claim, deal with the claim swiftly and refrain from taking unfair advantage that would defeat or impair the client's claim;
- in cases where liability is clear and the insurer or other indemnitor is prepared to pay its portion of the claim, make arrangements to pay the remaining balance of the client's claim (including payment of the deductible under a professional liability insurance policy).

There may be occasions when a lawyer believes that he or she may be liable for damages to the client when no liability actually exists. The requirement to inform and cooperate with the insurer preserves the rights of the insurer but must not interfere with the lawyer's obligations to the client.

3. Duty to lawyers and others

Lawyers have duties to the individual lawyers, paralegals, other legal practitioners (e.g., lawyers licensed in Canada but outside of Ontario), and other individuals that they may deal with while practising law. The *Rules* outline the lawyer's obligations concerning

- courtesy and good faith;
- communications with others, generally;
- communications with represented persons or organizations and the provision of second opinions;
- undertakings and other professional promises; and
- financial obligations.

3.1 Courtesy and good faith — rr. 6.03(1)–(4) and commentary

Lawyers are obliged to be courteous and civil and to act in good faith with all persons with whom they have dealings in the course of their practice. Discourteous and

uncivil behaviour between lawyers and other legal practitioners lessens the public's respect for the profession and may impair the lawyer's ability to fully serve the client in an efficient manner.

The *Rules* set out the type of conduct that is prohibited. Lawyers who engage in this conduct violate the *Rules* and will be subject to the Law Society's review if a complaint is made. In the course of professional practice, lawyers must not

- engage in *sharp practice*, such as trying to gain advantage for themselves or for their clients by using dishonest or dishonourable means when dealing with other legal practitioners;
- take advantage of another legal practitioner's slip or mistake without fair warning (including those that are purely formal or technical in nature, do not go to the merits of the case, or do not involve a sacrifice of the client's rights);
- deny reasonable requests from other legal practitioners that will not prejudice the client's rights, such as those concerning trial dates, adjournments, or the exclusion of strictly formal procedures when not necessary;
- engage in unfounded criticism about the competence, conduct, advice, or charges of other legal practitioners unless the lawyer has given the matter careful and wise consideration and has clear evidence or information to support the lawyer's judgment; and
- use a recording device to record a conversation with a client or another legal practitioner without that person's prior knowledge, even if to do so is lawful.

3.2 Communications — rr. 6.03(5)–(6)

The obligation to behave with courtesy and civility when dealing with others also applies to any communications from the lawyer. In the course of professional practice, a lawyer shall not

- communicate via correspondence or otherwise with a client, another legal practitioner, or any other person in a manner that is abusive, offensive, or otherwise unprofessional;
- cause undue delay in responding to communications from or in fulfilling professional commitments to other legal practitioners.

3.3 Communications with represented person or organization, second opinions — rr. 6.03(7)–(9.2) and commentary

The *Rules* impose specific obligations on a lawyer who wishes to communicate with a represented person or organization. The lawyer must respect the relationship between the opposing party and his or her legal practitioner. Unless the legal practitioner representing a person in a matter consents, subject to r. 6.03(8) regarding second opinions, a lawyer shall not

- approach, communicate, or deal with the person on the matter; or
- attempt to negotiate or compromise the matter directly with the person.

The prohibition concerns communications with any person who is represented by a legal practitioner, whether or not the person is a party to the matter to which the communication relates, and applies where the lawyer knows or has substantial reason to believe that the person is represented in the matter to be discussed. A lawyer may communicate with a represented person about matters outside the representation, and this subrule does not prevent parties to a matter from communicating directly with each other.

A lawyer may provide a second legal opinion to a person represented by a legal practitioner in a matter. However, the obligation to render competent service requires that the opinion be based on sufficient information, which may include facts that can only be obtained through consultation with the first legal practitioner involved. The lawyer should advise the client if this is necessary and, unless the client instructs otherwise, should consult the first legal practitioner.

Lawyers face a similar restriction regarding communication with a represented corporation or other organization, such as partnerships or limited partnerships, associations, unions, unincorporated groups, government departments and agencies, tribunals, regulatory bodies, and sole proprietorships. The restriction applies whether the legal practitioner is employed by the organization in-house or has been retained separately to act in the particular matter.

Unless the legal practitioner representing an organization in a matter consents or a lawyer is otherwise authorized or required by law, a lawyer shall not communicate, facilitate communication, or deal with any person

- who is a director or officer or is authorized to act on behalf of the corporation or organization;
- who is likely involved in decision-making for the corporation or organization or provides advice in relation to the particular matter;
- whose act or omission may be binding or imputed to the corporation or organization for the purposes of its liability; or
- who supervises, directs, or regularly consults with the legal practitioner and makes decisions based on the legal practitioner's advice.

Where a person described above is individually represented in the matter by a legal practitioner, that legal practitioner's consent to the communication is sufficient if the communication is about the individual's personal interests. However, where the legal representation is only with respect to the personal interests of the individual and the intended communication concerns the interests of the corporation or organization, consent of the corporation's or organization's legal practitioner would be required. A lawyer may communicate directly with such individuals about matters that are outside the representation and may communicate with any person not actively involved in the matter. The commentary clarifies the rule and provides examples as they relate to the context of unions, governments, and municipalities.

Where a lawyer representing a corporation or other organization has also been retained to represent its employees, the lawyer must comply with the *Rules* as they apply to avoiding conflicts of interest (r. 2.04) and joint retainers. However, unless the lawyer complies with the requirements of r. 2.04, a lawyer must not imply that the lawyer acts for an employee of a client and must not be retained by an employee solely for the purpose of sheltering factual information from another party.

3.4 Undertakings — r. 6.03(10) and commentary

Unless clearly qualified, a lawyer's undertaking is his or her personal promise and responsibility. Lawyers must fulfill every undertaking given in a timely manner and shall not give an undertaking that cannot be fulfilled. This also applies to any professional or practice-related promises the lawyer may give. The person who accepts a lawyer's undertaking or promise is entitled to expect that lawyer to personally carry it out. Using the phrase "on behalf of my client" even in the undertaking itself may not release a lawyer from the obligation to honour it. If a lawyer does not intend to take personal responsibility, this should be clearly stated in the undertaking or promise provided.

All undertakings and other practice-related promises should be written or confirmed in writing as soon as possible and should be unambiguous in their terms, including a time period for fulfillment. It may be appropriate to provide for contingencies (e.g., if the obligations in the undertaking rely on certain events occurring, indicate what will happen if these events do not occur), and before accepting an undertaking or promise, the lawyer should confirm that the individual providing it is a lawyer or paralegal.

Lawyers who act in real estate transactions using the system for the electronic registration of title documents (e-reg™) are required to sign (with client consent) and be bound by a Document Registration Agreement (DRA). The DRA will contain undertakings that, accordingly, become the lawyer's professional responsibility to fulfill upon the lawyer's signature of the DRA.

It should be noted that a court or a tribunal may enforce a lawyer's undertaking or other professional promise. The lawyer may be brought before a court or tribunal to explain why the undertaking was breached and ordered to take steps to satisfy the undertaking or pay damages caused by the breach. The Law Society may also discipline a lawyer for breach of an undertaking or other practice-related promise, which may result in a finding of professional misconduct.

3.5 Financial obligations — r. 6.01(2) and commentary

Unless it was otherwise documented in writing beforehand, lawyers must promptly meet all financial obligations incurred on behalf of clients during the course of practice. This is a professional duty that is separate from any legal liability and includes the responsibility to make payments to third parties that the lawyer assumed or undertook on the client's behalf.

4. Duty to uphold the integrity of the profession — r. 6.01(1)

As explained previously in these materials, lawyers have a duty to practise law and fulfill their professional responsibilities to others with honour and integrity. Upholding the integrity of the profession is especially important when a lawyer becomes involved in activities whereby there may be further scrutiny of the lawyer's conduct, professional or otherwise. The duty to uphold the integrity of the profession applies when the lawyer engages in activities related to

- outside interests;
- public office;
- public appearances and statements; and
- multi-discipline practices.

4.1 Outside interests — r. 6.04 and commentary

A lawyer must not allow activities that are unrelated to the practice of law interfere with his or her obligations under the *Rules*. A lawyer engaged or involved in outside interests while concurrently practising law must not allow that outside interest to

- jeopardize the lawyer's professional integrity, independence, or competence; and

- impair the exercise of the lawyer's independent judgment on behalf of a client.

The term *outside interest* covers the widest possible range of activities and includes those that may overlap with the practice of law, such as engaging in the mortgage business or writing on legal subjects, as well as activities that have no connection to a lawyer's practice. Where the outside interest is not related to the legal services being performed for clients, ethical considerations will usually not arise unless the lawyer's conduct might bring the lawyer or the profession into disrepute or impair the lawyer's competence.

4.2 Public office — r. 6.05

Whether or not the office was attained because of professional qualifications, a lawyer who is elected or appointed to a legislative or administrative office at any level of government has a duty to uphold the integrity of the profession because he or she is in the public eye. Generally, a lawyer in public office must properly discharge all official duties while adhering to the same standards of conduct as the *Rules* require of lawyers practising law. Specifically, the *Rules* outline the lawyer's responsibilities while in and after leaving public office, which include the obligation to

- maintain confidential information acquired by virtue of the office;
- exercise the lawyer's independent judgment, free of any influence;
- avoid conflicts of interest that relate to official duties or to issues that arose while in office;
- declare any conflicts and abstain from consideration, discussion, or vote on related issues;
- decline private legal business where the duty to the client will or may conflict with official duties;
- withdraw from private representation where a conflict develops that interferes with official duties; and
- refrain from appearing professionally before a public body of which the lawyer or the lawyer's partners or associates are a member.

Though the Law Society may not be concerned with the way in which a lawyer holding public office carries out official responsibilities, conduct in office that reflects adversely upon the lawyer's integrity or professional competence may be the subject of disciplinary action.

4.3 Public appearances and statements — r. 6.06

Lawyers may communicate with the media and may make public appearances or statements as long as there is no violation of the lawyer's duty to

- maintain confidential client information;
- uphold the integrity of the profession;
- promote courtesy and respect for the courts; and
- support and improve the administration of justice.

However, a lawyer is prohibited from making any public statements about a matter that is before a tribunal if the lawyer knows or should know that making such statements are likely to prejudice any party's right to a fair hearing. This includes opposing or related parties, in addition to the lawyer's client. When making statements to the public or the media, lawyers should avoid petty or unsupported criticism of fellow lawyers, paralegals, other legal practitioners, the tribunal, or the justice system.

Before making a statement to the public or the media, the lawyer must be satisfied that doing so is in the client's best interests and is within the scope of the lawyer's retainer with the client. A lawyer should not use public communications about a client's affairs for self-promotion, and the lawyer should be aware that he or she will normally have no control over any editing or the context in which any statement to the media is ultimately used.

4.4 Multi-discipline practices — r. 6.10

Where a lawyer has chosen to associate or partner with one or more non-legal professionals to serve clients through a multi-discipline practice (MDP), that lawyer must ensure that non-licensee partners and associates comply with the *Rules* and all ethical principles that govern a lawyer in the discharge of the lawyer's professional obligations. This includes the duty to uphold the integrity of the profession and, as previously discussed in these materials, the obligation to avoid conflicts of interest.

5. Duty to the administration of justice

Admission to and continuance in the practice of law implies on the part of the lawyer a basic commitment to the concept of equal justice for all within an open, ordered, and impartial system. Because of this, the lawyer's responsibilities to the justice system, its processes, and its participants, are greater than those of a private citizen. As detailed both in RR. 4 and 6 of the *Rules*, the lawyer's general duty to the administration of justice includes the obligations to

- encourage respect for the administration of justice;
- disclose the interest being advanced when seeking legislative or administrative change;
- maintain the security of court facilities;
- remain neutral and supportive to all parties involved when acting as a mediator; and

- preserve impartiality of the justice system when returning to the practice of law from the bench.

5.1 Encouraging respect for the administration of justice — r. 4.06(1) and commentary

Lawyers must encourage public respect for the justice system and take steps to try to improve it. Lawyers must avoid making careless remarks or complaints about the system since they may weaken or destroy public confidence in legal institutions or authorities. Lawyers should take care when commenting on judges or members of a tribunal since they are often restricted by law or by custom from defending themselves. Lawyers should be available to advise and represent a client in a complaint involving another lawyer or paralegal but should avoid making critical remarks about the competence, conduct, advice, or charges of other paralegals or lawyers without first learning all the facts.

5.2 Seeking legislative or administrative change — r. 4.06(2) and commentary

Because of training, opportunity, and experience, lawyers are in a position to observe the workings and discover the strengths and weaknesses of laws, legal institutions, and public authorities. Lawyers should lead the search for improvements in the legal system, but any criticisms and proposals should be *bona fide* and reasoned. A lawyer seeking legislative or administrative changes shall disclose the interest being advanced, whether the lawyer's interest, the client's interest, or the public interest.

5.3 Security of court facilities — r. 4.06(3) and commentary

The justice system cannot function effectively if its participants cannot safely attend court facilities. If a lawyer reasonably believes that a dangerous situation is likely to arise at a court facility, the lawyer must take action by informing the police of the details. Where appropriate, the lawyer should consider requesting added security at the facility and notifying other lawyers or paralegals that may be affected. As outlined previously in these materials, lawyers are not permitted to disclose confidential client information unless they are permitted or justified to do so in accordance with r. 2.03 of the *Rules*.

5.4 Acting as mediator — r. 4.07 and commentary

A lawyer who acts as a mediator must remain neutral to ensure that the mediation process is unbiased and serves the administration of justice. When acting as mediator, the lawyer is not acting for any party in the mediation, and the relationship between the parties and the lawyer is not a lawyer-client relationship. The lawyer must ensure that parties understand the role of the mediator is to facilitate agreement between the parties and that communications are not covered by confidentiality or lawyer-client privilege (though some other common-law privilege may apply).

Generally, a lawyer-mediator should suggest and encourage the parties to seek the advice of separate counsel before and during the mediation process if they have not already done so. Neither the lawyer nor the lawyer's partners or associates should provide legal advice to the parties, and where the lawyer prepares a draft contract for review by the parties, the lawyer should advise and encourage the parties to seek separate independent legal representation concerning the draft contract.

5.5 Retired judges returning to practice — r. 6.08

To preserve the impartiality of the justice system and its image as such, the *Rules* provide specific guidance for former judges and appellate judges who wish to return to the practice of law. Unless the former judge or appellate judge has obtained the express approval of a committee of Convocation appointed for that purpose,

- a former appellate judge is prohibited from appearing as counsel or advocate in any court, in chambers, or before any administrative board or tribunal; and
- a former judge is prohibited from appearing as counsel or advocate before the court on which the former judge served, any lower court, or any administrative board or tribunal over which the court on which the former judge served exercised an appellate or judicial review jurisdiction for two years after leaving the bench

In both cases, such approval may only be granted under exceptional circumstances and may be restricted.

Chapter 12
Advocacy

Rule 4 of the *Rules of Professional Conduct* (*Rules*) outlines the lawyer's professional responsibilities when acting on behalf of the client as the client's advocate. As advocates, lawyers may be required to appear in court, before boards, and in front of administrative tribunals, arbitrators, or mediators. The obligations set out in the *Rules* apply regardless of how informal the proceeding may be. When acting as advocate, lawyers must balance their duties to the client with their duties to the tribunal and to the administration of justice.

1. Lawyer as advocate — rr. 4.01(1), (5)–(7), and commentaries

When acting as an advocate, the lawyer must represent the client resolutely and honourably within the limits of the law while treating the tribunal with candour, fairness, courtesy, and respect. A lawyer has the duty to

- raise every issue, advance every argument, and ask every question that the lawyer thinks will help the client's case, however distasteful;
- endeavour to obtain for the client the benefit of every remedy and defence authorized by law;
- never waive or abandon a client's legal rights without the client's informed consent;
- avoid and discourage the client from resorting to frivolous or vexatious objections;
- avoid and discourage the client from attempts to gain advantage from mistakes or oversights made by the opposing side that do not go to the merits of the case; and
- avoid and discourage the client from using a strategy designed only to delay or harass the opposing side.

As advocate, the lawyer will provide advice and opinions to the client and may make submissions to a tribunal regarding the client's matter. A lawyer may express his or her professional opinions but should avoid expressing personal views on the merits of their client's case. The lawyer must ensure that the client matter remains the client's matter and does not become the lawyer's personal cause.

The *Rules* also specify the lawyer's obligations to disclose errors or omissions, to act with courtesy, and to fulfill all undertakings since they relate to his or her role as advocate.

1.1 Duty as defence counsel — commentary, r. 4.01(1)

The lawyer's duty when defending an accused person is to shelter the client from being convicted of an offence except by a tribunal of competent jurisdiction and upon legal evidence sufficient to support a conviction for that offence. Generally, defence counsel may put forward any defence not known to be false or fraudulent. If the client has admitted to the lawyer the elements necessary to constitute the offence, those admissions limit the lawyer because the lawyer may only put forward a defence that is consistent with the client's admissions. Lawyers who advocate for the accused should discuss this limitation with every client.

1.2 Duty as prosecutor — r. 4.01(3) and commentary

When engaged as a prosecutor, the lawyer is effectively an advocate for the public and the administration of justice. The prosecutor's prime duty is to not to seek a conviction but to see that justice is done through a fair trial on the merits. Because a prosecutor exercises a public function with substantial discretion and power, a prosecutor must act and treat the accused fairly and dispassionately.

2. Lawyer and the tribunal process

Despite a lawyer's duty to the client, a lawyer is limited as to what the lawyer may do to advocate the client's cause before a tribunal. Generally, the lawyer shall not

- abuse the tribunal process;
- mislead the tribunal;
- influence the tribunal;
- engage in dishonest conduct; and
- mistreat or influence witnesses.

The lawyer is also obligated to prevent anyone else from trying to do any of the above, including the lawyer's own client. The lawyer should remember that inappropriate behaviour before a tribunal or judge may result in discipline by the Law Society of Upper Canada, even in cases where the tribunal member or judge says nothing to the lawyer about the conduct.

2.1 Shall not abuse the tribunal process — rr. 2.02(2), (4), 4.01(2)(a), and (l)

Though a proceeding itself may be legal, a lawyer is not permitted to begin or continue a "useless proceeding" or

a proceeding motivated only by malice to injure another. A lawyer should not assist a client to bring a claim that the lawyer believes has no merit since such claims waste the time of the tribunal and its officers and do not further the cause of justice.

A lawyer is also not permitted to threaten to lay criminal charges against someone or offer to have criminal charges withdrawn in an attempt to gain an advantage for a complainant. As explained earlier in these materials, a lawyer is similarly prohibited from threatening criminal or quasi-criminal prosecution in order to secure a civil advantage for the client. Both would be considered an abuse of the tribunal process.

2.2 Shall not mislead the tribunal — rr. 4.01(2)(e)–(f) and (h)

For the tribunal to effectively review and decide upon a matter, the tribunal must have access to all that is relevant to the issues before them for a decision. A lawyer must not

- mislead the tribunal by providing misinformation about an issue, fact, or law;
- allow the tribunal to be misled by others; or
- allow the tribunal to mislead itself by not taking steps to correct any misunderstanding it may have about any aspect of the matter.

The lawyer must not offer false evidence or affidavits that contain statements that are untrue, misleading, or incomplete. The lawyer must not misstate the facts or the law and must disclose all that is required by law and according to the applicable rules of procedure. Though it is not the advocate's responsibility to assist the opposing side when before a tribunal, the lawyer must not deliberately avoid informing the tribunal of any binding authority that may be directly relevant to the matter.

2.3 Shall not influence the tribunal — rr. 4.01(2)(c)–(d)

For the justice system to function effectively, members of tribunals and courts must be fair and objective. To ensure independence and impartiality, there should be no personal connection between a tribunal member or judge and any of the parties in the proceeding or their legal representatives.

A lawyer is prohibited from appearing before a tribunal member or judge if that tribunal member or judge has or may seem to have an outside relationship with the lawyer, the lawyer's firm, or the client. This outside relationship may be a personal or business one. The lawyer must declare any outside relationship that exists and advise the tribunal member or judge that the lawyer is precluded by the *Rules* from appearing before him or her. If the tribunal member or judge does not recuse himself or herself from presiding over the matter or allow an adjournment to permit a new legal representative to act for the client, the lawyer would be in breach of the *Rules* and may be forced to withdraw.

Lawyers must also ensure that no one else directly or indirectly influences the tribunal's decisions. The only appropriate way to influence the tribunal's decision is through open persuasion as an advocate.

2.4 Shall not engage in dishonest conduct — rr. 4.01(2)(b), (e), and (g)

A lawyer must treat the tribunal and its officers with honesty and candour. A lawyer is prohibited from misstating the contents of a document, a client's testimony, an argument, or a statutory provision. A lawyer must not assist anyone to engage in fraud, dishonesty, or illegal conduct and must withdraw from representing a client who insists that the lawyer engage in or continue in this type of conduct.

Where the client in a criminal matter has admitted to the lawyer the elements of the offence with which the client is charged, the lawyer must not present a defence that contradicts the facts since it would mislead the court. For example, during the examination of a witness or in making submissions or arguments, a lawyer cannot suggest that someone else committed the offence. In this circumstance, the lawyer may only argue that the evidence given by each witness, as a whole, is not enough to prove that the client is guilty.

2.5 Shall not mistreat or influence witnesses — rr. 4.01(2)(i)–(k), (m), and 4.03

When acting as an advocate, a lawyer may contact all possible witnesses for both sides, but the lawyer must be fair and honest when dealing with them. The lawyer must disclose his or her interest and must ensure that no evidence is suppressed and no witness is dissuaded from testifying. A lawyer is prohibited from deliberately allowing a witness or a party to be presented to a tribunal in a false or misleading way, which would include allowing a witness to impersonate another individual. Lawyers must not abuse, harass, or inconvenience witnesses before or at the hearing.

3. Lawyer dealing with witnesses

Witness testimony is an important part of the tribunal process. Witnesses do not "belong" to either party in a proceeding since the evidence that a witness provides to the tribunal may support either side of a case. Though the lawyer is free to speak with any potential witness after disclosing the lawyer's interest, a witness does not

have to speak to the lawyer. The lawyer's duties when dealing with witnesses, outlined below, apply to all witnesses.

3.1 Interviewing witnesses — r. 4.03

As advocate, the lawyer should interview and prepare all possible witnesses. When speaking to a witness who may support the client's cause, the lawyer must ensure that he or she is only preparing a witness and not influencing the witness. A lawyer may help prepare a witness by discussing with the witness

- suitable dress for the hearing or court appearance;
- the need to be respectful and courteous in behaviour and tone;
- appropriate ways to address the judge or tribunal officer, lawyers, paralegals, and other parties;
- the need to listen to each question posed and to answer truthfully; and
- how to give evidence in a clear and straightforward manner.

As previously discussed, a lawyer is prohibited from mistreating or influencing a witness regarding the witness's testimony or participation in a proceeding. The lawyer also has special obligations with respect to interviewing a witness who is represented by his or her own legal practitioner.

3.2 Interviewing represented persons — rr. 4.03, 6.03(7)–(9.2), and commentary

As outlined in the previous chapter, lawyers are not permitted to deal with or approach any represented person except through or with the consent of that person's legal practitioner. This prohibition applies to any person related to the matter with whom the lawyer wishes to discuss and includes non-parties, such as a potential witness. The rule applies where the lawyer knows or should know that the person is represented by a lawyer, a paralegal, or a lawyer from a Canadian jurisdiction outside of Ontario, and a similar rule applies to represented organizations and their employees, agents, and other relevant persons.

3.3 Communication with witnesses giving evidence — r. 4.04

To ensure that a lawyer does not influence a witness who is giving testimony, the lawyer's ability to speak with a witness during a proceeding is limited. The lawyer must comply with the *Rules* unless the judge or tribunal allows or instructs the lawyer to do otherwise. To comply, lawyers must consider both

- the stage of a witness's testimony; and
- whether the evidence the witness is providing is sympathetic to one party in the proceeding.

3.3.1 Stage of witness's testimony

To decide whether the lawyer may communicate with a witness, the lawyer must determine the stage of the witness's testimony. Different considerations apply whether the lawyer intends to speak to the witness

- during the *examination-in-chief*, where the lawyer examines his or her own witness on behalf of the client;
- after the completed *examination-in-chief* by the lawyer but before *cross-examination* by the opposing legal practitioner;
- during *cross-examination*, where the opposing legal practitioner cross-examines the lawyer's witness;
- after the completed *cross-examination* by the opposing legal practitioner but before *re-examination* by the lawyer; or
- during *re-examination*, where the lawyer re-examines his or her own witness after that witness has been cross-examined by the opposing legal practitioner.

3.3.2 Sympathetic and unsympathetic witnesses

Either party may call witnesses to provide evidence that supports one side in the proceeding or to provide facts that are not in dispute. *Sympathetic* witnesses are witnesses whose testimony supports the cause of the lawyer's client. Witnesses are *unsympathetic* if their testimony supports the opposing party's case.

Usually, a lawyer will prefer to only call witnesses sympathetic to the client's cause and to decline to call unsympathetic witnesses. Because a witness may refuse to speak with the opposing side, it may be difficult to know what the witness's testimony will be. Consequently, it is possible that a lawyer may call a witness whose testimony does not support the lawyer's client or that a witness may be called by the opposing side that supports the lawyer's client. Lawyers may be faced with examining their own unsympathetic witnesses, or they may have to cross-examine sympathetic witnesses called by the opposing side. To determine whether the lawyer can communicate with a witness, in addition to the stage of the witness's testimony, the lawyer must consider whether the witness is sympathetic or unsympathetic to the client's case.

Generally, if the lawyer is dealing with a sympathetic witness,

- during the examination-in-chief, the lawyer may only discuss with his or her witness anything that

has not yet been mentioned in the witness's testimony (r. 4.04(a));

- after completion of the lawyer's examination-in-chief and before the opposing side's cross-examination of the lawyer's witness, the lawyer should not discuss with the witness any evidence mentioned during the examination-in-chief (r. 4.04(c));
- during the opposing side's cross-examination of the lawyer's witness, the lawyer cannot discuss with his or her witness any evidence or issues in the proceeding (r. 4.04(d));
- during the lawyer's cross-examination of the opposing side's witness (sympathetic to the lawyer's case), the lawyer may only discuss with the witness anything that has not yet been mentioned in the witness's testimony (r. 4.04(g));
- after completion of the opposing side's cross-examination but before the lawyer's re-examination of the lawyer's witness, the lawyer cannot discuss with the witness any evidence that will be dealt with during re-examination (r. 4.04(e)); and
- during the opposing side's re-examination of its own witness (sympathetic to the lawyer's case), the lawyer cannot discuss with that witness any evidence to be given during re-examination (r. 4.04(h)).

When the lawyer is dealing with a witness who is <u>not</u> sympathetic to the client's case

- during the opposing side's examination-in-chief of its own witness, the lawyer may discuss the witness's evidence with the witness (r. 4.04(1)(b))
- during the lawyer's cross-examination of the opposing side's witness, the lawyer may discuss the witness's evidence with the witness (r. 4.04(f)); and
- during the opposing side's re-examination of its own witness, the lawyer may discuss with that witness any evidence to be given during re-examination (r. 4.04(h)).

If the lawyer is unsure whether he or she may speak with a witness under this rule, the lawyer should obtain the consent of the opposing legal practitioner or leave of the tribunal to speak with the witness before actually doing so. This rule also applies to examinations out of court (e.g., cross-examinations on an affidavit), with some necessary modifications.

Though the *Rules* allow the lawyer to discuss limited topics with a witness who is giving testimony during the various stages of the proceeding before the tribunal, a lawyer may choose to avoid communicating with such witnesses altogether. Though not required, it may help the lawyer to avoid confusion or impropriety when communicating with witnesses who are giving testimony. The lawyer should consider implementing this policy when in doubt or as a best practice. The following chart summarizes the lawyer's obligations.

The following chart summarizes the lawyer's obligations.

	Witness Sympathetic to A	**Witness Unsympathetic to A**
During examination-in-chief	Witness called by Lawyer A: Lawyer A may discuss anything not yet covered in the examination (r. 4.04(a))	Witness called by Lawyer A: Lawyer A may discuss anything not yet covered in the examination (r. 4.04(a))
	*Witness called by Lawyer B: Nothing in the *Rules* prohibits or limits Lawyer A's discussion with the witness	Witness called by Lawyer B: Lawyer A may discuss any of the witness's evidence (r. 4.04(b))
After examination-in-chief but before cross-examination	Witness called by Lawyer A: Lawyer A should not discuss any evidence mentioned by the witness during the examination-in-chief (r. 4.04(c))	Witness called by Lawyer A: Lawyer A should not discuss any evidence mentioned by the witness during the examination-in-chief (r. 4.04(c))
	*Witness called by Lawyer B: Nothing in the *Rules* prohibits or limits Lawyer A's discussion with the witness	*Witness called by Lawyer B: Nothing in the *Rules* prohibits or limits Lawyer A's discussion with the witness
During cross-examination	Witness called by Lawyer A: Lawyer A should not discuss any of the witness's evidence or any issue in the proceeding (r. 4.04(d))	Witness called by Lawyer A: Lawyer A should not discuss any of the witness's evidence or any issue in the proceeding (r. 4.04(d))
	Witness called by Lawyer B: Lawyer A may discuss anything not yet covered by the cross-examination (r. 4.04(g))	Witness called by Lawyer B: Lawyer A may discuss any of the witness's evidence (r. 4.04(f))
After cross-examination but before re-examination	Witness called by Lawyer A: Lawyer A should not discuss any of the witness's evidence to be dealt with during re-examination (r. 4.04(e))	Witness called by Lawyer A: Lawyer A should not discuss any of the witness's evidence to be dealt with during re-examination (r. 4.04(e))
	*Witness called by Lawyer B: Nothing in the *Rules* prohibits or limits Lawyer A's discussion with the witness	*Witness called by Lawyer B: Nothing in the *Rules* prohibits or limits Lawyer A's discussion with the witness
During re-examination	*Witness called by Lawyer A: Nothing in the *Rules* prohibits or limits Lawyer A's discussion with the witness, but Lawyer A may be guided by r. 4.04(a) (Lawyer A may discuss anything not yet covered in the examination)	*Witness called by Lawyer A: Nothing in the *Rules* prohibits or limits Lawyer A's discussion with the witness, but Lawyer A may be guided by r. 4.04(a) (Lawyer A may discuss anything not yet covered in the examination)
	Witness called by Lawyer B: Lawyer A should not discuss any of the witness's evidence to be dealt with during re-examination (r. 4.04(h))	Witness called by Lawyer B: Lawyer A may discuss any of the witness's evidence (r. 4.04(h))

4. Relations with jurors

The role of the jury is an important one in the administration of justice. To ensure that any jury trial proceeds free of actual or suggested influence and that justice is served, jurors and prospective jurors are forbidden to discuss with anyone the case on which they are or may be sitting upon. As officers of the court, lawyers must not allow or tempt a juror to violate this obligation and must inform the court and the opposing side if they discover improper conduct by a member of the jury.

4.1 Communications with jurors — rr. 4.05(1), (4)–(5), and commentaries

A lawyer connected to a case for which a jury will or has been called is prohibited from communicating with or causing another to communicate with anyone the lawyer knows to be a potential or actual jury member, both before and during trial. Though a lawyer may investigate a prospective or actual juror to ascertain any basis for challenge or removal, there must be no direct contact between the lawyer and the juror or any of the juror's family members. A lawyer who is not connected to a case before the court is also prohibited from communicating with any juror about the case the lawyer is involved in.

4.2 Disclosure of information — r. 4.05(2)–(3)

Unless the judge and opposing counsel have been previously informed, a lawyer shall disclose to them that he or she is aware that a juror or prospective juror

- has or may have a direct or indirect interest in the outcome of the case;
- is acquainted with or connected in any way to the presiding judge, any counsel, or any litigant; or
- is acquainted with or connected in any way to any person who has appeared or is expected to appear as a witness in the matter.

A lawyer is also obligated to promptly notify the court of any information the lawyer has about improper conduct by a juror or a member of a jury panel toward another member of the jury panel, another juror, or a juror's family member.

5. Lawyer as witness — r. 4.02

As advocate, the lawyer's role is to further the client's cause within the limits of the law. The role of the witness is to give evidence of facts that may or may not assist in furthering the case of any of the parties to a proceeding. Because these roles are different, a person may not be able to carry out the functions of both advocate and witness at the same time. Therefore, the *Rules* do not permit a lawyer to represent a client in a matter and appear as witness in that same matter.

Subject to any legal requirements or the direction or order of the tribunal, a lawyer who appears as advocate

- shall not submit the lawyer's own affidavit to the tribunal;
- shall not testify before the tribunal unless permitted to do so by the procedural rules of the court or tribunal, or unless the matter is purely formal or is unchallenged (e.g., the matter must not deal with the legal rights or obligations of the parties or the parties must have agreed on all issues of the matter); or
- should not appear as an unsworn witness by expressing personal opinions or stating as fact anything that is subject to legal proof, cross-examination, or challenge.

If the lawyer becomes a necessary witness and must testify in the matter, the lawyer should cease to be advocate and withdraw from representing the client, entrusting the conduct of the case to another lawyer. A lawyer appearing as a witness should be prepared to be cross-examined and have testimony challenged as might occur with any other witness. A lawyer who has appeared as witness in a proceeding is further prohibited from acting as advocate in the appeal of any decision from that proceeding.

6. Discovery obligations — r. 4.01(4)

Where the rules of the tribunal require parties to produce documents or to provide information through an examination for discovery, a lawyer acting as advocate must

- explain to the client the need to make full disclosure (i.e., produce all documents and answer any proper question to the best of his or her ability);
- assist the client to fulfill his or her obligation to make full disclosure; and
- refrain from making frivolous demands for the production of documents or information.

Lawyers must not use the process of disclosure to wear down the opposing side. A lawyer must take care when dealing with a client who instructs the lawyer to take steps to make the process longer and more complicated than necessary to injure the other side since such instructions conflict with the lawyer's duty as an advocate. If the client insists that the lawyer follow those instructions after the lawyer has explained the purpose of the disclosure process to the client, the lawyer must take steps to withdraw in compliance with r. 2.09 of the *Rules*.

7. Agreement on guilty plea — r. 4.01(8)–(9)

As an advocate for a person accused in a criminal matter, a lawyer may discuss with the prosecutor how to resolve the case, unless the client has instructed the lawyer not to do so. Before entering into any agreement with the prosecutor regarding the plea, the lawyer must first

- advise the client about the prospects of acquittal or finding of guilt (i.e., explain the client's chances of being found guilty if the case were to go to trial); and
- explain how a guilty plea may affect the client's life (e.g., what effect the conviction following the guilty plea will have on the client's employment prospects or ability to travel outside the country).

The lawyer must inform the client that the court is not bound by any agreement on a guilty plea. The judge may ignore the agreement, refuse to accept the client's guilty plea, and order that the client proceed to trial. The judge may also impose a sentence on the client that is different than the terms of the plea agreement.

If the client wishes to enter into an agreement regarding a guilty plea, after the lawyer has properly informed the client as required by the *Rules*, the lawyer must ensure that the client voluntarily

- admits the factual and mental elements of the offence charged (i.e., admits that all the facts that make up the offence exist, are true, or happened and admits that he or she intended to and did commit the crime); and
- instructs the lawyer to enter into an agreement as to a guilty plea.

The lawyer should obtain the client's admission and instructions regarding the guilty plea agreement in writing before entering into a guilty plea.

The lawyer cannot assist the client with a guilty plea regarding a charge if the client denies involvement but hopes to obtain a lesser sentence by entering into a guilty plea. This rule applies even where the client believes that he or she will be convicted. In a case like this, the best the lawyer can do is to review the Crown's case with the client, explore why the client feels that conviction is inevitable, and tell the client that the lawyer cannot assist them in entering into an agreement as to a guilty plea.

Chapter 13
Practice management

Operating a successful law practice requires more than the skill and ability to provide advice, opinions, and services regarding the law. Running an effective practice means managing all of the responsibilities associated with that practice to properly serve the client. In addition to managing the client relationship, which is discussed elsewhere in these materials, the lawyer must address how he or she will

- make legal services available to the public;
- manage the files, time, and technology of the practice;
- manage financial responsibilities;
- manage supervisory responsibilities; and
- manage the administrative and business aspects of the practice.

Though the primary benefit is to ensure that the client is adequately served, proper practice management also allows a lawyer to manage or reduce the risks of claims. Because r. 2.01(1)(i) of the *Rules of Professional Conduct* (*Rules*) require a lawyer to manage his or her practice effectively, proper practice management is also a professional responsibility.

1. Permitted business structures and practice arrangements — By-Law 7

Because some of the practice management obligations contained in the *Rules* relate to the firm structure or arrangement, lawyers should be aware of the business structures or practice arrangements available to lawyers under the *Law Society Act* and its by-laws. In addition to an interprovincial law firm that carries on the practice of law in more than one province or territory of Canada, lawyers are permitted to practise law through a

- sole practice or sole proprietorship;
- general partnership under the *Partnerships Act*;
- limited liability partnership (LLP) under the *Partnerships Act*; and
- professional corporation under the *Business Corporations Act*.

The Law Society of Upper Canada also recognizes two practice arrangements that involve professionals who are neither lawyers nor paralegals: multi-discipline practices (MDPs) or multi-discipline partnerships, and affiliations. The specific Law Society requirements for these business entities are contained in By-Law 7.

2. Making legal services available — r. 3.01

Lawyers who offer legal services must do so in a way that is efficient and convenient for the public. Lawyers may offer their services by any method; however, the means shall not

- be false or misleading;
- amount to coercion, duress, or harassment;
- take advantage of a person who is vulnerable or who has suffered a traumatic experience and has not yet had a chance to recover;
- be intended to influence a person who has retained another lawyer or paralegal for a particular matter to change the legal representative for that matter unless the change is initiated by the client or the existing legal representative; or
- otherwise bring the profession or the administration of justice into disrepute.

Lawyers must ensure that they do not misrepresent the nature of their practice to prospective clients and the public at large. In presenting and promoting a law practice, the lawyer must comply with the *Rules* relating to the marketing of legal services (in any medium) and the advertising of fees for those services. The *Rules* are in place to ensure that lawyers do not mislead clients or the public, while still permitting lawyers to differentiate themselves and their services from those of other lawyers and law firms.

2.1 Marketing legal services — rr. 3.02(1)–(2) and commentary

For purposes of the *Rules*, marketing includes

- firm names (including trade names);
- letterhead;
- business cards;
- logos; and
- advertisements and other similar communications in various media.

Lawyers may market their services in any medium; however, the marketing must be

- demonstrably true, accurate, and verifiable;
- not misleading, confusing, or deceptive and not likely to mislead, confuse, or deceive; and
- in the best interests of the public and consistent with a high standard of professionalism.

Examples of inappropriate marketing may include those that suggest the lawyer is aggressive, that suggest qualitative superiority over other lawyers, or that use testimonials that contain emotional appeals. Where a lawyer is a member of an interprovincial law firm, the lawyer must ensure that his or her partners, associates, or employees who are not qualified to practise in Ontario are not held out and do not represent themselves as such in any of the firm's marketing or otherwise.

To ensure that a law firm's descriptive or trade name is not misleading, it should not refer to a specific geographical area nor should it imply a connection with any other organization, entity, or public agency. A law firm name should not include phrases such as "John Doe and Associates," "John Doe and Company," or "John Doe and Partners" unless there are actually two or more associates or partners with John Doe at that law firm. A firm that is a professional corporation or a limited liability partnership must also indicate this on any marketing to comply with Ontario's *Business Corporations Act* and the *Partnerships Act*, respectively.

2.2 Advertising of fees — r. 3.02(3)

A lawyer or law firm may advertise in any medium the fees charged for legal services as long as the following conditions are complied with:

- The advertising is reasonably precise as to the services offered for each fee quoted.
- The advertising states whether other amounts will be charged in addition to the fee, such as disbursements and taxes.
- The lawyer adheres to the advertised fee.

2.3 Advertising nature of practice — r. 3.03

A lawyer's marketing materials may include information to assist a potential client to choose a lawyer who has the appropriate skills and knowledge for the client's particular legal matter. A lawyer may advertise areas of practice, including preferred areas of practice or that the lawyer's practice is restricted to a certain area of law. Marketing may also include a description of the lawyer's or firm's proficiency or experience in an area of law. In all cases, the representations must not be misleading.

Where a lawyer has been certified by the Law Society as a specialist in a specified field, the lawyer may include this in advertising and other marketing. Under s. 20(2) of By-Law 15, made under the *Law Society Act*, a lawyer who is not a certified specialist is not permitted to use any designation from which a person might reasonably conclude that the lawyer is a certified specialist.

3. File management

Effective file management provides the basis for timely and effective client service. Being able to easily store, organize, and retrieve information and documents regarding a client's matter means less time looking for documents and more time serving the client. Files may be electronic or paper-based or both. A proper file management system will assist the lawyer in complying with requirements under the *Rules*, such as preserving client confidentiality and avoiding conflicts. Lawyers should have and use systems to

- record information and store copies of documents required to identify and verify the identity of clients and third parties, as per By-Law 7.1;
- store and retrieve key information regarding all firm clients and opposing parties;
- open and maintain active client files for individual client matters;
- check for conflicts;
- check for limitation periods;
- close, retain, and dispose of closed files;
- review and update systems to ensure they meet changing standards, techniques, or practices;
- identify clients' property and place it in safekeeping; and
- comply with the Law Society's record and bookkeeping requirements.

Lawyers may also wish to use systems to manage their own documents (electronic and hardcopy) in order to ensure that undertakings have been satisfied, and manage their obligations to any third-party service providers.

3.1 Conflict checking — rr. 2.04(1)–(3) and commentaries

The *Rules* require lawyers to avoid acting in a matter where there is a conflict of interest or where a conflict may develop. Lawyers must examine whether a potential conflict exists at the very first contact with the prospective client, at the outset of the retainer, and throughout the retainer. The lawyer should maintain a record of each search that includes the date the search was completed, the names searched, and the name of the person who conducted or reviewed the search.

To determine whether a conflict or potential conflict exists, lawyers should use a system that checks for conflicts

- at the initial point that the prospective client first contacts the firm seeking legal services, usually by phone or email (i.e., before giving any confidential information);

- after the first interview with the client or when additional (i.e., confidential) information about the prospective client's matter is available;
- after being retained by the client, at any time a new party or person is added to the matter; and
- when a lawyer is considered for employment by a firm.

At the initial meeting with the prospective client, a lawyer needs to determine who the client is, persons that may be involved in or associated with the client in the matter, and the opposing parties in the matter. Information regarding current and former clients should be documented in the firm records and conflicts checking system. Conflicts checking systems require the lawyer to record and check *conflict names*. Conflict names are the names of individuals or entities that have some relationship to the client or the matter that may give rise to a conflict of interest. Conflict names include, for example, the names of

- *adverse parties* in the matter;
- persons (or entities) *related or associated to adverse parties* in the matter; and
- persons (or entities) *related or associated to the client* in the matter.

Every variation of conflict names (such as nicknames, maiden names, and company names) should be checked; every possible spelling of conflict names should be checked.

Conflicts checking systems may be manual or computerized. *Manual* conflicts checking systems make use of index cards: one for each client identifying the client and listing all conflict names. Additional cards for each conflict name are cross-referenced to the client. The cards are filed alphabetically in an index card box and are reviewed whenever a prospective client contacts the office. *Computerized* systems can store and manage a large amount of information about individuals and their relationships to each other, and allow for fast and easy inputting and retrieval of this information.

Whether manual or computerized, every conflicts checking system should contain a record of

- all current and previous client names (e.g., former and other names used by the client);
- all adverse parties;
- all persons connected to the matter;
- officers and directors of a corporate client;
- owners of a corporate client;
- parent corporation or subsidiary of a corporate client;
- partners or affiliates of a client;
- co-plaintiffs or co-defendants;
- common-law spouses or relatives of the client, and any other affiliated persons; and
- members of the law firm and any organizations in which they have a major interest.

When a prospective client contacts the firm, the lawyer or a staff member should check the prospective client's name and any other adverse party names against the names in the firm's conflicts checking system. If there is a match, the lawyer must review and determine if there is or is likely to be a conflict of interest. If there is or is likely to be a conflict, the lawyer must determine the appropriate way to manage the conflict. If a lawyer cannot act for a client because of a conflict, the lawyer must advise the client of this and should confirm the non-engagement in writing.

3.2 Opening files, file organization, and storage

Lawyers should follow appropriate file opening procedures to organize file contents and to properly store files. A lawyer should use a system, electronic or otherwise, that allows him or her to

- identify, organize, store, and track information, documents, evidence, and property relating to each file or client matter; and
- confirm in writing the substance of every communication with the client and other individuals associated with a client's matter, by way of dated file notation or memo to file (i.e., every meeting, conversation, or telephone communication, including messages left and received).

A lawyer should open a file when retained to provide services for any new matter for new, current, and former clients. This includes a new matter that is related to an existing client matter. However, if a prospective client reveals confidential information during the initial communication with the firm, the lawyer should open a new file then and should not wait until the lawyer meets with the prospective client at the initial interview. A memorandum to file outlining the confidential information received from the prospective client during the first communication should be made and added to the file.

Maintaining a notation of confidential information received from a client or a prospective client during any communication is important whether dealing with a client or an individual who has not yet retained the lawyer or firm. Apart from ensuring that the lawyer has confirmation of what was said during that initial conversation, the memorandum will assist the lawyer in managing potential conflicts of interest since conflicts

may arise as a result of the lawyer's duty to protect a client's confidential information.

Generally, there is no need to open a new file when an individual contacts the lawyer or firm to make general inquiries and does not disclose any confidential information. At the initial contact, whether or not the lawyer accepts the client's matter, the lawyer should note any limitation period and advise the client if it is imminent. This should be confirmed by way of memo to file and by letter to the client. To ensure the client receives such a letter, the lawyer should provide it to the client at the end of the consultation or send it via registered mail. A copy of this letter should also be included in the file.

A dated notation should be made of every meeting, conversation, or telephone communication, including messages left and received, and stored in the file. It should confirm the substance of the communication; it should record the information provided to the client or third party by the lawyer, as well as the information received by the lawyer from the client or others regarding the client matter. Confirmation may be made by way of a memo to file or, in some cases, by letter to the client or other party. A copy of the confirming letter should be kept in the file.

Lawyers may use a file opening checklist to ensure that all required information is gathered each time they meet with a prospective client for the first time or with an existing client or former client for a new matter. A separate file should be opened for each individual client matter. They should assign a distinct file name and number to each file. The file name should include the client name and the reference or matter number.

To enable the lawyer to retrieve file contents or information quickly, file contents should be organized according to class or type of document, including

- communications (e.g., correspondence, memorandums to file, conversation or meeting notes, and telephone notes);
- substantive memorandums and investigations;
- original documents;
- retainer letter;
- firm accounts and billing information;
- legal research;
- undertakings to be satisfied; and
- other documents or items, as appropriate to the file.

Active client files should be stored separately from closed files. They should be contained in a secure or locked cabinet or location, and filed in an orderly fashion (i.e., by file number or alphabetically, as per the file naming system) for easy retrieval. All documents relating to a client matter should be kept in the file.

3.3 Closing, retaining, and disposing of file contents

A lawyer should only close a file after all matters related to the file have been completed and all undertakings have been satisfied. When dealing with client files, lawyers should use a file closing procedure that requires the lawyer or firm to

- assign a new closed file code to the file;
- store closed files separately from active files;
- protect closed files from damage or destruction;
- organize closed files for easy retrieval;
- store electronic files in a format that can be retrieved later;
- preserve client confidentiality;
- distribute or dispose of file contents properly prior to closing;
- assign a retention period; and
- destroy closed files only when appropriate.

Prior to closing the file, unnecessary documents should be removed from the file. Documents belonging to the client should be returned the client. These include the client's original documents, any opposing party documents, any reports, asset or liability statements, and any other documents related to the matter. If not provided to the client during the course of the retainer, the lawyer should also forward any other court or legal documents to the client (e.g., pleadings and affidavits).

The lawyer should have the client sign an acknowledgement indicating receipt of the client's documents, which should be added to the closed file. Lawyers may also consider destroying or disposing of any documents that can be obtained again later from court or another government registry if they do not anticipate that they will need the information for purposes of their own defence.

Lawyers should consider whether each closed client file should be retained indefinitely or if it should be destroyed. If the file is to be destroyed, the lawyer should determine

- the date the file is to be destroyed, considering any legal or regulatory requirements to maintain file contents and any limitation periods relating to the lawyer's potential liability for malpractice or misconduct; and
- the manner of file destruction to preserve confidentiality (e.g., shredding documents may be an appropriate method for destroying file contents, while simply recycling them is not).

It is the lawyer's responsibility to decide whether file contents should be destroyed or retained. If the lawyer chooses to store file contents, the lawyer must also decide for how long. The lawyer should review and consider each file individually before making this decision. Files containing client documents, as opposed to the lawyer's copy of client documents, must not be destroyed. These documents belong to the client and must be returned to the client before the other documents in the file are destroyed.

3.4 Documents to be retained by the lawyer

Documents that belong to the lawyer should be retained by the lawyer in the closed client file. The documents created by the lawyer during the retainer belong to the lawyer if

- they were not prepared for the client's benefit;
- the lawyer was under no duty to prepare them; or
- the client is not considered liable to pay for them.

Such documents include

- copies of all original correspondence copied at the lawyer's own expense;
- copies of all original documents belonging to the client that were copied at the lawyer's expense;
- working notes, summaries of evidence, and submissions to the court;
- pre-trial notes and tape recordings of conversations other than with witnesses;
- inter-office memoranda;
- time entries or dockets;
- accounting records and financial information that relate to the client matter (i.e., client bills, trust statements, and ledgers); and
- notes and other documents prepared for the lawyer's own benefit and protection and at the lawyer's own expense.

These documents belong to the lawyer and would not normally be sent to the client. As well, accounting records related to the client matter belong to the lawyer, not the client. They are part of the office accounting system, must be maintained by the lawyer in accordance with By-Law 9, and should not be kept in the client file for the particular matter.

Lawyers should consider keeping copies of documents that will be returned to the client in case the client sues the lawyer for negligence, makes a complaint to the Law Society alleging misconduct, or disagrees with the lawyer's account. The lawyer may wish to keep copies of

- all correspondence, including non-engagement letters;
- written retainer agreements;
- client's written authorizations and directions;
- documents containing client's instructions or changes to instructions;
- draft agreements or other documents to support changed instructions;
- documents that confirm the client's refusal to follow the lawyer's instructions;
- offers to settle and the client's acceptance or rejection of such offers; and
- documents or records that cannot easily be obtained from another source.

Lawyers who choose to make and keep copies of the above for their own files must do so at their own expense. Lawyers must not charge clients for the cost of these copies.

4. Time management

Timeliness is an important part of client service and, therefore, of managing a law practice. Lawyers who manage their time effectively are more productive and more likely to meet the client's needs and service expectations in a cost-effective manner. The basic features of an effective time management system are time planning, reminders, and time docketing.

4.1 Time planning

Lawyers should organize the time they spend on their practice to ensure they are using their time wisely. To assist in planning the lawyer's time, the lawyer should maintain regular office hours and allocate blocks of time to specific tasks for each day, week, month, and year.

The lawyer should schedule time each day to

- review the tasks that need to be completed that day;
- return phone calls and emails from clients and opposing parties;
- review and respond to correspondence;
- ensure time docket entries are recorded or assigned to client files; and
- address urgent or arising matters.

Depending on the lawyer's practice, the lawyer should allot time each week or each month to

- review the tasks that need to be completed that week or that month;
- meet with clients;
- work uninterrupted on client files (e.g., drafting, research, and document review);
- schedule external attendances (e.g., client meetings, examinations, and court and tribunal appearances);
- meet with firm staff and colleagues;

- attend to the administration or business aspects of the law practice;
- attend to accounting, bookkeeping, and filing requirements; and
- conduct periodic reviews of open client files (usually monthly).

Lawyers should also schedule time monthly and yearly to take part in continuing education and professional development activities to ensure they maintain their competence.

To accomplish more during the time they devote to their practice, lawyers should use strategies to

- *control interruptions* by limiting "open door" policies and by accepting phone calls or meetings at a specific time each day;
- *focus on one task at a time* to avoid distractions;
- *delegate work to supervised support staff* to free the lawyer's time for tasks and activities that may only be addressed by the lawyer;
- *cultivate time management skills* by overcoming procrastination and limiting or refusing unreasonable requests from others;
- *maintain time records* for individual client matters and also to evaluate where there are inefficiencies in their use of their time;
- *adopt procedures to reduce inefficiency* including proper meeting management through the use of an agenda or telephone conference, tracking completed work to avoid duplication, proper file organization and storage to allow efficient access, prompt filing of documents to prevent loss, and standardizing routine tasks.

4.2 Reminder systems

Lawyers should have systems in place to remind them of what needs to be accomplished and when. An effective system will assist the lawyer to meet important deadlines, such as limitation dates or filing periods and court appearances. Missing a limitation date can damage a client's case and missing a Law Society filing date could result in a suspension of the lawyer's licence to practise law. Lawyers should use to-do lists to set priorities, and desk diaries or calendars (either paper or electronic) to plan time and track appointments, appearances, and crucial dates.

A centralized reminder or *tickler system* should be used to

- flag limitation periods or deadlines;
- follow up in order to respond to reminder notices on time; and
- remind lawyers of the upcoming steps to take in ongoing client files.

Reminder systems may be manual or computerized. A manual system uses index cards containing the client name, file, or matter number, the name of the lawyer handling the file, and relevant deadlines. The cards are sorted by month and date and are filed chronologically in an index card box. A computerized reminder system must draw the lawyer's attention to any deadlines or due dates and keep these dates on the system until the tasks associated with each date have been completed. When using an electronic computerized system, the information should be backed-up daily to ensure information for that day is not damaged or lost. This will also help the lawyer avoid a negligence claim from a missed deadline resulting from a computer problem.

Though the responsibility for noting and following up on key dates may be assigned to a trusted employee, it is ultimately the lawyer's responsibility to ensure that deadlines and limitation periods are met. Lawyers should conduct a periodic review of all open client files to confirm that work on all files is being completed in a timely and effective manner. Lawyers should also consider conducting a physical inventory of open files at a frequency appropriate to the nature and size of the lawyer's practice. Review and inventory dates should also be included in the lawyer's reminder system.

4.3 Time docketing

A *time docket* is a record of the time the lawyer spends on a client matter. A docket entry should record the client name, file or matter number, date, time, time spent, and a description of the work performed. Lawyers should consider maintaining time dockets for all files, either through paper or electronic means, to ensure that fee billings are accurate or to assist in justifying fees if the client later questions the amount charged, whether or not the lawyer charges an hourly rate. For example, time dockets may assist the lawyer in determining whether the block fee being charged for a particular task, service, or matter is appropriate.

Lawyers should also track non-billable hours to monitor their own productivity. Dockets should be detailed, updated as soon as any activity on the client file is completed, and recorded or assigned to client files daily. This will allow the lawyer to bill most clients on a regular basis.

When implementing a manual or computerized time docketing system, lawyers should select one that will allow them to

- explain services to be performed;
- accumulate the total time spent on the file by each lawyer;

- record billable and non-billable time;
- produce interim and final statements of accounts for services rendered to clients; and
- produce time data for monthly, quarterly, and annual reports to assist in management of the firm.

A manual time docketing system involves the use of paper time sheets. The lawyer records the time spent on each file, and firm staff manually inputs the time records into the appropriate client file or firm database. A computerized system allows the lawyer to docket electronically and is fully integrated with the accounting and billing software implemented by the lawyer or law firm.

5. Use of technology

A lawyer should use whatever tools are available to effectively manage the lawyer's law practice. Many aspects of practice management can be efficiently accomplished by the use of manual or computerized systems. The lawyer or law firm must evaluate which systems will best suit the lawyer's or firm's needs. Lawyers may use technology to offer legal services and advertise, to serve the client, and to manage their files and time. Lawyers should ensure that they obtain and make proper use of the software, hardware, and other equipment they may need to effectively manage a practice.

5.1 To make available, market, and provide legal services

Lawyers may use electronic media to offer or advertise services. This includes the Internet, email, online chat rooms, discussion groups, and bulletin boards. When using electronic means to market or make legal services available, the lawyer must still comply with the *Rules*. Lawyers should also recall that

- to prevent confusion, the lawyer should properly identify himself, herself, or the law firm by providing the firm name and address, the jurisdiction where the lawyer is licensed, and the name and email address of one lawyer responsible for electronic communication;
- to ensure convenience, the lawyer should not use methods where the advertisement is directly and indiscriminately sent to a number of newsgroups or email addresses (e.g., spamming);
- to avoid misleading anyone, the lawyer should not post advertisements to newsgroups or bulletin boards where the posting topic does not match what is being advertised in the posting; and
- the lawyer should implement internal controls to restrict the downloading, viewing, or circulating of discriminatory material and provide for the immediate deletion of unsolicited discriminatory material that is received from third parties.

When providing legal advice or services through electronic media, the lawyer

- should clearly indicate the capacity in which the lawyer is acting, especially if the lawyer is not providing legal advice, opinions, or services;
- must avoid conflicts of interest by ascertaining the identity of the parties with whom the lawyer is dealing;
- must maintain confidentiality by using appropriate means to minimize the risk of disclosure, discovery, or interception of such communications by using and advising clients to use encryption software, and by implementing internal controls to offer reasonable protections; and
- must uphold the law of other jurisdictions (e.g., other provinces, states, or countries) and not engage in the unauthorized practice of law.

5.2 To assist in practice management

To adequately manage the lawyer's practice, the lawyer should consider using technology tools such as

- *legal research tools* such as online facilities (e.g., CanLII or Quicklaw), Internet-based programs, or CD databases;
- *practice area specific software* such as Teraview software for the electronic registration of documents in real estate matters;
- *document management systems* or services such as case management or litigation support software, or templates to create legal forms and documents;
- *analysis support software* such as spreadsheets or calculators;
- *word processing software* to reduce time spent on writing and drafting;
- *communication tools* such as voice mail, email, facsimile transmission, and video or telephone conferencing;
- *database management systems* for housing client information or checking for conflicts of interest;
- *calendaring and scheduling systems* to meet current and future deadlines; and
- *time docketing and accounting systems* to accurately bill clients and meet record-keeping requirements.

5.3 Special considerations

A lawyer should have a reasonable understanding of the technologies used in his or her practice or should have access to someone who has such understanding. If the lawyer uses third-party providers to set up, maintain, or repair any problems with technology tools that store or use client information, the lawyer must ensure that client

information remains confidential. Lawyers who use technology in their practice must also take appropriate security measures, make adequate plans for back-up and disaster recovery, and select tools that will last into the future.

Lawyers should implement security measures to prevent

- unauthorized copying of electronic data;
- accessing of electronic files by hackers;
- destruction of electronic information and hardware by computer viruses;
- damaging of electronic information and hardware by power failures and electrical storms; and
- theft of electronic information stored in stolen hardware.

Security measures may include the use of passwords to limit access to electronic data, the installing of firewalls or virus scanning software, and the installing of surge protection hardware or encryption software.

Despite efforts to prevent it, a lawyer may be required to deal with the loss or destruction of electronic information after it has occurred. Lawyers should have back-up and disaster recovery plans in place. Such plans should require the lawyer or law firm to

- perform regular back-up of data;
- store back-up disks or tapes in a secure off-site location;
- perform routine checks to ensure data can be restored; and
- have insurance in place to cover the cost to recover lost electronic information or hardware.

Lawyers must also ensure that the systems they implement will continue to meet their needs in the future. Lawyers should regularly review the software and hardware they have used to ensure that the information it contains can still be accessed and viewed, and that the technology has not become obsolete. This is especially important when retaining records or client information in electronic format only, either housed in a rarely used software program or deposited to an electronic storage device (e.g., CD). Lawyers should ensure that advances in technology do not result in an inability to access the data at a later date.

As a final consideration when using technology, lawyers must ensure that any activities or tasks are still being completed without error or omission. For example, a lawyer who sends a completed document to the opposing side via email must ensure that it is free of errors and does not contain any notes or references that might reveal strategy, tactics, or confidential client information. Similarly, a lawyer who sends client correspondence via email must ensure that it is sent only to the proper recipient and should discuss with the client in advance the risks associated with corresponding electronically. Lawyers should consider encrypting all electronic communications to ensure confidentiality is preserved or should take other precautions.

6. Managing financial responsibilities

Effective management of a law practice includes management of the lawyer's financial responsibilities. To meet those financial obligations, the lawyer must know what they are and when they are due. Lawyers

- must meet financial obligations incurred on the client's behalf;
- should fulfill financial responsibilities related to operating a law practice; and
- must satisfy financial reporting and compliance requirements.

These materials refer only to a lawyer's professional responsibility obligations under the *Rules* and Law Society by-laws, which are quite apart from any legal obligations under other legislation or law.

6.1 On behalf of the client — r. 6.01(2) and commentary

As previously discussed in these materials, lawyers must promptly meet all financial obligations incurred in the course of practice on behalf of clients unless it is documented in writing beforehand that it is not the lawyer's personal obligation to do so. These include expenses such as the payment of fees to file a claim on the client's behalf, to obtain a transcript or other document needed for the client's matter, or to secure the services of a third party.

Lawyers should obtain the client's consent before retaining a third party on behalf of the client, which may include an expert, a consultant, or some other professional. The terms of that retainer should be confirmed in writing and should outline the services to be provided by the third party, the fees for the services, and the person responsible for payment. Payment may be made by either the client directly or the lawyer on behalf of the client. Where the lawyer has indicated in writing that he or she is not responsible for the payment of the third party's fees and the client has not taken steps to pay, the lawyer should assist in making satisfactory arrangements for payment if it is reasonably possible to do so. This may include negotiating a reduction in the third party's fees or arranging a payment plan for the client.

The lawyer should include in the estimate of fees and disbursements to the client the cost of payments to third

parties. To ensure that the client has funds available to pay for the services of the third party, the lawyer should obtain and hold in trust the estimated fees to pay for third-party services before hiring that third party. If something unexpected arises that raises the cost of a third-party service, the lawyer should immediately advise the client and revise the estimate for legal services and disbursements. The lawyer should explain why the costs have increased and why it may be reasonable for the client to incur these additional charges. This should be confirmed in writing for the client. If appropriate, the lawyer should ask for further additional funds to cover the increased cost of the third party services. Where the lawyer plans to bill the client for the third party's costs after they have been paid by the lawyer, the lawyer should also confirm this in a letter to the client.

In the event that the client discharges the lawyer or the lawyer otherwise withdraws before a third party has been paid for his or her services provided to the client, the lawyer who originally hired the third party should advise about the change and provide the name and contact information for the new legal representative.

6.2 To operate a law practice

It is prudent that lawyers meet their own financial responsibilities as they relate to running a law practice. Such financial obligations may include those associated with

- professional regulation fees;
- professional liability insurance premiums;
- business insurance;
- employee salaries;
- remittance of the Harmonized Sales Tax (HST);
- renting or leasing office space;
- office utilities (e.g., heat, electricity, and telephone);
- postage and courier costs;
- business supplies; and
- bank fees.

A successful law practice is a well-managed one. Lawyers must adopt accepted accounting and bookkeeping systems and must attend to billing, collecting, and paying ongoing firm expenses.

6.3 Reporting and compliance requirements — By-Laws 8 and 9

A final part of meeting a lawyer's financial responsibilities is to fulfill the reporting and compliance requirements related to those financial obligations. As outlined in By-Law 8, each year lawyers must file with the Law Society an annual report that includes information on their books and records for client funds (i.e., the trust account) and their own funds (i.e., the general account). Lawyers must maintain accurate accounting records to properly track client funds as required by By-Law 9.

According to r. 3.04(3), a lawyer who is a member of an interprovincial law firm and qualified to practise in Ontario has the additional obligation to ensure that the books, records, and accounts pertaining to the practice in Ontario are available in Ontario on demand by the Law Society's auditors or their designated agents.

Lawyers must also report to the Law Foundation regarding the interest accrued on trust accounts and to the Canada Revenue Agency regarding income tax or the HST.

7. Managing supervisory responsibilities — r. 5.01; By-Law 7.1, Part I

Under the *Rules*, lawyers are responsible for the supervision of any support staff they employ. Proper use of support staff allows the lawyer to make efficient use of the time he or she has for the practise of law and may result in savings to the client. Lawyers must assume complete responsibility for all business entrusted to them, including tasks and work products completed by their non-lawyer employees, so proper hiring, training, and supervision practices are essential.

Because the definition of *non-lawyer* contained in the *Rules* does not include a candidate enrolled in the Law Society's Licensing Process for Lawyers, a lawyer's supervision of an articling student is not captured by this rule. As outlined separately in r. 5.02, the duty of a lawyer who has been approved as an articling principal is to give the student meaningful training and exposure to and involvement in work that will provide the student with knowledge and experience of the practical aspects of the law, together with an appreciation of the traditions and ethics of the profession. Because articling students are also subject to the *Rules*, principals should also ensure that articling students are familiar with the responsibilities contained within the *Rules*.

7.1 Hiring support staff

Lawyer should hire trustworthy individuals for their practice. Lawyers should obtain as much professional information about a potential employee as possible, and when interviewing a potential employee, the lawyer should ask about the candidate's past performance and experience. If the position involves handling money, the lawyer may ask for the candidate's consent to check his or her criminal record and credit reports. Lawyers must comply with privacy legislation and should refer to the

Rules to review questions that can and cannot be asked of an applicant, as outlined in the Ontario *Human Rights Code*. Lawyers should confirm the information contained in a candidate's resumé, consult references, and verify previous employment experience before offering employment to a candidate.

7.2 Training

Proper training ensures that employees have the skill, knowledge, and ability needed to fulfill job-related duties. The lawyer must properly train non-licensed employees before delegating tasks to them. In addition to training on the types of matters the lawyer handles, the lawyer should educate support staff on

- the need to act with courtesy and professionalism;
- the definition of discrimination and harassment, and the prohibition against conduct that amounts to discrimination and harassment;
- the duty to maintain client confidentiality and methods used to protect confidential client information (e.g., avoiding gossip inside and outside of the office);
- the definition of a conflict of interest, the duty to avoid conflicts, and how to use a conflicts checking system;
- proper handling of client property, including money; and
- proper record keeping.

Lawyers should consider documenting their office procedures and policies in an office manual. An office manual may be used to train new employees and support staff, may be used by them as a reference, may help ensure consistency to a lawyer's practice, and may assist to protect the lawyer from potential claims.

7.3 Delegation and supervision

Lawyers must ensure that employees only complete tasks for which they have been properly trained and have the required competence. The lawyer is responsible for all work delegated to employees and must directly and adequately supervise them. The extent of that supervision will depend on the type of matter, regardless of how standardized or repetitive the task, and the experience of the employee, both generally and with the matter in question. Extra care may be needed if there is something different or unusual in the matter.

To prevent the unauthorized practice of law or provision of legal services, lawyers must not allow any non-licensed employee to perform any of the duties that only a lawyer may perform. This rule applies at the lawyer's practice and at any satellite office of the practice. Part I of By-Law 7.1 outlines the specific obligations placed on lawyers who delegate work to non-lawyer employees, while the commentary to r 5.01 provides examples of appropriate delegation of tasks as they relate to real estate matters, including electronic registration and title insurance; corporate and commercial matters; and wills, trusts, and estates.

With prior express instruction and authorization, a lawyer may allow a non-lawyer employee to

- take instructions from the client;
- give or accept an undertaking on the lawyer's behalf;
- act before an adjudicative body on the lawyer's behalf in respect of a scheduling or other related routine administrative matter; and
- upon client consent, conduct routine negotiations with third parties in relation to the client's matter, where the negotiation results are approved by the lawyer before any other action is taken.

Lawyers must not allow a non-lawyer employee to

- accept a client on the lawyer's behalf;
- provide the client legal advice;
- act finally in respect of the client's affairs;
- perform any of the duties that only lawyers may do;
- perform any duties that lawyers themselves are not permitted to do; or
- be held out as a lawyer.

Lawyers should ensure that non-lawyer employees clearly identify themselves as such when communicating with clients, prospective clients, or the public. This includes both written and verbal communications.

7.4 Supervision in real estate matters

The *Rules* also provide guidance on the supervision of non-lawyer employees in real estate matters for activities that relate to the electronic registration of title documents and title insurance.

A lawyer who acts in real estate transactions using the system for the electronic registration of title documents (e-reg™) assumes complete responsibility for documents he or she signs electronically and is responsible for the content of any document electronically signed and registered by a non-lawyer employee upon the lawyer's approval. The lawyer

- shall not permit a non-lawyer employee or others to use the lawyer's personalized specially encrypted diskette to access e-reg;
- shall not disclose the lawyer's personalized e-reg passphrase to others;

- shall ensure that a non-lawyer employee does not permit others to use the employee's personalized, specially encrypted diskette to access e-reg;
- shall ensure that a non-lawyer employee does not disclose the employee's personalized e-reg passphrase to others; and
- shall not permit a non-lawyer to sign for completeness any document that requires compliance with law statements.

A lawyer must not allow a non-lawyer employee to give legal opinions regarding title insurance. Where there is direct supervision by the lawyer, the lawyer may permit a non-lawyer to advise the client about any insurance (including title insurance), present to the client insurance options or information about premiums, and recommend one insurance product over another.

7.5 Supervision of paralegals

Due to the definition contained in Part I of By-Law 7.1, the supervisory responsibilities of a lawyer over non-licensed employees also applies to any paralegals the lawyer may employ. Despite the paralegal's own obligations and responsibilities under the *Paralegal Rules of Conduct* and his or her licence to provide independent legal services within the permitted scope of practice, a paralegal employed by a lawyer must expressly agree to the lawyer's effective control over the paralegal's provision of services to the lawyer.

7.6 Supervision of affiliated entities

Unless the client provides informed consent to do so, a lawyer is not permitted to delegate to staff of an affiliated entity any tasks in connection with the provision of legal services to the client. Where the client does provide consent, this should be confirmed in writing.

8. Managing administrative and business aspects of the practice

Effective management of a law practice also includes managing the administrative and business aspects of the practice. As mentioned previously in these materials, a lawyer's licence to practice law may be suspended if he or she fails to meet the Law Society's administrative requirements. Lawyers must

- inform the Law Society of any changes to status or contact information, per By-Law 8;
- pay an annual fee to the Law Society, due January 1st each year, per By-Law 5;
- submit an annual report to the Law Society, due March 31st each year, per By-Law 8;
- maintain appropriate professional liability insurance, per By-Law 6 (individual policy or exemption status will dictate due dates and fees);
- complete and report on continuing professional development hours, per By-Law 6.1;
- meet other requirements related to business structure, per By-Law 7, if applicable; and
- meet other requirements related to bankruptcy or insolvency and offences, per By-Law 8, if applicable.

Depending on the type of law practice, business structure, or other arrangements the lawyer has made, he or she may have administrative requirements beyond those imposed by the Law Society. Examples may include federal, provincial, or municipal business registrations or renewals, or commercial or personal insurance filings. Failure to comply with any administrative requirement may impact a lawyer's practice.

Proper practice management also involves protecting the practice and safeguarding clients' interests in all circumstances. Lawyers should create contingency plans that protect the client's interests by ensuring continuity during a business interruption or the lawyer's absence. A lawyer should also have plans that allow for others to properly deal with the practice in the event the lawyer is unable to return to the practice of law. Plans should address

- practice interruptions (e.g., natural disaster, office disaster, technology failure, theft or vandalism, or law office search or seizure);
- planned absences (e.g., vacation, parental leave, medical leave, or other leaves of absence); and
- unplanned absences (e.g., personal difficulties, sudden illness, incapacity, disability, or death).

A lawyer should consider drafting a power of attorney for the practice that grants another named lawyer the authority to act on his or her behalf and to access the general and trust accounts to continue with the practice during a planned or unplanned absence, with terms that allow that named lawyer to arrange for and oversee the sale, transfer, or closure of the practice in the event that the lawyer is unable to return to the practice of law.

A lawyer should also consider including in his or her will a clause that addresses how the practice should be sold, transferred, or closed in the event of the lawyer's death. A lawyer should consider appointing another named lawyer as the estate trustee or a co-estate trustee to oversee the conclusion of his or her practice.

Chapter 14

Accounting, bank accounts, and bookkeeping

Knowledge of accounting principles and record keeping requirements are essential for running a successful law practice. They are also a required part of competence, as outlined in the *Rules of Professional Conduct* (*Rules*). A lawyer's level of involvement in the accounting aspects of his or her practice may vary. Lawyers may choose to maintain their own books and records through manual or computerized accounting systems and may choose to delegate these tasks to a trained staff member or to a third-party accountant or bookkeeper. Whatever choice the lawyer makes, he or she is ultimately responsible for ensuring that client and firm funds are properly accounted for and that the appropriate books and records are maintained in accordance with By-Law 9, made under the *Law Society Act*.

1. Accounting in a law practice

Lawyers must use accounting principles and procedures to have a successful practice. This includes using procedures to record transactions as they occur, regularly reviewing records and transactions, and preparing and reviewing financial statements. Lawyers who fail to do any one of these may face difficulties with clients over billings or discipline by the Law Society. At the very least, lawyers should be aware of bookkeeping and the types of accounting systems that are available for the lawyer to use.

1.1 Types of accounting systems

Financial recording, reporting, and billing systems are an important part of a law practice. There are several kinds of accounting systems: manual, "one-write," spreadsheet software, general accounting software, and law firm accounting software. When choosing an accounting system, a lawyer should consider what will work best in his or her practice by assessing

- the number of transactions the lawyer has or expects to have;
- whether the lawyer maintains his or her own records or hires someone to do them;
- what the lawyer can afford; and
- how well the lawyer understands bookkeeping and computer programs.

The Law Society cannot make this decision for the lawyer. The lawyer must determine what is right for his or her needs. The following is a comparison of five main types of accounting systems.

Type of System	Advantages	Disadvantages
manual	+ simple + inexpensive	- time consuming if many transactions - does not automatically post to sub-ledgers - math errors more common
one-write	+ simple + inexpensive + posts to sub-ledgers	- time consuming if many transactions - math errors more common
spreadsheet software	+ inexpensive + automatic calculations	- time consuming if many transactions - requires training - formulae errors are difficult to detect
general accounting software	+ automatic calculations + posts to sub-ledgers + produces financial reports	- reports not designed for trust accounting - requires training
legal accounting software	+ designed for trust accounting + automatic calculations + posts to sub-ledgers + produces financial reports	- may be expensive - requires training

When using an electronic or computerized method for accounting and bookkeeping, the lawyer must ensure that the computer program will enable or allow the lawyer to produce hard copies of any documents to meet the requirements of By-Law 9. The lawyer must also implement proper security, back-up, and disaster recovery plans to ensure that this information can be recreated if damaged or lost.

2. Bank accounts in a law practice

Lawyers may open as many bank accounts as required to meet the needs of the law practice. Every account must be operated and account records maintained in accordance with Law Society requirements. Most practices will have at least one *general account* for the business of the practice and one mixed *trust account* to hold client funds. Lawyers must not mix firm funds with client funds. If a lawyer intends to receive client funds and hold them for any period of time, the lawyer must operate a trust account separate from any account containing the lawyer's or the firm's funds. Lawyers must not deposit client money directly to the general account and must not deposit personal funds or the firm's money into the trust account. Lawyers who do not accept or hold client funds in trust are not required to operate a trust account.

Lawyers should note that the rules relating to accounting, bank accounts, and bookkeeping apply to individual lawyers who practise law as sole practitioners and to every lawyer member of a law firm, including lawyers who are employees.

3. General account

A *general account* is an operating account used by a lawyer or law firm to run the law practice. The money deposited or held in the general account belongs only to the lawyer or to the firm, and no client money can be directly deposited to this account. Payments from clients for services already provided and billed by the lawyer or firm should be deposited to this account.

A lawyer may use his or her personal bank account as a general account for the practice, but this is not recommended. If the Law Society performs a spot audit of the practice, the lawyer will be required to produce records regarding the personal account, which may include personal transactions not related to the lawyer's practice. To avoid having to reveal personal financial information unrelated to the practice, lawyers should open a separate account for the practice. Also, the lawyer's personal account may not generate the appropriate statements, returned cheques, and duplicate deposit slips required by By-Law 9.

3.1 Depositing to the general account (general receipts)

Often, a lawyer's fee income will be the only income coming into his or her law practice. To generate a steady cash flow, lawyers should establish a routine of billing clients at regular intervals. This will assist lawyers to manage their flow of income throughout the year and will assist them to meet their financial obligations related to the practice. Interim bills keep the client informed as to the ongoing cost of the matter, even in cases where the client has provided the lawyer with a money retainer for future services. Providing the client with interim bills will allow the client to avoid a large payment at the end of the retainer.

When the lawyer receives a payment from a client for fees that have been earned and billed and disbursements paid by the lawyer on the client's behalf (a billing is not required before the lawyer repays himself or herself for disbursements), that money belongs to the lawyer or law firm and must be deposited into the general account. Lawyers may make deposits to the general account by whatever method they choose as long as the method provides the source documents required by By-Law 9. Deposits to the general account must be recorded in the *general receipts journal*, explained further in the "Record keeping requirements" section of this chapter.

3.2 Withdrawing from the general account (general disbursements)

As an operating or business account, payments for a lawyer or law firm's expenses will come from the general account. Payments include

- professional regulation and liability insurance fees;
- lease or rent for office space;
- employee salaries;
- business expenses (e.g., office utilities, bank fees, courier, and postage);
- office supplies;
- remittance of Harmonized Sales Tax (HST);
- bank fees (for both the general and trust accounts);
- transaction fees for accepting credit or debit card payments (for both the general and trust accounts); and

- disbursements paid on a client's behalf when there are no or insufficient client funds in trust.

Lawyers may make withdrawals from the general account by whatever method they choose, as long as they can provide the source documents required by By-Law 9. Withdrawals from the general account must be recorded in the *general disbursements journal*, explained further in the "Record keeping requirements" section of this chapter. Ideally, a lawyer or firm's general receipts should match or exceed their general disbursements.

3.3 Harmonized Sales Tax (HST)

If the revenues from a law practice exceed a certain amount, the lawyer must register with the Canada Revenue Agency (CRA) to collect and remit HST on billings and disbursements. Depending on the firm's income, the lawyer or firm will be required to remit HST monthly, quarterly, or annually. HST is payable by clients on the lawyer's fees and some disbursements, as outlined by the CRA. To track the HST receivable on fee billings each month, all fee billings should be recorded in the *fees book*, which is explained further in the "Record keeping requirements" section of this chapter. Books and records regarding the HST must be up to date since lawyers may be subject to a HST audit by the CRA.

Where the lawyer has received a money retainer from the client and has billed the client for HST eligible services, the HST should be removed from trust and deposited to the general account or another account belonging to the lawyer or firm until the lawyer is required to remit it to the CRA. However, if the lawyer chooses to, the HST portion for a particular client matter may be left in trust as long as it remains as a credit to that client's trust ledger account.

4. Trust account

Lawyers have special obligations when handling client funds. Lawyers must preserve money held on the client's behalf. Mishandling of client funds may result in discipline by the Law Society. When a lawyer receives money that belongs to a client or is to be held on behalf of a client, the lawyer must deposit it into a trust account. Because client funds must be held *in trust* by the lawyer, they are also known as *trust funds*. Per r. 2.02(5.0.2) of the *Rules*, a lawyer may only use a trust account for purposes related to the provision of legal services; he or she must not hold money in trust if it is not directly related to the legal services he or she is providing to the client.

Part II of By-Law 9 prohibits the handling of client funds and property by a bankrupt lawyer within the meaning of the *Bankruptcy and Insolvency Act*, unless the Law Society provides the individual special permission to do so. That permission may be subject to any terms and conditions that the Law Society may see fit to impose.

4.1 Opening a trust account

To open a trust account, lawyers may need to provide their financial institution with proof that they are licensed by the Law Society to practise law. Each financial institution may have different requirements, which may involve obtaining a letter from the Law Society that confirms the lawyer's status or "good standing." When opening a trust account, the lawyer must ensure that

- the trust account is named and designated as a trust account and this is clearly indicated on the statements for the account;
- the account is in the lawyer's name or the name of the law firm where the lawyer is a partner or is employed;
- the financial institution returns cancelled trust account cheques or electronic images of cancelled cheques to meet the record keeping requirements under By-Law 9; and
- the financial institution will not withdraw money from the trust account without the lawyer's authorization, including service fees to operate the trust account.

Lawyers must provide written instructions to the financial institution to ensure that any banking fees or service charges associated with operating the trust account are withdrawn from the general account. These fees must not be taken from the trust account, because the money contained in the trust account belongs to the client. Though it is not required, lawyers may find it convenient to open their general account at the same financial institution as they have their trust account(s). This may reduce the number of trips to the financial institution and may reduce the likelihood of mistakenly debiting the trust account for operating fees or service charges.

4.1.1 Types of trust accounts

Lawyers may open a *mixed trust account* where funds belonging to different clients are pooled. As outlined in the *Law Society Act*, the interest earned on a mixed trust account must be remitted by the financial institution to the Law Foundation of Ontario (LFO) for the benefit of various law-related organizations and

projects. The mixed trust account must bear interest at a rate approved by the trustees of the LFO. Lawyers must provide their financial institution with a letter of direction authorizing them to forward the interest to the LFO.

If a client wishes to receive the interest earned on their funds, that client must instruct the lawyer to open a *separate interest-bearing trust account* for the client's funds. The account should still be in name of the lawyer or law firm in trust for the client and may only hold that client's funds. As part of the lawyer's fiduciary duties, the lawyer should discuss this option whenever holding client funds for an extended period of time. The lawyer must ensure that clients understand that he or she is not providing them with investment or financial advice.

If the client instructs the lawyer to put the funds in a separate interest-bearing account, the lawyer should

- ensure that the client's instructions to open a separate interest bearing trust account are in writing;
- obtain the client's Social Insurance Number or corporate number;
- discuss with the client how the interest is to be allocated for income tax purposes, since the lawyer will receive a T5 supplementary income slip from the financial institution for the interest earned; and
- check with the financial institution as to how much notice is required to have the funds released and whether earlier redemption will affect the interest paid.

Some examples of separate interest-bearing accounts include a passbook account, a guaranteed investment certificate (GIC), or a term deposit. The lawyer who opens a separate interest-bearing trust account for a client must still meet the record keeping requirements of By-Law 9. The requirements for placing money received in trust into any other type of income-generating investment (e.g., a money market fund and Treasury bills) are identical to the requirements for interest-bearing accounts.

4.1.2 Financial institutions for trust accounts

Lawyers may open trust accounts at any financial institution outlined in By-Law 9, such as a

- chartered bank;
- provincial savings office;
- registered trust company; and
- credit union or a league under the *Credit Unions and Caisses Populaires Act, 1994*.

Lawyers are not required to have all of their accounts at the same financial institution, but this may be more convenient for their practice. When selecting a financial institution for the general and trust account(s), the lawyer must make sure that the financial institution can provide the necessary source documents to meet the record keeping requirements outlined in By-Law 9. If the financial institution cannot or will not provide the source documents required, the lawyer may have to choose another financial institution that will allow him or her to meet these obligations. More information on *source documents* can be found later in this chapter.

4.1.3 Sharing trust accounts

A lawyer may only share a trust account with another lawyer or paralegal if they are partners or if one of them is employed by the other. A lawyer who is a sole practitioner and who shares office space with other sole practitioners may not share a trust account with those other legal service providers. To share a trust account, there must be a partnership or employment relationship between the lawyer and other licensees.

4.2 Depositing to the trust account (trust receipts)

Lawyers must deposit into a trust account all of the following:

- money provided to the lawyer by the client to secure legal services or as a deposit for the fees that will be charged for those services (i.e., a money retainer);
- money provided to the lawyer for payment of disbursements that will be incurred on behalf of the client by the lawyer;
- money provided to the lawyer by the client to be held by the lawyer pending the client's instruction;
- settlement funds that belong to the lawyer's client that are received by the lawyer from the opposing party in a matter;
- settlement funds that belong to the opposing party in a matter that are received by the lawyer from the lawyer's client;
- any money that is shared by the lawyer and the client where it is not practical to split the payment (e.g., the client overpays a bill rendered to the client by the lawyer); and
- any funds withdrawn from the trust account in error.

All deposits to the trust account must be entered in the *trust receipts journal*, and the deposits for each individual client must be recorded in the *clients' trust ledger*. These are discussed further in the "Record

keeping requirements" section of this chapter. All of the funds a lawyer holds in trust must be allocated to his or her clients. As previously stated, the lawyer must not deposit money to the trust account if it is not directly related to the legal services the lawyer is providing to the client. Lawyers may not have "miscellaneous" funds nor can they carry a float of their own money in the trust account.

Lawyers are not required to deposit into a mixed trust account funds that are received from or for a client if

- the client requests in writing that the lawyer does not deposit the money to the mixed trust account (e.g., if the client wants his or her funds kept in a separate interest-bearing account);
- the lawyer deposits the money into an account kept in the name of the client, a person named by the client, or an agent of the client (other than the lawyer); and
- immediately upon receiving it, the lawyer pays the money to the client or to a person on behalf of the client, following normal business practices.

Lawyers must include a description or a paper trail of the handling of such client moneys, in accordance with By-Law 9. Because client funds cannot mix with the lawyer's funds, the lawyer must not deposit his or her funds into a trust account.

4.2.1 Methods for depositing to trust

Lawyers may make deposits to their trust account in person at their financial institution or by using an Automated Bank Machine (ABM). If using an ABM, the lawyer must ensure that convenience cards are coded for deposits only and that security is maintained as if the funds were dealt with in person through a teller. Where applicable, trust funds may be transferred to the trust account by wire transfer or electronic transfer (e.g., Internet banking). When making any deposit to trust, the lawyer must keep the duplicate deposit slip, the ABM receipt, or the confirmation provided by the electronic transfer. These are called *source documents* and are discussed further in the "Record keeping requirements" section of this chapter.

4.2.2 When to deposit to trust

Client funds should be deposited to a trust account on the day they are received and must be deposited by the end of the following banking day.

4.3 Withdrawing from trust (trust disbursements)

A lawyer must not withdraw money from trust with respect to a client matter in an amount larger than what he or she is holding in trust for that client. The lawyer must not take funds from trust that the client has not instructed him or her to withdraw or that do not belong to the lawyer for payment of fees or reimbursement of disbursements. To withdraw funds for any other reason may be considered *misappropriation of trust funds*, which is prohibited by the *Rules*. All withdrawals from the trust account must be recorded in the *trust disbursements journal,* discussed further in the "Record keeping requirements" section of this chapter.

4.3.1 Reasons for withdrawal from trust

Lawyers may only withdraw from the trust account

- money required to pay a client or a person on behalf of a client;
- money required to reimburse the lawyer for money spent on behalf of a client;
- money required to pay the lawyer for fees for services that the lawyer has performed and for which a bill was sent to the client; and
- money that does not belong in the trust account but was deposited to trust in error.

Lawyers may not withdraw money from the trust account for any other reason.

4.3.2 Methods for withdrawal from trust

The lawyer may withdraw money from the trust account only by the following means

- by cheque, signed by the lawyer or another lawyer or paralegal authorized to disburse funds from the lawyer's trust account(s);
- by transfer to the lawyer or law firm's general account, authorized by the lawyer in writing; and
- by electronic transfer in accordance with By-Law 9.

These methods for withdrawing from the trust account provide the necessary records to meet Law Society record keeping requirements. These methods should be used when withdrawing money from the trust account for any reason. Lawyers must never make a trust cheque payable to "cash" or "bearer" and should ensure that they limit who may access the above methods for withdrawal from trust.

There are special requirements when withdrawing trust funds by electronic transfer, which include the use of Internet or personal computer (PC) banking software.

The lawyer must start the process by completing an *Electronic Trust Transfer Requisition Form* (Form 9A) for his or her records. The software must require two persons to effect the transfer: one to input the transfer transaction details and one to authorize the transfer. These two people must be identified by passwords or other means and cannot share the same password. However, By-Law 9 provides an exception to the two-person requirement if the lawyer is a sole practitioner who practises alone without employees. In any case, the system must generate a confirmation of the transaction details, including all of the information required under By-Law 9. The lawyer must compare the system confirmation printout with the previously completed Form 9A, and must sign and date the confirmation printout to ensure that the transaction details were properly sent to and received by the financial institution. This comparison must be completed by the end of the second business day after the transfer. A sample completed Form 9A has been included in the final section of this chapter.

Lawyers may not use an ABM to withdraw funds from trust, since an ABM does not provide adequate papers or documents to meet the record keeping requirements of By-Law 9. Lawyers who use a convenience card to make deposits to trust through an ABM must ensure the card is coded for deposits only.

4.3.3 Individuals authorized to withdraw from trust

Lawyers must be in control of their trust account(s). A lawyer who practises alone is the only individual who may operate and disburse funds from his or her trust account. If a lawyer is at a law firm, the managing partners of the firm or the sole practitioner who employs the lawyer will likely be the lawyer(s) in control of the firm's trust account(s).

If there is only one lawyer with signing authority on the trust account(s), it would be prudent to make arrangements for another lawyer to have signing authority on the trust account(s) in case of an unexpected emergency (e.g., illness or accident) or planned absence (e.g., vacation). The chosen substitute must be insured and entitled to to practise law or provide legal services in Ontario. The lawyer may arrange this through his or her financial institution by means of a power of attorney or by including a relevant clause in his or her will. In such cases, the lawyer may also want a person who knows his or her practice (e.g., law clerk, accountant, or bookkeeper) to co-sign any trust cheques. This will assure and assist the substitute lawyer who may have to make payments of funds from the trust account.

Lawyers may wish to use the co-signature of a non-licensee employee (e.g., an office administrator or bookkeeper) on all trust cheques as an internal measure. Lawyers must not allow such an employee to be able to disburse trust funds alone. To ensure that no unauthorized withdrawals from trust are being made, the lawyer should limit access to blank trust account cheques and electronic banking software. The lawyer should never sign a trust check that is missing any information (e.g., payee, amount, date) or leave signed blank trust cheques to be filled in by anyone at a later time. The lawyer should use pre-numbered trust cheques and keep them secured when not in use.

4.3.4 Withdrawal from trust in error, corrections

If the lawyer's financial institution withdraws service fees from the trust account instead of the general account, the lawyer must ensure that the error is corrected and the funds are returned to trust. If necessary, the lawyer may have to correct this by depositing his or her own funds to trust. Though the lawyer's account statement may show this, lawyers should request something in writing from the financial institution for their records to confirm when the error occurred, that it was the fault of the financial institution, and when it was corrected.

If a lawyer mistakenly withdraws funds from trust, he or she must return those funds to trust as soon as the error is discovered. If a lawyer mistakenly disbursed funds on the client's behalf that the client did not have in trust, the lawyer should transfer funds from the general account to cover the shortfall as soon as possible. Correcting entries must also be made to the client trust ledger, trust receipts, and trust disbursements journals. To avoid confusing blank trust account cheques with blank general account cheques, lawyers should ensure that they are easily distinguished from each other (e.g., a different style or colour) and are stored separately.

4.4 Unclaimed trust funds

Lawyers should review the clients' trust ledger regularly to ensure there are no client funds sitting in trust that do not belong there. Once the client has been billed for services rendered, the lawyer should pay himself or herself from the client's funds in trust as soon as it is practical. If a trust cheque issued to the client or a third party has not yet been cashed, the lawyer must follow

up with the payee to ensure that they received the cheque or to find out why it was not cashed.

Trust cheques may become stale dated and non-negotiable if outstanding too long. Stale-date periods vary with the financial institution and may be anywhere from six months to a year. Once a trust cheque written by the lawyer becomes stale dated the lawyer should

- contact the financial institution to put a stop payment on the cheque;
- re-enter the amount of the cheque in the clients' trust ledger for that client; and
- reissue the trust cheque, if appropriate.

Where the lawyer has money in trust for a client for at least two years, the lawyer may apply to have these unclaimed trust funds transferred to the Law Society's *Unclaimed Trust Fund* if

- despite reasonable attempts to locate the client, the lawyer cannot find the client to whom the funds belong; or
- the lawyer does not know to whom the funds belong.

The fund is operated by the Law Society's Trustee Services department in accordance with By-Law 10, made under the *Law Society Act*, and information regarding the fund is available through the Law Society's website at www.lsuc.on.ca.

5. Receiving money from clients

Subject to the provisions of By-Law 9 that relate to cash transactions, a lawyer or law firm may choose to accept payment from clients using any method including

- electronic or wire transfer;
- cash;
- credit or debit card;
- personal cheque or certified personal cheque; and
- bank draft or money order.

Lawyers who accept payment by electronic or wire transfer will need to provide the trust or general account details to the party sending payment. Lawyers should confirm with their financial institution that these details may be used for deposit only. If a lawyer chooses to accept payment by cash, credit or debit card, and personal cheque, the lawyer must be aware of his or her responsibilities discussed below.

5.1 Restrictions on accepting cash

As part of its mandate to govern the paralegal profession in the public interest, the Law Society has adopted provisions to assist in the prevention of money laundering. These address the handling and record keeping of cash transactions and are contained in Part III of By-Law 9. For the purposes of this by-law, *cash* means

- current coin within the meaning of the Currency Act;
- notes intended for circulation in Canada issued by the Bank of Canada pursuant to the Bank of Canada Act; and
- current coin or bank notes of countries other than Canada.

For any one client file, a lawyer may only accept less than $7,500 Canadian in cash. Lawyers are forbidden to accept cash in the amount of $7,500 Canadian or more with respect to any one file. The same restriction applies to foreign currency. If a lawyer accepts foreign currency, he or she must convert it to Canadian funds using the formula outlined in By-Law 9 to ensure the value of the funds is less than $7,500 Canadian. Once converted, if the amount of foreign currency for any one client file is $7,500 Canadian or more, the lawyer may only accept an amount less than $7,500 and must tell the client that the remainder must be provided to the lawyer by some other method (for example, credit card, debit card, or cheque).

This rule applies when the lawyer engages in or gives instruction on behalf of the client with respect to the following activities:

- the lawyer receives or pays funds; and
- the lawyer transfers funds by any means.

There are some exceptions. The lawyer may accept $7,500 cash or more on behalf of one client matter if the cash is received

- for future fees or disbursements (i.e., a money retainer), for fees or disbursements charged to the client, or for expenses or bail, provided that any refund out of such receipts is also made in cash;
- to pay a fine or penalty;
- pursuant to an order of a tribunal;
- from a peace officer, law enforcement agency, or other agent of the Crown acting in an official capacity; or
- from a public body, an authorized foreign bank within the meaning of s. 2 of the *Bank Act* in respect of its business in Canada or a bank to which the *Bank Act* applies, a cooperative credit society, savings and credit union, or caisse populaire that is regulated by a provincial Act, an association that is regulated by the Cooperative Credit Associations Act, a company to which the Trust and Loan Companies Act applies, a trust

company or loan company regulated by a provincial Act, or a department or agent of Her Majesty in right of Canada or of a province where the department or agent accepts deposit liabilities in the course of providing financial services to the public.

If the lawyer accepts a cash payment for fees, disbursements, expenses, or bail, there may be cases where he or she must refund some of those funds in cash. To refund money to the client in cash, the lawyer may withdraw funds from the general or trust account by

- completing a withdrawal slip for either the general or trust account; or
- issuing a general or trust cheque payable to the lawyer (noting the client file number and that it is a cash withdrawal), cashing the cheque, and giving the cash to the client.

Using a cheque will create a better paper trail. A lawyer who uses a withdrawal slip should request a duplicate copy of the withdrawal slip for his or her records. When the cash is refunded to the client, the lawyer should obtain a receipt from the client or have a witness present to document the transfer of cash. Whichever method of withdrawal, the lawyer should consider obtaining the client's written instructions prior to making the withdrawal.

Accepting cash payments to either the general or trust account will impose additional record keeping requirements upon the lawyer, as outlined in the "Record keeping requirements" section of this chapter. As with any method of payment, lawyers may refuse to accept cash from clients.

5.2 Use of credit and debit cards

Lawyers may accept credit card and debit card payments from clients. Payments for future fees and disbursements (i.e., a money retainer) must be deposited to the trust account. Payments for services rendered for which a fee bill has been sent to the client must be deposited to the general account. Lawyers must ensure that all merchant discounts and service charges associated with accepting credit and debit card payments are charged to the general account.

If the lawyer's financial institution will only allow one account to be designated for credit and debit card deposits, the account the lawyer chooses will dictate what methods of payment the lawyer may accept. That is,

- if the lawyer selects the general account, which holds funds that belong to the lawyer or the law firm, the lawyer may only accept payment by credit or debit card for services already rendered and billed to the client; and
- if the lawyer selects the trust account, which holds funds that belong to clients, the lawyer may only accept payment by credit and debit card for payment of money retainers.

Lawyers may not make all deposits to one account and then transfer the appropriate amounts to the other account. If a lawyer wishes to accept client credit and debit card payments for both money retainers and bills, the lawyer may have to set up two point-of-sale (POS) machines: one for trust deposits and one for general deposits. If the lawyer's financial institution provides him or her with a POS machine linked to both the trust and general accounts that will allow the lawyer to select to which account the payment should be deposited at the time of the transaction, the lawyer must use internal controls so that the appropriate account is selected to receive the client's payment.

5.3 Clearance periods

When receiving funds in trust that must later be disbursed, the lawyer must be aware of the clearance period that applies to the method of payment received. The *clearance period* refers to the period of time it will take for the funds to actually be available for use and will be set by the lawyer's financial institution (i.e., the receiver of the funds). Clearance periods vary by method of payment and financial institution.

For example, a standard clearance period for an uncertified personal cheque is from five to 10 business days. Once the clearance period has passed and the funds are in the trust account and may be disbursed, the funds are considered "cleared." Certified cheques, bank drafts, and money orders are usually considered cleared as soon as they are deposited because the issuing financial institution has guaranteed or certified the funds. If the lawyer is unsure whether the funds deposited to the trust account have cleared, he or she should call the financial institution for confirmation.

When receiving funds from a client for deposit to the mixed trust account, the lawyer must ensure that the funds have cleared before he or she disburses any of those funds. If the lawyer disburses client funds before they have cleared and the client's original payment is returned because of non-sufficient funds (NSF),

- the lawyer's financial institution will debit the trust account to reverse the deposit (this is acceptable);
- the lawyer must ensure that any resulting service charges are not deducted from the trust account, as they must come from the general account;

- the lawyer must record the reversal of the NSF funds in the trust receipts journal and the clients' trust ledger, with a detailed explanation for the reversal;
- the lawyer will need to discuss the matter with any payees who received trust cheques disbursing those client funds to arrange for deferral of payment;
- if any of the payees have negotiated the trust cheques, the lawyer must reimburse the trust account from his or her own funds (i.e., the general account); and
- the lawyer must obtain replacement payment from the client whose cheque was returned "NSF."

If a lawyer has disbursed funds from trust with respect to a client that had insufficient funds in trust, the client trust ledger account is *overdrawn*. This represents a shortage of client funds, and the lawyer is responsible for fixing any such shortages that occur in the trust account. If the lawyer does not have enough funds of his or her own to correct an overdrawn client trust ledger account, the trust account will be short. In essence, the lawyer has misused or misapplied funds belonging to other clients. If the lawyer cannot correct an overdrawn client trust ledger account, he or she must report this to the Law Society.

In a situation where the lawyer must disburse client funds quickly after receiving them in trust from the client, the lawyer should request certified funds from the client. The lawyer should also review the client trust ledger accounts regularly to ensure that there are sufficient funds in trust for the client's future disbursements and to determine when those funds need to be replenished.

6. Record keeping requirements

Part V of By-Law 9 outlines the *minimum* requirements for books and records to be kept in a law or legal services practice. These requirements are designed to protect the public, and they focus on trust records, which are the records kept to track the handling of clients' money held by the lawyer. Lawyers who hold client funds must be able to account for those funds to their clients at any time. To do this, the lawyer must record the money received from each client, the money disbursed for each client, and what the unused trust balance is for each client. Lawyers must also keep their bank statements as an independent record or *source document* of trust transactions. Source documents are discussed later in this chapter.

Maintaining complete, accurate, and up-to-date records is in the lawyer's best interest as it will give him or her the financial information needed to make sound financial decisions about the practice. Proper accounting records also help lawyers meet their obligations to file reports on time to the CRA for income tax and HST, to the professional liability insurer, and to the Law Society. Falling behind in record keeping may cost the lawyer time and money and may damage client relationships.

Lawyers who are not familiar with accounting practices or cannot devote the time and effort to maintaining their own books and records as required by By-Law 9 should consider delegating these duties. Lawyers may delegate bookkeeping tasks to trained support staff or to an independent bookkeeper or accountant who can be hired for this purpose. The lawyer must supervise staff to ensure that records are complete, current, and accurate.

6.1 Records must be current, permanent, available in paper copy

With the exception of the *monthly trust comparison* discussed later in this chapter, lawyers must keep their records current at all times. That means they must be up to date or updated daily. The best way to do this is to make or "post" their entries to all records on a daily basis. If the lawyer prepares any financial records by hand, these must also be permanent (i.e., in ink). Lawyers may keep their financial records electronically but must be able to produce paper copies of them promptly when requested by the Law Society. To avoid problems with computer crashes, data corruption, and software becoming outdated, lawyers may wish to print their journals and records monthly. By-Law 9 outlines the lawyer's financial record keeping requirements for both the general and trust accounts in a law practice.

6.2 General account

For his or her general account, a lawyer must keep

- a general receipts journal;
- a general disbursements journal;
- a fees book; and
- source documents for the above.

Together, the general receipts and general disbursements journal may be referred to as the *general cash journal*. The Law Society recommends that lawyers also maintain client general ledger accounts, but they are not required. As a rule of thumb, lawyers must keep most general account records for a period of six years. This means the most recent six years plus the current year. The information that must

be kept in each record is described below and sample documents are at the end of this chapter.

6.2.1 General receipts journal (6 years)

The general receipts journal tracks all of the money the lawyer receives, other than money received in trust for clients. This is money that belongs to the lawyer or law firm. For each amount of money received in the general account, the lawyer must record the

- date money was received;
- method by which money was received (e.g., cash, cheque, bank draft, and debit card);
- amount of money received; and
- person from whom money was received.

6.2.2 General disbursements journal (6 years)

The general disbursements journal records all of the money disbursed by the lawyer or law firm, other than money held in trust for clients. This is money that belongs to the lawyer or law firm. For each amount of money disbursed from the general account, the lawyer must record the

- date payment was made;
- method used to make payment (e.g., cheque, electronic transfer, money order);
- reference number of payment method (e.g., cheque number, Internet banking reference number, money order number);
- amount of payment; and
- person to whom payment was made.

6.2.3 Fees book (6 years)

The fees book contains entries for each bill or account issued to clients. Lawyers must keep either a fees book or a file containing copies of client bills, ordered by date. In the fees book, the lawyer must record the

- amount of fees charged to the client;
- amount of other billings to the client (e.g., disbursements and HST);
- date of billing; and
- name of client who was billed.

Lawyers may keep both a fees book and a file of client bills, if they wish. For convenience, lawyers should also keep a copy of the client's bills in the particular client's file. When a client billing is recorded in the fees book, it must also be entered into the client's general account. The fees book is also where lawyers should track the total HST receivable on fee billings.

6.2.4 Client general ledger (optional)

The client general ledger is not required by the Law Society but is useful for tracking all the expenses, invoices, and payments made for each client. The balance in the individual client's general account shows the amount of money that the client owes the lawyer at any given time. The balance reflects fee and disbursement billings that have been sent to the client but have not yet been paid for and unbilled disbursements that the lawyer has paid but not yet billed to the clients. Lawyers should review this monthly to assist them to prepare bills for their clients.

Lawyers should review the client general ledger monthly to ensure there is not a negative balance in either the general receipts or general disbursements for any client. A negative balance in the client receipts journal would indicate the lawyer received an overpayment, payment for a bill not yet posted, or an amount was transferred from trust that exceeds the amount that was billed to the client. A negative balance in the client disbursement journal would indicate the client was billed for a disbursement not yet paid for by the lawyer or law firm.

6.2.5 Monthly general reconciliation (optional)

Lawyers may also wish to do a monthly reconciliation of their general account, although it is not required by the Law Society. The reconciliation involves checking all entries in the general account statement against the general account source documents, books, and records to ensure that they match. It allows the lawyer to confirm that the statement from the financial institution agrees with the general account records and to ensure that the financial institution has made no mistakes. It also allows the lawyer to track general account activities, to manage cash flow, and to prevent unauthorized spending. A monthly general reconciliation follows the same principles as a *trust reconciliation*, which is explained below.

6.3 Trust account

For his or her trust account, a lawyer must keep a

- trust receipts journal;
- trust disbursements journal;
- client trust ledger, with individual client accounts;
- trust transfer journal;

- monthly trust comparisons; and
- trust account source documents.

These are all required records. Together, the trust receipts and trust disbursements journal may be referred to as the *trust cash journal*. With the exception of the trust transfer journal, all trust records must be kept for a period of 10 years. This means the most recent 10 years plus the current year. The information that must be kept in each record is described below and sample documents appear at the end of this chapter.

6.3.1 Trust receipts journal (10 years)

The trust receipts journal tracks the amounts received from clients in trust. This is money the lawyer holds for clients. For each amount received in trust for a client, the lawyer must record the

- date money was received;
- method by which money was received (e.g., cash, cheque, bank draft, and debit card);
- person or institution from whom money was received;
- amount of money received;
- name of the client for whom money was received; and
- reason the money was received in trust (e.g., payment or replenishment of a money retainer).

6.3.2 Trust disbursements journal (10 years)

The trust disbursements journal tracks payments made out of trust on behalf of clients. This is client money the lawyer pays out on behalf of the client. For each amount disbursed from trust on behalf of a client, the lawyer must record the

- date payment was made;
- method used to make the payment (e.g., cheque, electronic transfer, and money order);
- reference number of payment method (e.g., cheque number, Internet banking reference number, and money order number);
- amount of payment;
- person to whom payment was made;
- name of the client on whose behalf payment was made; and
- reason the money was paid from trust (e.g., payment of a disbursement or fee invoice).

If withdrawing funds from trust by electronic transfer, lawyers must complete and keep a copy of the *Electronic Trust Transfer Requisition Form* and bank confirmation of the transfer.

6.3.3 Client trust ledger (10 years)

Lawyers must maintain records that show the amount that they hold in trust for each client separately. Each client "account" in the client trust ledger tracks the amount of money received in trust for that client, the amount of money paid from trust on behalf of that client, and any remaining balance that client has in trust. If representing a client in more than one matter, the lawyer will have more than one (client trust ledger) account grouped in that client's client trust ledger.

The client trust ledger is an important accounting record because it helps the lawyer to avoid spending more money on the client's behalf than the lawyer holds in trust for that client. It also helps the lawyer to identify whether the client should provide further funds to replenish the money retainer. If the lawyer is not holding any money in trust for a client, no trust ledger for that client is required.

6.3.4 Trust transfer journal (6 years)

Lawyers must also keep a record that shows any amounts of money transferred between client trust ledger accounts and explains the reason for each transfer. Such a transfer may occur when the lawyer has opened more than one client trust ledger account for a particular matter (i.e., the lawyer represents more than one party in a joint retainer). The lawyer would also use this journal when transferring money between client trust ledger accounts to correct any errors made in an original posting. For example, if funds received from Client A were supposed to be deposited to trust but they were incorrectly posted to Client B's trust ledger account, the transfer from Client B to Client A to correct the client trust ledger accounts would be entered in the trust transfer journal.

6.3.5 Monthly trust comparison (10 years)

The monthly trust comparison is a required record. It consists of a detailed listing that shows how much money is held in trust for each client and a detailed monthly reconciliation of each trust account. The monthly trust comparison is performed to ensure that the lawyer's trust accounting records agree with his or her trust bank account(s) statements. It allows the lawyer to identify any differences that may result from posting or financial institution errors. It must be completed by the 25th of each month for all trust funds the lawyer or law firm held at the previous month's end. The trust comparison compares

- the reconciled trust bank balance; and

- the client trust listing total.

These two amounts must be the same. This is one of the most important trust records that the lawyer must maintain. The lawyer should correct any trust shortages immediately and correct any bank or posting errors before the next month end.

The *trust reconciliation* is a way to ensure that the amount of money held in trust according to the lawyer's trust account statements from the bank agrees with the amount recorded in the lawyer's books and records. Every month, the lawyer should receive a statement from his or her financial institution showing all transactions processed through the lawyer's trust account during the month and the balance at the end of the month. A trust account is "reconciled" by checking all the entries on the bank statement against the lawyer's source documents and trust records. This requires the lawyer to check the statement against deposit slips (i.e., trust receipts), returned cashed cheques (i.e., trust disbursements), and the trust receipts and disbursements journal.

The trust reconciliation will identify whether the lawyer's financial institution made any errors in processing payments made from and deposited to the trust account. It can also reveal amounts the lawyer may have forgotten to post to the trust receipts or disbursements journal, such as an electronic transfer of funds in or out of trust. Lawyers must also note any outstanding items, such as uncashed trust cheques or trust money received on the last day of the month but not deposited until the next day (i.e., the first of the following month).

To complete the trust reconciliation, the lawyer must follow all steps in the process outlined below:

1. Check off all returned cheques on the trust bank statement for the previous month, noting any discrepancies in the amounts.
2. From the trust disbursement journal, identify any cheques that were issued that have not yet cleared the bank.
3. List outstanding cheques by cheque number, issue date, and amount and total the amounts.
4. From the trust deposit book, check off all deposits on the trust bank statement noting any discrepancies in the amounts.
5. List any deposits for the previous month, by date and amount, that are not recorded on the trust bank statement; these are outstanding deposits.
6. List any bank errors and/or posting errors individually by date of occurrence and provide a brief explanation. A copy of any supporting documentation, such as a bank memo, should be attached to the reconciliation.
7. From the ending balance on the trust bank statement subtract the amount of the outstanding cheques, add any outstanding deposits, and adjust for any bank and posting errors to calculate the reconciled trust bank balance.

The *client trust listing* is a monthly list of all clients for whom the lawyer or law firm holds money in trust. From the client trust ledger, make a list of all clients for whom money was held at the previous month end. Beside each client's name list the amount of funds held for that client at the previous month end. The list is added, and the total shows the total money held in trust on behalf of clients or owed to clients at that particular month end. These are the lawyer's *client liabilities*. The listing must include the names of all clients for whom the lawyer or law firm holds money in trust, either in the mixed trust account or separate interest-bearing accounts.

To complete the client trust listing, the lawyer must follow all steps in the process outlined below:

1. From the clients' trust ledger, identify any client for whom trust funds were held at the previous month end.
2. List the client names in a logical order, with the unexpended trust balance for each client as at the previous month end.
3. Include the last activity date for each client's trust balance on the client trust listing to help monitor inactive or dormant amounts.
4. Total the client trust listing.

Lawyers must compare the reconciled trust bank balance with the client trust listing total. This is the *monthly trust comparison* that must be completed by the 25th of each month. If these two amounts are not the same, the lawyer must find and correct the discrepancy. If the lawyer has only one mixed trust account, the trust reconciliation should agree with the total on the client trust listing. If the lawyer has more than one trust account, the lawyer should make a list that details each trust account balance to ensure that none of the trust account balances are missed.

Regardless of who prepares it, the lawyer should review the trust comparison and all supporting documentation by the 25th of the following month to ensure that

- the comparison has been completed on time;
- all client trust funds are included (e.g., mixed, pass book, GICs, term deposits, etc.);
- balances of bank statements, passbooks, GICs, term deposits, etc., are correct;
- the arithmetic is correct;

- items are reconciled (e.g., bank errors and posting errors) are cleared each month and are explained and supported by documentation;
- stale-dated cheques are reversed, the client liability reinstated in the clients' trust ledger, and if appropriate, stop payment orders are made and cheques reissued;
- client trust ledger accounts are not overdrawn;
- the amounts in trust for each client are correct; and
- any client trust ledger accounts that have not had any activity in the previous 12 months are reviewed.

6.4 Other record keeping requirements

In addition to the records lawyers must keep that are related to the general and trust account(s), By-Law 9 outlines some additional record keeping requirements. These include maintaining source documents, a duplicate cash receipts journal, and a valuable property record. The details on these records are described below and selected sample documents appear at the end of this chapter.

6.4.1 Source documents — general and trust accounts (10 years)

Lawyers are required to keep all copies of source documents for both the general and trust accounts of their law practice. *Source documents* refer to documents that are the source of the information entered into the lawyer's accounting books and records. Source documents may be in either paper or electronic form, and lawyers must keep all source documents for 10 years. Examples of source documents include

- cashed or cancelled general and trust cheques or electronic images of these;
- trust and general account statements from the lawyer's financial institution;
- general account passbooks and trust account passbooks;
- detailed duplicate deposit slips for both the general and trust accounts, either stamped by teller or with attached ATM receipt;
- copies of fee invoices to clients if the lawyer does not keep a fees book (lawyers should also keep copies of these invoices in the client files); and
- completed copies of the *Electronic Trust Transfer Requisition Form* (Form 9A) with signed confirmations attached if the lawyer withdraws from trust via electronic transfer (lawyers may also wish to keep a similar form and signed confirmations for electronic transfers from the general account).

There are special considerations for *cheque imaging*. Some financial institutions no longer return the original cashed cheques to customers, but instead provide an electronic image of cashed cheques. These are sent by email or can be accessed by the customer over the Internet. If the lawyer's financial institution provides cheque images instead of cancelled cheques, the lawyer must ensure that the images provided are of both the front and back of the cancelled cheque and can be easily read. Since there is no guarantee the financial institution will offer the images on the Internet indefinitely, lawyers should print hard copies for their records or save the images electronically in their own computer systems. If keeping them electronically, the method the lawyer chooses must allow him or her to reprint them throughout the required 10-year retention period.

To maintain *detailed duplicate deposit slips*, the lawyer should record on all copies of general and trust deposit slips the

- date the funds were deposited;
- lawyer or law firm's name if it is not pre-printed;
- bank account number if it is not pre-printed;
- source of each receipt;
- related client, if applicable; and
- amount of funds deposited.

Though not required by the Law Society, lawyers may also wish to keep copies of any invoices paid from the general account. These would include business expenses as well as payments made on behalf of clients that were later reimbursed by the client. If the lawyer's financial institution does not provide the source documents required by By-Law 9, the lawyer will be unable to meet his or her record keeping requirements and may need to switch to another financial institution that will accommodate these requirements.

6.4.2 Duplicate cash receipts book (6 years)

For every amount of cash the lawyer or law firm receives, the lawyer must prepare and keep a book of duplicate cash receipts. This is required every time a cash payment is accepted, whether it is deposited to the general or trust account. The duplicate cash receipt must contain the

- date cash was received;
- name of the person who gave the cash;
- amount of cash received;
- name of the client for whom the cash was received;

- file number, if any;
- the lawyer's signature or that of an authorized designate; and
- signature of the person who gave the cash.

Lawyers should number their accounting documents in sequence, including their duplicate cash receipts. One copy of the receipt should be given to the person who provided the cash to the lawyer, and one copy should be kept with the lawyer's accounting records. Lawyers may also want to prepare the receipt in triplicate and keep the third copy in the client file.

The lawyer must make reasonable efforts to get the signature of the person who provides the cash. The lawyer may need to explain to the individual offering cash why the signature is necessary, outlining his or her obligation under By-Law 9 and that the purpose is to prevent money laundering. Not being able to obtain that person's signature does not mean that the lawyer cannot accept the cash, but the lawyer should be wary of accepting cash from someone who does not want to sign a receipt. If the person refuses to sign the receipt after the lawyer has explained the requirements of the by-law, the lawyer should document his or her efforts to obtain a signature in accordance with By-Law 9.

A lawyer's support staff may be reluctant to accept responsibility for receipt of cash payments. A lawyer who decides to make it a policy not to accept cash or cash over a certain amount should notify prospective clients in writing before accepting retainers. Lawyers may not accept cash in the amount of $7,500 or more, except as outlined in By-Law 9.

6.4.3 Valuable property record (10 years)

Lawyers are required to keep a record of all negotiable or valuable property (other than money) that they receive that is to be held in trust for clients. The main reason for the record is to protect the lawyer from any allegations from a client or third party that the lawyer misappropriated valuable property given to him or her for safekeeping. Lawyers should avoid holding valuable property for clients for an extended period of time and should only hold property related to the matter for which they were hired by the client. Apart from recording the valuable property, the lawyer must ensure the property is kept in a secure place, such as a safety deposit box at the financial institution. The valuable property record should

- show all property, other than money, held in trust for clients;
- describe each property and the date that the paralegal or lawyer firm took possession;
- indicate who had possession of the property immediately before the lawyer or law firm took possession;
- show the value of each property;
- indicate the client for whom each property is held in trust; and
- show the date each property is given away and to whom it is given.

7. Sample documents

The following pages show sample documents for the general and trust accounts. Examples of a duplicate cash receipts journal, the valuable property record, and a sample completed *Electronic Trust Transfer Requisition Form* have also been provided.

- Figure 1: General Receipts Journal, General Disbursements Journal, and Fees Book
- Figure 2: General Client Ledger
- Figure 3: Trust Receipts Journal, Trust Disbursements Journal, and Trust Transfer Journal
- Figure 4: Client Trust Ledger
- Figure 5: Monthly Trust Comparison
- Figure 6: Duplicate Cash Receipt
- Figure 7: Valuable Property Record
- Figure 8: Sample *Electronic Trust Transfer Requisition Form* (Form 9A)

Figure 1: General Receipts Journal, General Disbursements Journal, and Fees Book

Leslie Lawyer – General Receipts Journal

Date 2011	Funds Received From	Amount	Method of Payment
Oct 1	ACME Bank re Bank Loan	2,5000.00	Bank Draft
Oct 7	Stephen Bell re Inv # 0116	5,000.00	Cheque
Oct 12	Angela Finelli re Inv # 0117	1,695.00	Cheque
Oct 30	Transfer from trust re Piper, Inv # 0118	2,825.00	ET # 0081
Nov 15	Stephen Bell re Inv # 0116	250.00	Cash
Nov 22	Transfer from trust re Said, Inv # 0119	1,130.00	ET # 0082
Nov 30	Stephen Bell re Inv # 0116	400.00	Cash

Leslie Lawyer – General Disbursements Journal

Date 2011	Method / Ref #	Paid To	Particulars	HST Paid	Amount
Oct 1	Cheque # 051	Lucy Landlord	Rent	130.00	1,130.00
Oct 12	ET # 0080	ABC Office Supplies	Stationery	26.00	226.00
Oct 25	Debit from account	Acme Bank	Service Fees	2.60	22.60
Nov 1	Cheque	Lucy Landlord	Rent	130.00	1,130.00

Leslie Lawyer – Fees Book

Date 2011	Inv #	Client	Fees Billed	Disburse. Billed	HST Billed	Total Billed
Oct 2	0116	Bell re small claim	5,000.00		650.00	5,650.00
Oct 10	0117	Finelli re traffic	1,500.00		195.00	1,695.00
Oct 25	0118	Piper re small claim	2,500.00		325.00	2,825.00
Nov 17	0119	Said re indictment charge	1,000.00		130.00	1,130.00

Figure 2: General Client Ledger

Leslie Lawyer – Client General Ledger

Account:	**BELL, Stephen re small claim**					
Date 2011	**Particulars**	**Expenses Paid**	**HST**	**Fees**	**Payments**	**Balance Owed**
Oct 2	Fees – Inv # 0116		650.00	5,000.00		5,650.00
Oct 7	Client Payment				5,000.00	650.00
Nov 15	Client Payment				250.00	400.00
Nov 30	Client Payment				400.00	0.00

Account:	**FINELLI, Angela re traffic**					
Date 2011	**Particulars**	**Expenses Paid**	**HST**	**Fees**	**Payments**	**Balance Owed**
Oct 10	Fees – Inv # 0117		195.00	1,500.00		1,695.00
Oct 12	Client Payment				1,695.00	0.00

Account:	**PIPER, Jane re small claim**					
Date 2011	**Particulars**	**Expenses Paid**	**HST**	**Fees**	**Payments**	**Balance Owed**
Oct 25	Fees – Inv # 0118		325.00	2,500.00		2,825.00
Oct 30	From Trust				2,825.00	0.00

Account:	**SAID, Ali re indictment charge**					
Date 2011	**Particulars**	**Expenses Paid**	**HST**	**Fees**	**Payments**	**Balance Owed**
Nov 17	Fees – Inv # 0119		130.00	1,000.00		1,130.00
Nov 22	From Trust				1,130.00	0.00

Account:	**SILVER, David re small claim**					
Date 2011	**Particulars**	**Expenses Paid**	**HST**	**Fees**	**Payments**	**Balance Owed**
Nov 28	Filing defendant claim	175.00				175.00
Nov 28	From Trust				175.00	0.00

Account:	**SILVER, Susan re traffic**					
Date 2011	**Particulars**	**Expenses Paid**	**HST**	**Fees**	**Payments**	**Balance Owed**
Nov 5	Parking Ticket Paymt	90.00				90.00
Nov 5	From Trust				90.00	0.00

Figure 3: Trust Receipts Journal, Trust Disbursements Journal, and Trust Transfer Journal

Leslie Lawyer – Trust Receipts Journal

Date 2011	Funds Received From	Client	Amount	Method of Payment
Oct 12	Jane Piper	Piper re small claim	3,000.00	Cheque
Nov 1	Susan Silver	Silver re traffic	100.00	Credit Card
Nov 8	Jane Piper	Piper re small claim	1,250.00	Cheque
Nov 15	Ali Said	Said re indictment charge	21,130.00	Cert. Cheque
Nov 18	David Silver	Silver re small claim	200.00	Credit Card

Leslie Lawyer – Trust Disbursements Journal

Date 2011	Method / Ref #	Paid To	Client	Amount
Oct 30	ET # 0081	Leslie Lawyer	Piper re small claim	2,825.00
Nov 5	Cheque # 012	City of Toronto	Silver re traffic	90.00
Nov 15	Cheque # 013	Minister of Finance	Piper re small claim	100.00
Nov 22	Cheque # 014	Minister of Finance	Said re indictment charge	20,000.00
Nov 22	ET # 0082	Leslie Lawyer	Said re indictment charge	1,130.00
Nov 28	Cheque # 015	Minister of Finance	Silver re small claim	175.00

Leslie Lawyer – Trust Transfer Journal*

Date 2011	From Client	To Client	Amount	Reason
Nov 30	Susan Silver re traffic	David Silver re small claim	10.00	Unused retainer, completed matter; on Susan Silver's written direction

* In this example, Susan Silver's traffic matter is now over and she has already been fully billed for the services provided. She provided written instruction to Leslie Lawyer to transfer her remaining retainer balance from the traffic matter to her son's account for the small claim matter that Leslie Lawyer is also handling. A trust transfer entry is required for transfers between clients and not matters for the same client.

Figure 4: Client Trust Ledger

Leslie Lawyer – Client Trust Ledger

Account:	**PIPER, Jane re small claim**			
Date 2011	**Particulars**	**Receipts**	**Disbursements**	**Balance in Trust**
Oct 12	Retainer re small claim	3,000.00		3,000.00
Oct 30	Transfer to general Invoice # 0118		2,825.00	175.00
Nov 8	Retainer re small claim	1,250.00		1,425.00
Nov 15	Notice of garnishment		100.00	1,325.00

Account:	**SAID, Ali re summary charge**			
Date 2011	**Particulars**	**Receipts**	**Disbursements**	**Balance in Trust**
Nov 15	Bail advance	21,130.00		21,130.00
Nov 22	Bail payment		20,000.00	1,130.00
Nov 22	Transfer to general Invoice # 0119		1,130.00	0.00

Account:	**SILVER, David re small claim**			
Date 2011	**Particulars**	**Receipts**	**Disbursements**	**Balance in Trust**
Nov 18	Retainer re small claim	200.00		200.00
Nov 28	Filing defendant claim		175.00	25.00
Nov 30	Transfer from S. Silver	10.00		35.00

Account:	**SILVER, Susan re traffic**			
Date 2011	**Particulars**	**Receipts**	**Disbursements**	**Balance in Trust**
Nov 1	Retainer re traffic	100.00		100.00
Nov 5	Parking ticket payment		90.00	10.00
Nov 30	Transfer to D. Silver		10.00	0.00

* No trust ledger accounts were created for Angela Finelli or Stephen Bell since no money is being received in trust for them. Leslie Lawyer is simply billing these clients as services are being rendered, with no advance of a money retainer.

Figure 5: Monthly Trust Comparison

Leslie Lawyer

Trust Bank Reconciliation as at November 30, 2011

Mixed Trust Account:

Balance per Bank Statement		$3,533.00
Less:	Outstanding Cheques (see list below)	2,175.00
Plus:	Outstanding Deposits – 30Nov11	0.00
Plus:	Bank Error- 11Nov11	2.00
Chq# 062 cleared as $344.00 s/b 342.00, corrected 18Dec11 by credit memo		
Reconciled Mixed Trust Bank balance at November 30, 2011		**$ 1,360.00**

Outstanding Cheques:

Cheque #	Date	Amount
014	22Nov11	$2,000.00
015	28Nov11	175.00
Total Outstanding Cheques:		$2,175.00

Client Trust Listing as at November 30, 2011
(from clients' trust ledger balances)

File Name	Last Activity Date	Amount
PIPER, Jane re small claim	15Nov11	$1,325.00
SAID, Ali re summary charge	22Nov11	0.00
SILVER, David re small claim	28Nov11	35.00
SILVER, Susan re traffic	05Nov11	0.00
Total client funds in trust:		$ 1,360.00
Total trust liabilities to clients at November 30, 2011		**$ 1,360.00**

Trust Comparison as at November 30, 2011

Total Reconciled Trust Bank Balance	**$ 1,360.00**
Total of unexpended balances per Clients' Trust Ledger	**$ 1,360.00**

Figure 6: Duplicate Cash Receipt

DUPLICATE CASH RECEIPT # 0001

Date _____

Received from _____ the amount of $ _____

On behalf of _____ for file # _____

_____ _____

Signature of Payor [person paying cash] Authorized signature on behalf of [name of firm]

Figure 7: Valuable Property Record

Client	Description of Property	Date Received	Received From	Value of Property	Given To	Date Given
BELL, Stephen	pearl necklace	01Dec10	BELL, Stephen	530.00	BELL, Allison	02Jan11
SILVER, Susan	silver jewellery	01Jan11	SILVER, Susan	475.00		
FINELLI, Angela	collector plates	07Feb11	FINELLI, Angela	320.00		

Figure 8: Sample Electronic Trust Transfer Requisition Form (Form 9A)

[sample] FORM 9A

ELECTRONIC TRUST TRANSFER REQUISITION
Requisition **#ET0081**

Amount of funds to be transferred: **$2,825.00**

Re: **PIPER small claim**

Client: **Jane Piper**

File No.: **10-47**

Reason for payment: **Fees ($2,500.00) disbursements ($0.00) and HST ($325.00) billed to client**

Trust account to be debited:	Name of financial institution:	**Bank of Ontario**
	Account number:	**123456789**
	Name of Recipient:	**Leslie Lawyer, General Account**
Account to be credited:	Name of financial institution:	**Bank of Ontario**
	Branch name and Address	**20 Downtown St., City, ON Z9Y 2T2**
	Account number:	**987654321**

Person requisitioning electronic trust transfer: **Leslie Lawyer**

October 30, 2011 ***Leslie Lawyer***

Date Signature

Additional transaction particulars:

Person entering details of transfer:

Name: **Sandy Secretary** ***Sandy Secretary***

Signature

Person authorizing transfer at computer terminal:

Name: **Bobby Bookkeeper** ***Bobby Bookkeeper***

Signature

Business Law

Chapter 15
Methods of carrying on business

1. Sole proprietorship

A sole proprietorship is the most basic form of business organization and can be used in a wide variety of circumstances. Sole proprietorships are relatively inexpensive to set up and require few legal formalities. Rather, a sole proprietorship exists whenever an individual carries on business for his or her own account without the involvement of other individuals, except as employees. Many small businesses are organized as sole proprietorships. All benefits flowing from the business, such as income and assets, accrue exclusively to the sole proprietor, and correspondingly, all obligations including losses, and contractual and tortious liability associated with the business are also the sole proprietor's responsibility.

A major disadvantage of sole proprietorships is that there is no limited liability for the sole proprietor; all business and personal assets may be seized in satisfaction of the sole proprietor's business obligations and liabilities. The sole proprietor can limit his or her personal liability exposure by contract or through insurance.

The federal *Income Tax Act* (*ITA*) requires that individuals with business income report that income on a calendar-year (fiscal period) basis. This rule applies to sole proprietorships. However, another (elective) fiscal period (non-calendar-year) may be used by an individual carrying on a business, provided the Minister of National Revenue (MNR) agrees. Should the MNR revoke the election, the individual must revert to reporting income on a calendar-year basis. To ensure there is little or no deferral of reporting income by an individual using an off-calendar-year fiscal period, the rules in s. 34.1 of the *ITA* require that such business income be effectively calculated on a calendar-year basis. The income or losses from a sole proprietorship must then be included with the sole proprietor's income or losses from other sources during the year. This aggregated income is subject to tax under the *ITA* at the marginal tax rates applicable to individuals.

A sole proprietor's business losses (i.e., non-capital losses) can be used to offset the sole proprietor's other income. If a sole proprietor is unable to utilize a business loss (i.e., does not have sufficient other income against which he or she can deduct the loss) in the year it occurs, the entire loss can be carried back to reduce the sole proprietor's income in any of the three previous taxation years and in the 20 years following the year the loss is incurred.

Example

If a sole proprietor's operating loss was incurred in 2012, the loss could be used to reduce the income of the sole proprietor for any of his or her fiscal years in the period from 2009 to 2032.

This extended carryforward period for non-capital losses (i.e., business losses) has changed in recent years as follows:

- The extended carryforward period (increased from 10 to 20 years) for non-capital losses (i.e., business losses) applies to business losses arising in taxation years ending after 2005.
- For business losses arising in taxation years ending between March 23, 2004, and December 31, 2005, such business losses may be carried forward only 10 years.
- For business losses arising in taxation years ending before March 23, 2004, such business losses may be carried forward only 7 years.

There have been no changes to the three-year carryback period for business losses.

Similar rules apply to capital losses realized by a sole proprietor from the disposition of capital assets. However, capital losses may only be used to reduce capital gains (not business or operating income), and the carryover period for capital losses is three years back and forward indefinitely.

Before beginning to carry on business, sole proprietors should review municipal, provincial, and federal licensing requirements, since licences are required for a number of activities.

Furthermore, sole proprietors must comply with s. 2(2) of Ontario's *Business Names Act* (*BNA*), which states that no individual shall carry on business or identify his or her business to the public under a name other than his or her own, unless the name is registered by that individual. Under s. 7(1) of the *BNA*, leave of the court is required if an individual, corporation, or partnership commences or defends an action under a name other than the registered name of the business. "Business" includes every trade, occupation, profession, service, or venture carried on with a view to profit. The registration must be filed with the Ministry of Government Services

when the name or designation is first used. The *BNA* contains additional requirements for renewals and amendments to the registration. In addition, a penalty is provided on summary conviction for non-compliance with these requirements.

Subrule 8.07(1) of the *Rules of Civil Procedure* enables a sole proprietor carrying on business under a name other than his or her own to sue or be sued in the name of the sole proprietorship.

2. Partnership

When two or more persons, whether individuals or corporations, carry on business together with a view to profit, the relationship is called a partnership, and the members of the partnership are called partners. A partnership is like a sole proprietorship in that it is relatively inexpensive to set up, there are few legal formalities required to create it, and the partners carry on the business themselves directly, since the partnership is not a legal entity separate from its partners.

The laws of Ontario recognize three types of partnerships: general partnerships, normally just called partnerships; limited liability partnerships (LLPs); and limited partnerships. In Ontario, general partnerships and LLPs are governed by the *Partnerships Act* whereas limited partnerships are subject to the requirements of the *Limited Partnerships Act*.

In a general partnership, the liability of each partner for the debts and other obligations of the partnership is unlimited. This is in contrast to limited partnerships. In a limited partnership, there is one or more "general partners" whose liability is unlimited and one or more "limited partners" whose liability is limited to the amount they have contributed or agreed to contribute to the partnership business, as stated in the record of limited partners. LLPs are essentially a cross between general partnerships and limited partnerships and are typically used by groups of professionals who may not be permitted to incorporate and obtain full limited liability. While the assets of the LLP are available to satisfy debts and claims against it, partners are liable only for their own negligence or the negligence of employees under their direct supervision and control. Although a judgment against an LLP for negligence is not enforceable against the other partners, all partners in an LLP remain liable for all other obligations of the LLP.

Subparagraph 249.1(1)(b)(ii) of the *ITA* requires that a partnership (in which there is at least one individual partner, professional corporation, or other affected partnership) report its partnership income on a calendar-year (fiscal period) basis like a sole proprietorship. Otherwise, a partnership may have a tax year that ends with the fiscal period of the partnership (i.e., a non-calendar-year fiscal period). While a partnership is not a person under the *ITA*, the *ITA* provides that a partner's income is to be calculated as if the partnership were a separate person resident in Canada. For example, this means that capital cost allowance (CCA) under the *ITA* is claimed by the partnership itself. Income or losses from the partnership business and capital gains or losses realized by the partnership from the disposition of capital property are determined for the fiscal period of the partnership, but are not taxed in the partnership. Rather, the income/losses or capital gains/losses of the partnership are allocated to the partners pursuant to the terms of their partnership agreement, and if there is no agreement, on an equal basis. The partners include in income their share of the income/losses or capital gains/losses of the partnership. The partnership income/losses or capital gains/losses allocated to a partner is aggregated with the other income of the partner in the partner's tax return and taxed at the partner's tax rate (i.e., the marginal tax rate for individual partners or the applicable corporate rate for a corporate partner).

The type of income that flows through a partnership retains its original character when allocated to partners (i.e., business or rental income, capital gains/losses, foreign income, interest, etc.) and therefore allows a partner to benefit from other provisions in the *ITA* (i.e., the capital gains deduction/exemption on qualified farm or fishing property or shares of a qualified small business corporation, a foreign tax credit, etc.). As with business losses from a sole proprietorship, business losses from a partnership may be used by a partner against the partner's other income. It should be noted that for limited partnerships, special rules apply to restrict a limited partner's deduction of business or property losses to only the partner's investment in the partnership (i.e., the partner's "at risk amount"). Although a partnership does not file a tax return, it does file a partnership information return (Form T5013) with the Canada Revenue Agency (CRA) and also provides a copy of the T5013 to each partner.

Partnerships, including limited partnerships, are frequently used instead of corporations in the creation of "tax shelters," which are vehicles for providing investors with income tax deductions to "shelter" their other income from tax. Partnerships are used for this purpose because taxation at the level of the individual partner allows net tax losses or large tax deductions associated with the nature of the partnership business to "flow-through" the partnership to the partners and so reduce the partners' taxable income from other sources. In

limited partnership situations, this reduction in taxable income and tax payable is limited to the cost that the partner has invested or committed to the partnership. It is called the partner's "at risk amount." Any tax losses taken reduce the effective cost of the investment (i.e., the investor's or partner's adjusted cost base (ACB)) until it is reduced to zero, at which point no further losses can be utilized without an increase in the investment, i.e., through future profits. If a corporation were to be used, generally speaking, there would be no "flow-through" of the corporation's losses or deductions to the shareholders, and therefore no "sheltering" of the shareholder's other income from tax could occur (because it is a separate legal entity, a corporation's income is determined and subject to tax separate from that of its owners, the shareholders).

3. Co-ownership

When two or more persons jointly own property they are known as co-owners. Section 3 of the *Partnerships Act* makes it clear that such a relationship alone does not result in a partnership even if the co-owners share in the profits generated by the property.

The most significant difference between a partnership and co-ownership is the level of ability to deal with one's interest in the property. In a co-ownership, each co-owner owns and is free to deal separately with his or her interest in the property, unless he or she has limited the freedom to do so by contract with the other owners; whereas in a partnership, the partners have no separate interest in the property. Each partner's right is to a division of the profits of the partnership. If a partner wishes to sell his or her interest, it must be sold as a partnership interest, not an interest in the assets of the partnership.

Furthermore, co-owners are not agents for each other. Partners are agents of each other with respect to activities falling within the scope of the partnership. Majority rule normally exists in partnerships in that most, if not all, business decisions can be made by some specified majority against the will of the minority as set out in a partnership agreement. This is not true of a co-ownership unless the co-owners agree to enter into such an arrangement by contract.

Often there will be an agreement between the owners, and care must be taken in preparing this agreement to ensure that the terms of the agreement do not result in co-owners being (or being viewed as) partners.

There may also be tax benefits to a co-ownership arrangement because of the separate ownership interest in property. For example, co-owners may wish to claim CCA at different times or at different rates. In a co-ownership arrangement, each owner can make his or her own claim for CCA based upon his or her separate interest in the property and in light of his or her other tax circumstances. This difference would allow one co-owner who has losses and does not wish to claim CCA to postpone claiming CCA to a later year when the co-owner has taxable income. On the other hand, another c0-owner with taxable income may wish to claim CCA as a deduction to shelter some income from current taxation. In a partnership, this flexibility to claim (or defer claiming) CCA by co-owners is not available to the partners individually since CCA is claimed at the partnership level and the partners must agree on whether and how much CCA the partnership should claim in each year.

4. Corporations

A corporation is the most common form of business organization.

A corporation is a legal entity separate in law from its owners and can own property, carry on business, possess rights, and incur liabilities. Although the shareholders own the corporation through their ownership of shares, they do not own the property belonging to the corporation, and the rights and liabilities of the corporation are not the rights and liabilities of the shareholders.

Shareholders' liability is limited to the value of the assets they have transferred to the corporation (in the form of money, property, or past services) in exchange for shares. If a corporation incurs liabilities in excess of the value of its assets, its creditors can demand to be repaid from the assets of the corporation but have no further recourse for the unpaid liabilities.

If shareholders in their personal capacity guarantee the obligations of the corporation, they will effectively lose their limited liability. Typically, not all debts of a corporation will be guaranteed by the shareholders.

Because corporations are distinct legal entities, they can sue in their own names and enjoy perpetual existence. A corporation continues notwithstanding the death or withdrawal of a shareholder by the sale of his or her shares. Corporate dissolution may only occur in the following situations:

- The requisite majority of shareholders resolve that it should.
- A court orders that the corporation be dissolved.
- Pursuant to statute, it is deemed to be inactive or has breached certain statutory provisions.

As a separate legal entity, a corporation's income is determined and subject to tax separate from that of its

owners, the shareholders. A shareholder cannot treat the net income or loss of a corporation in which he or she owns shares as his or her income or loss. A corporation's net income is subject to tax each year. If any of the corporation's after-tax income is to be paid to its shareholders, the directors may declare a dividend to the corporation's shareholders. Paying dividends is not a deductible expense to a corporation. However, dividends do constitute income (from property) to shareholders who are individuals, and this income is generally taxed again. In certain circumstances, dividends received by corporate shareholders can be received tax-free (via the inter-corporate dividend) and, in other circumstances, may be subject to income tax under other Parts (including Part IV) of the *ITA*.

The income taxation of corporations and other available tax incentives depends on the type of corporation (i.e. public, private, Canadian-controlled private corporation (CCPC), not-for-profit (also known as non-profit), registered charity, etc.) and on the types of activities and income generated therefrom.

5. Joint ventures

There is no precise legal definition for joint ventures. Various meanings have been attributed to the term, including

- a partnership;
- an association of two or more persons for a limited purpose without the participants becoming partners; or
- any combination of resources by two or more persons in order to conduct a commercial venture jointly under agreed-upon rules.

Whatever the relationship among them, in most cases, the co-venturers should have a written agreement setting out the rules by which the venture will be governed. Matters to be considered in such agreements include

- the nature of the commercial activity in which the joint venture will engage;
- the contribution of each co-venturer;
- each co-venturer's share in the profits and losses;
- the duration of the joint venture;
- the management arrangements; and
- the dissolution of the joint venture.

The provisions accepted by the co-venturers are implemented by including them in the joint venture agreement or, if a joint venture corporation is utilized, in a separate shareholder agreement, or the articles or by-laws of the joint venture corporation.

Generally speaking, members of joint ventures retain their ownership interest in property used in the joint venture. Therefore, if a joint venturer sells property (even to the joint venture), there is no rollover available, and a gain or loss on the sale (as well as recapture or a terminal loss for depreciable capital property) of the property would be recognized. Similarly, joint venturers (like co-owners) would claim and deduct CCA on their separate property used in the joint venture. Therefore, unlike a partnership, joint venturers compute their net income separately. Whether a joint venture exists is a question to be decided based upon all the facts and circumstances of the venture or enterprise undertaken.

6. Franchises and licences

6.1 What is the parties' relationship?

Both franchise and licence agreements are contractual relationships whereby information or industrial or intellectual property rights are transferred from one person to another to enable the transferee to engage in a commercial activity.

A franchise or licence agreement may be made between business entities of any sort.

A franchise is an arrangement established by contract whereby one person, the franchisor, grants a right to another person, the franchisee, to use a distinguishing trade-mark or trade name in connection with the supply of goods and services by the franchisee. This arrangement requires the franchisee to conduct its business in accordance with prescribed operating methods and procedures developed and typically controlled by the franchisor. Generally, an up-front fee is payable by the franchisee upon the initial grant of the franchise, and the franchisee's business makes extensive use of the franchisor's know-how, expertise, and established business goodwill. The franchisor maintains a continuing interest in the franchisee's business by advising and providing ongoing assistance and expertise and by monitoring compliance by the franchisee with common standards and operating techniques required by the franchisor. The franchisor has a continuing right to receive compensation from the franchisee through fees or lease payments or by its sale of products to the franchisee for resale.

Use of a franchise permits a franchisor to expand operations more rapidly than it could if it used its own financial resources to establish its own business outlets. Franchisees use their capital and borrowing capacity to establish the franchised outlets.

Franchising arrangements can take many different forms, from master franchising relationships, where a

person or corporation is granted the right to carry on the franchised business and operate multiple outlets within a designated territory, to simple franchise agreements, where the right to operate a single outlet at a designated location is granted.

A licence is a contractual arrangement where the owner of a patent, trade-mark, copyright, know-how, or technical data grants (i.e., licenses) to another the right to use such property for an up-front fee and/or an ongoing royalty fee.

Licensees and franchisees are independent contractors. A key distinction between a franchisee and a licensee is the greater ongoing involvement and control exercised by a franchisor in the business of a franchisee, compared to that exercised by a licensor in the business of a licensee.

Disadvantages to the franchisor arise from the difficulty of predetermining the method and amount of the franchisor's compensation and the negative effect it may have on the franchisee's cash flow. It is often very difficult to maintain common standards among the various franchises, and the transfer of know-how may create potential competitors. Terminating a franchise as opposed to firing a manager is fraught with the practical difficulties of retrieving confidential information, regaining control over the business location, repurchasing stock, and honouring trade debts, as well as the usual conveyancing problems involved in purchasing a business.

A franchise is attractive to a franchisee because the franchisee immediately obtains the benefit of the reputation or goodwill associated with the franchisor and its products.

Disadvantages to a franchisee may include the degree of control exercised by the franchisor and the amount of compensation that must be paid by the franchisee while carrying on the new business.

The *Arthur Wishart Act (Franchise Disclosure), 2000* (*AWA*), Ontario's franchise legislation, came into effect on January 31, 2001. The primary focus of the *AWA* is "disclosure." Franchisors are required to provide prospective franchisees with relevant and meaningful information concerning the franchisor, its principals, the franchise organization, and the franchise system, prior to the franchisee making an investment in the franchise.

The disclosure document must be accurate, clear, and concise and contain a certificate signed by the franchisor as to the truth and completeness of the document. The *AWA* contains various penalties, including rescission and damages where non-compliance occurs.

In addition to the existing case law on the relationship between a franchisor and its franchisee(s), s. 3 of the *AWA* imposes a duty of "fair dealing" on each party whereby they must act in good faith and in accordance with reasonable commercial standards.

It has been held that there is normally no fiduciary duty owed by a franchisor to a franchisee, although the franchisor establishes controls over the franchisee's business for the protection of the franchisor's goodwill, integrity of its products, trade techniques, trade-marks, and marketing methods.

Restrictions on a franchisee in a franchise agreement may be challenged on the ground that they are in restraint of trade. Such challenges are determined on a case-by-case basis.

A franchisee may also have an action for damages against a franchisor and may also be able to obtain an injunction if a franchisor exercises or attempts to exercise unauthorized control over the franchisee's business.

6.2 What are the tax consequences?

The income tax consequences of a franchise or licence arrangement will depend upon the business vehicle chosen by the taxpayer (i.e., sole proprietorship, partnership, corporation, etc.) to carry out the rights and obligations under the franchise or licence arrangement. In addition, there are special tax rules related to a franchise, concession, licence, and similar property.

Generally speaking, a franchise, concession, licence, patent, and similar property are granted for a limited period of time (i.e., where the grant is for a fixed period or has a limited useful life). There are specific tax rules under the *ITA* dealing with each type of interest, which require careful consideration before finalizing any agreement. In this case, a franchise, concession, licence, patent, and similar property are considered Class 14 property, and their cost is expensed under the CCA rules on a straight-line basis over this fixed period.

7. Not-for-profit organizations and charities

Not-for-profit (also known as "non-profit" in the *ITA* and tax community) organizations and charities are not necessarily the same type of entity. Typically, a not-for-profit organization refers to social clubs, professional groups, recreation or sporting clubs, fraternal organizations, and trade groups. Subject to compliance with s. 149(1)(l) of the *ITA*, the income of a not-for-profit organization is not subject to income tax.

By contrast, to qualify as a charity, an organization is required to register under the *ITA* and must satisfy the

definition of "registered charity" contained in s. 248(1) of the *ITA*. For an entity to be considered a charity, it must satisfy or meet three criteria:

- It must have a charitable object or purpose.
- Such object(s) or purpose(s) must be exclusively charitable.
- It must promote a public benefit recognized by the courts and not a private benefit.

Both not-for-profit organizations and charities can be organized as unincorporated associations of individuals, trusts, or corporations with or without share capital. However, most are organized as non-share capital corporations. If organized as a non-share capital corporation, the not-for-profit/charity enjoys all the benefits and liabilities of a corporation discussed earlier. Considerations in determining the appropriate form of organization include the following:

- **Duration of the activity**: Corporations are a more permanent vehicle; trusts are used for activities being carried on for a limited time.
- **Liability**: Members of an unincorporated association or trust are personally liable. Individual members of a corporation generally do not incur personal liability.
- **Type of property held or owned**: Unincorporated associations cannot hold real estate in their own name but only in the name of a trustee or a member, a situation that can give rise to trustee/member succession issues.
- **Procedures**: Corporations have greater statutorily imposed compliance obligations.
- **Delegation**: Trustees have limited rights to delegate responsibility, apart from administrative matters, compared with corporate directors.

If incorporation is decided upon, the first consideration should be whether to incorporate under Ontario or federal legislation. The new *Canada Not-for-Profit Corporations Act* establishes a new set of rules for federally incorporated not-for-profit corporations in Canada. These new rules replace Part II of the *Canada Corporations Act*. However, the new *Act* does not automatically apply to existing federally incorporated not-for-profit corporations. Every existing federally incorporated not-for-profit corporation is required to take steps to make the transition to the new *Act*, and until that transition occurs, the *Canada Corporations Act* continues to apply. During the transition process, which must occur before October 17, 2014, the corporation must replace its letters patent, supplementary letters patent if any, and by-laws with new charter documents by submitting articles of continuance to obtain a certificate of continuance and by creating and filing new by-laws that must comply with the new *Act*.

In Ontario, not-for-profit corporations will be governed by the *Not-for-Profit Corporations Act, 2010*, once proclaimed. The new *Act* will remove such corporations from the governance of Ontario's *Corporations Act*, which has been correspondingly amended (it continues to apply to insurance corporations and for five years to corporations with objects of a social nature). A transitional provision of the *Not-for-Profit Corporations Act, 2010* will provide non-share capital corporations three years to amend their articles or other constating documents to bring them into conformity with this *Act*. After three years, if no steps are taken by the corporation, the amendments are deemed to have been made.

In general, the operations of a not-for-profit corporation must be carried on without monetary gain to its participants, who are called members rather than shareholders.

Not-for-profit corporations are entitled to be incorporated upon the submission of articles of incorporation, any documents that may be required by the regulations under the applicable statute, and the requisite fee. Such corporations are given the capacity rights, powers, and privileges of a natural person, subject to any limitation in the governing legislation Not-for-profit corporations may have any purpose that is within the governing legislative authority; however, they may only have commercial purposes to advance or support their non-profit purposes. The affairs of such a corporation are managed by a board of directors consisting of a minimum of three directors.

The qualifications for membership are outlined in the legislation. Members are generally admitted into the corporation by a resolution passed by the directors. If the articles or by-laws so provide, membership may be divided into different classes such as honorary members, life members, and ordinary members. Different voting rights may attach to different classes of membership.

In the case of a not-for-profit corporation that is a charitable corporation, upon dissolution and after the payment of all debts and liabilities, the remaining property, or part thereof, shall be distributed or disposed of to charitable organizations whose objects are of a similar nature.

The *ITA* exempts the income of "registered charities" and "non-profit organizations" that meet the requirements of the *ITA* from income tax. In order to maintain such tax-exempt status, care must be taken to comply with the statutory requirements. Certain (i.e., larger) not-for-profit organizations are required to file an information

return six months after the organization's fiscal year-end, and all incorporated not-for-profit organizations must also file information returns. Every registered charity is required to file both an information return and a public information return for the year (i.e., CRA Form T3010, Registered Charity Information Return) with the MNR within six months of the end of its tax year.

8. Choosing the best method

When advising a client as to the most appropriate method, care should be taken since no one method is best in every case.

8.1 What is legally possible

Not all legal arrangements are possible in each case. For instance, the number of potential owners and the nature of the activity being carried on may influence the form of business organization used.

8.2 Limited liability

Sole proprietors and most partners are liable to the full extent of their personal assets for the liabilities of their businesses, whereas a shareholder's liability to creditors of the corporation is limited to the amount of the shareholder's investment. Therefore, if a substantial uninsurable risk is possible, a corporation is the preferable vehicle to limit a proprietor's (or partner's) liability.

8.3 Desirability of perpetual existence

Unless the partnership agreement provides to the contrary, death or disagreement amongst the partners can result in the dissolution of the partnership. A corporation continues notwithstanding the death or withdrawal of a shareholder or director. A corporation with perpetual existence may be preferable to a partnership or sole proprietorship that relies for its existence on the survival of individuals.

If the venture is for a single project or a limited number of commercial transactions, consideration should be given to the partnership or limited partnership form, since they can be more easily and expeditiously dissolved than a corporation.

8.4 Estate planning

It may be preferable to use a method that will provide financial benefits to family members while keeping the business under the proprietor's control and direction. Such an objective can be achieved by carrying on the business through a corporation. A well-designed share structure can enable the proprietor to control the business while permitting the equity growth to be owned by successive generations. Passing on an interest in a business under a will to one or more legatees is also best done through shares in a corporation.

8.5 Number of proposed proprietors

Where there will be a large number of owners, incorporation is preferable since the responsibility of one shareholder for the acts of the other shareholders is absent. Moreover, incorporation provides established and accepted rules for control of the business and permits greater flexibility in financing. In addition, it may be simpler to transfer shares in a corporation than to either execute new partnership agreements or amend existing agreements upon the admission of new partners.

8.6 Relationship of proposed proprietors

A significant consideration is whether it is intended that each proprietor take an active role in the affairs of the business. In a partnership, one partner can bind the partnership, whereas typically one shareholder alone cannot subject the corporation to obligations.

If some proprietors wish to limit their risk or have greater security for their investment than others or if there are to be several degrees of control and risk-taking (some bordering on the status of lenders), a limited partnership or incorporation utilizing varying classes of shares and share conditions available to a corporation may be preferable.

One disadvantage of incorporation to note is that minority shareholders are subject to the will of the majority, and their shares are not very marketable in the absence of a compulsory buy-sell agreement on the withdrawal of a shareholder. By contrast, if a partner wishes to withdraw and the majority will not buy him or her out, the partnership can normally be dissolved and the assets liquidated.

8.7 Employees

If the owners want to allow employees to participate in the growth and profits of the business without giving them the management rights of a partner, incorporation or a limited partnership should be used. It should be noted that a limited partnership is not available if it is intended to give the employees an interest as a limited partner in return for the employees' services. A corporation must be used if the employees are also to be owners, since employees may not be general partners.

8.8 Costs

The cost of creating and maintaining a corporation will often exceed that of a partnership or limited partnership and almost always exceed the costs associated with carrying on business as a sole proprietorship.

Preparation of or amendments to a carefully drawn partnership agreement may cost as much in legal fees as the incorporation of a corporation or the execution of corporate amendments. Government fees associated with the creation of partnerships are less than those associated with the creation of corporations.

Ontario's *Corporations Tax Act* not only imposes a tax on the income of a corporation, but also imposed in some cases (other than for small businesses) a tax on the "taxable paid-up capital" of a corporation. Ontario phased out its capital tax on July 1, 2010.

Previously, Ontario's capital tax was levied on the aggregate of a corporation's share capital, contributed surplus, retained earnings, and long-term debt. It was then pro-rated according to the percentage of gross revenue and wages relating to the particular province. Ontario's general capital tax rate was 0.015% in 2010 (until June 30, 2010) for most corporations, and the exemption amount was $15,000,000 of taxable capital in 2010.

Since 1994, Ontario has imposed a corporate minimum tax ("CMT") based on financial statement income. In 2012, CMT is levied at the rate of 4% on adjusted accounting net income over "regular" income. However, CMT is only payable by a corporation to the extent the CMT exceeds the corporation's regular Ontario corporate income tax. CMT is creditable (carried forward and can be applied) against regular corporate income tax for up to 20 years (10 years for years ending before March 22, 2007). Ontario's CMT rate was lowered to 2.7% for corporate tax years ending after June 30, 2010. Corporations (or an associated group of corporations) with total assets of less than $5,000,000 and annual gross revenues of less than $10,000,000 are not subject to CMT. In addition, for tax years ending after June 10, 2010, CMT will not apply to corporations with total assets of less than $50,000,000 or annual gross revenues of less than $100,000,000. There is no similar minimum tax payable in Ontario in connection with sole proprietorships and partnerships.

Corporations must also keep records specified by statute, comply with certain formalities respecting maintenance of records and procedures to withdraw capital, and qualify to carry on business in other jurisdictions. These are continuing and additional costs not required to the same extent by the law governing sole proprietorships or partnerships. As a result, a corporation may incur higher recurring legal and accounting costs than a partnership or a sole proprietorship.

8.9 Citizenship requirements

Both Ontario's *Business Corporations Act* (*OBCA*) and the *Canada Business Corporations Act* (*CBCA*) contain certain citizenship requirements in respect of directors of corporations. Unless businesses owned by foreign shareholders are able and willing to accept the citizenship requirements for directors, it will be necessary either to proceed by way of partnership or to incorporate in a province without such requirements. A possible alternative solution is incorporation under the *CBCA* or the *OBCA*, appointment of nominee directors with the proper citizenship qualifications, and assumption by the shareholders of all the powers and duties normally exercised by directors by means of a unanimous shareholder agreement (USA).

8.10 Flexibility of structure

While the *Partnerships Act* provides various rules for the partnership structure, many may be negated by agreement. As a consequence, one is left with considerable latitude to structure the arrangement between the parties. By contrast, many of the rules governing the relationship between shareholders are mandatory. Nevertheless, the ability to include in the articles of incorporation provisions that may be contained in by-laws and the availability of a USA can provide considerable flexibility for structuring arrangements between shareholders.

8.11 Income tax

Although the foregoing considerations are significant when determining which form of carrying on business to select, unquestionably a most important and often the determining factor will be the impact of income tax directly and indirectly on the proprietor. The following discussion is not exhaustive and merely highlights some of the points that should be considered before deciding which business form to choose.

An important difference between partnerships and corporations is that while the income or loss of the business carried on by a partnership is determined at the partnership level, that income or loss is taxed in the hands of the partners, not at the partnership level. Conversely, each partner may, subject to certain rules, use his or her share of losses of the partnership to reduce income from other sources.

The income or loss of a business carried on by a corporation is both computed and subject to tax at the level of the corporation. When a corporation's after-tax income is distributed to its shareholders by the payment of dividends, these dividends are generally taxed again in the hands of the shareholders.

In order to minimize taxes, people who are going to carry on business in common with a view to profit may prefer to do so in a partnership rather than through a corporation. This is so if they expect the business to lose money in its early years and the partners have income from other sources, such as investments. If the proprietors are partners, each can deduct his or her share of non-capital losses (i.e., business losses) from the partnership against other income in the current year, the three preceding years, and the next 20 years (the carryover periods). The extended carryforward period (increased from 10 to 20 years) is available for non-capital losses (i.e., business losses) incurred in taxation years ending after 2005. Note that business losses arising in taxation years ending before March 23, 2004, may be carried forward only seven years, and business losses arising in taxation years ending between March 23, 2004, and December 31, 2005, may be carried forward only 10 years.

If the business is incorporated, the losses are the corporation's and may be applied only against the corporation's profits for the same carryover periods for tax purposes, not against its shareholders' income. In addition, if the corporation has losses or little profit for several years, some of the losses carried forward may expire.

If an individual is going to carry on business alone, expects the business to lose money in its early years, and has other income, it may be preferable to carry on the business as a sole proprietor rather than through a corporation in order to use losses from the business to reduce income from other sources and, therefore, the amount of income tax that must be paid.

There is one very important instance in which less immediate tax will be paid if a business is carried on through a corporation rather than on an unincorporated basis—where the business is carried on in Canada throughout the taxation year by a CCPC (defined in s. 125(7) of the *ITA*) that earns active business income (ABI) qualifying for the "small business deduction" (SBD). A CCPC in Ontario is taxed at about one-half the regular corporate tax rate on a certain amount of ABI in each year.

If a corporation is not eligible for the SBD, there is still an advantage from a tax standpoint to carrying on the business through a corporation rather than as a sole proprietorship or partnership: a lower rate of tax and deferral of tax while the after-tax money is retained in the corporation. An individual proprietor or partner in Ontario was taxed in 2011 at marginal tax rates of up to about 46.41% (i.e., 46.41% is the top personal marginal tax rate in Ontario (combined federal and provincial rate) and applies to income in excess of $128,800 in 2011). On the other hand, a corporation was and will be taxed at a flat rate of

- 28.5% from January 1 to June 30, 2011, and 28.0% from July 1 to December 31, 2011; and
- 27.0% from January 1 to June 30, 2012, and 26.5% from July 1 to December 31, 2012,

on its first dollar of income.

If all income earned by the corporation is paid out in the form of salary, the corporation will pay no income tax. The shareholder or shareholders will be taxed at the same rate as if they had earned the income through a sole proprietorship or a partnership.

In 2011, with the top corporate rate of about 28.5% (or 28.0% after June 30, 2011) (combined federal and provincial rate for income not eligible for the SBD), the tax deferral is approximately 17.91% (18.41% after June 30, 2011) by leaving the after-tax business income in a corporation. If the top marginal personal tax rate does not change in 2012, this deferral of tax will become greater in 2012 with the 1.0% reduction to the federal corporate tax rate on January 1, 2012, and the further 0.5% reduction to the Ontario corporate tax rate on July 1, 2012.

On the other hand, if the corporation earns investment income (instead of business income), such as portfolio dividends (as in a holding company that owns a stock portfolio), there is no tax deferral by earning investment income in a corporation.

Chapter 16
Partnerships

1. General partnerships

Because partnerships normally comprise more than one decision-maker, rules were developed by the courts to provide a framework for the relationship between the partners carrying on business together and to determine the rights of third parties dealing with the partnership. Most of these rules have been codified in the *Partnerships Act* (*Act*). Section 45 of the *Act* provides that the rules of equity and common law applicable to a partnership continue in force, except so far as they are inconsistent with the express provisions of the statute. Case law interprets the basic principles set forth in the *Act*.

1.1 The formation of a partnership

Section 2 of the *Act* defines a partnership as "the relation that subsists between persons carrying on a business in common with a view to profit" and contains three criteria:

First, there must be a "business," defined in s. 1 to include "every trade, occupation and profession." A business may be an ongoing activity or any separate commercial transaction. As a result, almost any commercial activity constitutes a business.

The second element requires that there be "a view to profit." If the object of the activity is charitable, social, or cultural, it will not be a partnership.

The third criterion is an agreement to carry on business in common and to share the profits. The agreement may be in a written contract or an oral agreement, or it may be evident from the conduct of the parties.

In some instances, it may be difficult to determine whether the persons intended their relationship to be that of partners or something else. Section 3 of the *Act* sets out rules for determining the existence of a partnership including

- control over the business;
- participation in management;
- sharing of profits; and
- responsibility for losses.

Furthermore, in determining whether a partnership exists, the courts will look at the intention of the parties as disclosed in the partnership agreement, if any, and at their conduct. If persons wish to be partners, it is not difficult for them to make the relationship clear, either by means of a written partnership agreement or, in the absence of a written agreement, by describing themselves as partners and behaving as such. A partnership will be found to exist if two or more persons carry on business in common, contribute property or services to the business, share in its net profits and losses, and are involved in the affairs of the business.

1.2 Registration of general partnerships

A partnership must comply with s. 2 of Ontario's *Business Names Act* (*BNA*), which provides that no persons associated in partnership shall carry on a business or identify themselves to the public unless the name of the partnership is registered by all of the partners, except for a limited partnership carrying on business in accordance with the *Limited Partnerships Act* or where the partnership identifies itself or carries on business under a name that is composed of the names of all the partners. The form of the registration is set out in ss. 2 and 3 of *General*, O. Reg. 121/91, made under the *BNA*. Failure to file renders the partnership and each partner incapable of maintaining a proceeding in any court in Ontario in connection with the business carried on by the partnership, except with leave of the court (*BNA*, s. 7(1)). Failure to file a registration is also an offence under s. 10 of the *BNA*.

1.3 Characteristics of general partnerships

Sections 6–19 of the *Act* govern the relationship of partners and persons dealing with them. These provisions are mandatory and cannot be varied by agreement. Particular attention should be paid to the following.

1.3.1 No separate legal existence

While the persons who have agreed to be partners are referred to collectively as a firm and the name under which their business is carried on is called the firm name, a partnership is not a separate legal entity from the partners who compose it. Initially, at common law, the effect of this doctrine was that lawsuits could only be brought by or against partners; they could not be brought in the name of the firm. This has since been changed by legislation. Rule 8.01 of the *Rules of Civil Procedure* enables partners carrying on business in Ontario to sue or be sued in the firm name. Another effect of the doctrine that a partnership is not a separate legal entity is that a person cannot be both a partner and an employee

of the partnership because no person can enter into a contract with himself or herself.

1.3.2 Agency

Each partner is the agent of the partnership and the other partners when acting in the normal course of partnership business or in what reasonably appears to be so (*Act*, s. 6). Accordingly, when acting as a partner, one partner's action binds all the partners pursuant to the law of principal and agent. Only when it is apparent that the partner is not acting within the scope of the firm's normal business activities, or when a third party knows that the partner has no authority to act for the firm in that particular matter, will the partner not bind the partnership (ss. 6–9).

1.3.3 Liability

In keeping with this agency relationship, each partner in a firm is jointly liable with the other partners to the full extent of his or her personal assets for all debts and obligations of the firm incurred while a partner. Judgment against or release of one partner bars action against the others (*Act*, s. 10). Upon death, a partner's estate remains severally liable for partnership debts and obligations in so far as they remain unsatisfied, subject to the prior payment of his or her individual debts (s. 10). In the case of tortious liability, the firm is liable, and each partner is jointly and severally liable, to the same extent as the wrongdoing partner for any penalty, loss, or injury caused to a non-partner by the wrongful act or omission of a partner acting in the ordinary course of the firm's business or with the authority of the partners (s. 11). If a partner, acting within the scope of apparent authority, receives property of a third person and misapplies it, or if a partner misapplies property of a third person received by the firm in the course of its business, the firm is liable, and each partner is jointly and severally liable, to make good the loss (s. 12).

A partner is not liable to the creditors of the firm for anything done before he or she became a partner. However, a retired partner remains liable for partnership debts or obligations incurred before retirement unless he or she is discharged by an agreement with the remaining partners and the firm's creditors. Under the *Act*, a retired partner can formally achieve this retired status with persons who had not had dealings with the firm before his or her retirement, by publishing an advertisement in the *Ontario Gazette* regarding retirement. Other persons who did deal with the firm when the retired partner was a partner should be given notice of retirement (ss. 18 and 36).

1.3.4 Duty of loyalty and good faith

Because of the agency relationship between partners and the resulting exposure to seizure of one partner's individual assets in satisfaction of liabilities arising from another partner's actions, the law places each partner under a duty to act at all times towards the other partners loyally and in good faith from the time of negotiating the partnership's formation until its affairs are finally wound up. This is the cardinal principle of the internal law of partnerships, which is found in the case law but is not stated expressly in the *Act*. However, the concept is reflected in s. 29 of the *Act*, which requires a partner to account to the firm for any benefit derived from a transaction relating to the partnership or partnership property, and in s. 30, which prohibits a partner from carrying on a business competing with that of the firm without the consent of the other partners.

1.3.5 Partnership property

Although a partnership is not a separate legal entity from the partners, all property contributed by the partners to the partnership or purchased in the course of the partnership business is called "partnership property" (s. 21). It is the property of the partnership and is not divisible among the partners. This is another example of the tendency to view a partnership as a unit for some purposes. The partner's "right" is a right to a division of profits on the basis agreed upon by the partners or on an equal basis if there is no other agreement as to how the profits are to be shared (s. 24). A partner is entitled only to the sale and division of the proceeds of partnership property on dissolution of the partnership after the discharge of all liabilities of the partners (s. 39).

1.4 Relation of partners to one another

The terms of a partnership are usually expressed in an agreement between the partners that will govern their relationship. However, absent this partnership agreement, the terms of the partnership will be determined by the default provisions contained in ss. 20–31 of the *Act*, including the following:

- All partners share equally in the capital and profits of the business and must contribute equally to the losses (s. 24.1).
- The firm must indemnify partners for payments made or personal liabilities incurred in the ordinary course of business or for the preservation of the business or partnership property (s. 24.2).
- Partners are not entitled to interest on their capital contribution (s. 24.4).
- Each partner may take part in the management of the partnership business (s. 24.5).

- Any differences arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners, but no change in the nature of the partnership business can be made without the consent of all partners (s. 24.8). (This focus on the numerical majority of the partners involved is normally modified in the partnership agreement to reflect the economic interests of the partners where levels of participation or economic interest are not always equal).
- Every partner must account to the firm for any benefit derived, without the consent of the other partners, from any use of the partnership name, property, or business connection (s. 29).
- All profits from a competing business carried on by a partner without the consent of the other partners must be accounted for (s. 30).

1.5 Dissolution of partnerships

Sections 32–44 of the *Act* are concerned with the dissolution of the partnership. In the absence of any agreement to the contrary, a partnership is dissolved

- on the expiration of the term fixed for its existence (s. 32(a));
- at the termination of the single adventure or undertaking for which it was entered into (s. 32(b));
- if entered into for an undefined time, by a partner giving notice to the other partners of his or her intention to dissolve the partnership on the date mentioned in the notice or, if no date is given, on the date of the notice's communication (s. 32(c)); and
- by the death or insolvency of a partner (s. 33(1)).

If any of these events of dissolution are not appropriate, they should be expressly excluded by specific written arrangements between the parties. A partnership is, in every case, dissolved by the happening of any event that makes it unlawful for the business of the firm to be carried on or for the members of the firm to carry it on in partnership (s. 34). On application by a partner, a court may order dissolution of the partnership in the circumstances provided in s. 35 of the *Act*.

2. Limited partnerships

A limited partnership may be formed to carry on any business that a general partnership may carry on. The principal feature of a limited partnership is that the liability of each limited partner is limited to the amount of money or other property that partner contributes (*Limited Partnerships Act* (*LPA*), s. 9). Pursuant to s. 7(1) of the *LPA*, a limited partner may contribute money or property to a limited partnership but not services or agrees to contribute to the limited partnership as stated in the record of limited partners, which the limited partnership is required to maintain (*LPA*, s. 4).

2.1 Formation of limited partnerships

A limited partnership is formed by filing a declaration with the Ministry of Government Services signed by all the general partners and stating, among other things, the firm's name, the general nature of its business, the names and addresses of the general partners, and the address of the principal place of business in Ontario of the limited partnership. A declaration expires every five years but may be renewed by filing a new declaration before the expiry date (*LPA*, s. 3(3)). If the firm name is changed, a new declaration must be filed. If there is any other change in the information in the declaration on file, a declaration of change must be filed with the Registrar of Partnerships. A change is not effective for the purposes of the *LPA* until a declaration of change is filed with the registrar (s. 19).

A limited partnership is subject not only to the provisions of Ontario's *LPA*, but also the *Act*, the *BNA*, and the common law to the extent that the latter three bodies of law are not inconsistent with the provisions of the *LPA*.

A limited partnership must consist of one or more persons who are general partners and one or more persons who are limited partners (*LPA*, s. 2(2)). A person may be a general partner and a limited partner at the same time in the same limited partnership (s. 5). A "person" is defined in the *LPA* to include, among other things, an individual, a sole proprietorship, and a corporation (s. 1).

2.2 Characteristics of a limited partnership

A limited partner is basically a passive investor rather than an active participant in the operation of the limited partnership. Limited partners share the profits of the limited partnership in proportion to their contributions, unless there is a limited partnership agreement, which gives priority to one or more limited partners as to profits (*LPA*, s. 14). No profits may be paid out to a limited partner or to a general partner if the payment would reduce the assets of the limited partnership to an amount that is insufficient to discharge the liabilities of the limited partnership to persons who are not general or limited partners (s. 11(2)).

A limited partner may also loan money and transact business with the limited partnership and will rank equally with general creditors in respect of claims arising from such loans or transactions. A limited partner may not hold any limited partnership property as collateral security for a loan to the limited partnership. Nor may a limited partner receive any payment ahead of a creditor

that is not a partner if the assets of the limited partnership are not sufficient to discharge partnership liabilities to such creditors (*LPA*, s. 12(1)).

Subject to the terms of a limited partnership agreement, limited partners share in the assets of the limited partnership in proportion to their contribution in respect of any profits or return of contribution (s. 14). A limited partner is entitled to the return of his or her contribution in the following circumstances: at the dissolution of the partnership, at the time specified in the limited partnership agreement, after six months' written notice to all partners if the agreement is silent, or when all partners consent to the return of the contribution (s. 15(1)). In order for the contributions to be returned there must be sufficient limited partnership assets to pay all liabilities, except liabilities to general partners and to limited partners for their contributions, and the partnership agreement must be terminated or amended to reflect the reduction in the contribution being returned (s. 15(2)).

A limited partner has the same rights as a general partner to inspect the records of the limited partnership and to receive full disclosure of the affairs of the partnership (*LPA*, s. 10). The limited partner may also from time to time investigate the state and progress of the limited partnership business and advise as to its management and act as a contractor, agent, or employee of the limited partnership or the general partner (s. 12(2)). While a limited partner may give advice from time to time as to the management of the limited partnership, if a limited partner takes part in the control of the business, that limited partner loses his or her limited liability and becomes a general partner (s. 13). A limited partner will also lose limited liability with respect to any creditor if that limited partner permits a distinctive part of his or her name to appear in the firm name of the limited partnership and the creditor has no actual knowledge that the limited partner is not a general partner (s. 6(2)).

Section 8 of the *LPA* provides some protection to limited partners by restricting general partners from doing certain acts except with the written consent to or ratification of the specific act by all limited partners.

A limited partner's interest is assignable (*LPA*, s. 18(1)). The assignee may become a "substituted limited partner" if all the partners, except the assignor, consent in writing or if the limited partnership agreement so provides (s. 18(4)). An assignee who is entitled to become a substituted limited partner becomes such when the declaration is amended to so indicate (s. 18(5)). A substituted limited partner has all the rights and powers of the limited partner who assigned his interest and is subject to all the restrictions and liabilities of his assignor. This excludes any liability of which the substituted limited partner did not have notice at the time he or she became a limited partner and that could not be ascertained from the limited partnership agreement, the declaration, or the record of limited partners (s. 18(6)). An assignee who is not a substituted limited partner has no right to inspect the limited partnership books or to be given any information about the limited partnership or its affairs. Such an assignee is entitled only to receive the share of profits or other compensation by way of income and the return of the contribution to which the assignor would have been entitled (s. 18(3)).

A general partner has all the rights and powers and is subject to all the restrictions and liabilities of a partner in a partnership without limited partners. General partners in a limited partnership require the consent or ratification of all limited partners for actions that fall within the categories listed in s. 8 of the *LPA*, and this list may be augmented in a limited partnership agreement.

A person who is both a general partner and a limited partner in the same limited partnership has the rights and powers and is subject to the restrictions and liabilities of a general partner. However, in respect of the person's contribution as a limited partner, the person has the same rights against the other partners as a limited partner (s. 5(2)). A general partner's liability can only be unlimited, and becoming a limited partner has no effect on this liability. A general partner may nevertheless want to be a limited partner in order to participate with the limited partners in distributions of any profits.

2.3 Dissolution of a limited partnership

Section 21 of the *LPA* provides that a limited partnership is dissolved if a general partner dies, retires, becomes mentally incompetent, or is dissolved in the case of a corporate general partner. This provision can be displaced by a provision in the partnership agreement allowing the general partners to continue the business of the limited partnership if all the remaining partners, general and limited, consent to the continuance. The provisions of the *Act* regarding dissolution also apply to a limited partnership. A limited partner is given the same right as a general partner to obtain dissolution of the limited partnership by court order. In addition, a limited partner is entitled to have the limited partnership dissolved and its affairs wound up where

- the limited partner is entitled to have his contribution returned but, upon demand, it is not returned; or
- the limited partner is not entitled to the return of his or her contribution because the liabilities of the limited partnership have not been paid or there are

not sufficient limited partnership assets out of which to pay them (*LPA*, s. 15(4)).

Upon the dissolution of a limited partnership, the liabilities of creditors are paid first. Then, unless the partners have otherwise agreed, payments are made in the following order:

- to limited partners in respect of their profits and other compensation;
- to limited partners in respect of their contributions;
- to general partners other than for capital and profits;
- to general partners in respect of their profits; and
- to general partners in respect of capital (s. 24).

A declaration of dissolution shall be filed with the Registrar of Partnerships when the limited partnership is dissolved or when all the limited partners cease to be limited partners (s. 23).

2.4 Extra-provincial limited partnerships

In the absence of legislation respecting the status of a limited partnership organized in one province and carrying on business in another province, it is unclear whether the limited partners retain their limited liability in the latter province. This matter is dealt with in the *LPA*, which provides that no extra-provincial limited partnership shall carry on business in Ontario unless it has filed a declaration with the Registrar of Partnerships together with a power of attorney appointing an attorney in Ontario (s. 25). The power of attorney ensures that there is someone in Ontario who may be served if a person in Ontario wishes to bring an action against the extra-provincial limited partnership. Until a declaration and a power of attorney are filed, the extra-provincial limited partnership is incapable of maintaining an action or other proceeding in any court in Ontario. A limited partner of an extra-provincial limited partnership is not liable in Ontario as a general partner by reason only that the limited partnership carries on business in Ontario without filing the required declaration and power of attorney (s. 27(1)). Furthermore, it is the laws of the jurisdiction under which an extra-provincial limited partnership is organized that govern its organization, internal affairs, and the limited liability of its limited partners (s. 27(2)).

All provinces other than Manitoba and Quebec presently have partnership legislation that provide that if an extra-provincial limited partnership is registered in the province, the limited partners continue to enjoy limited liability. In Manitoba and Quebec, it is unclear whether limited partners in an Ontario limited partnership that conducts business in such a province will retain their limited liability.

2.5 Limited partnership agreements

A written limited partnership agreement is normally advisable to deal with matters not addressed in either the *Act* or the *LPA* or with matters provided for in these statutes that the partners desire to alter by agreement.

With a carefully drawn agreement, it is possible to structure a limited partnership to achieve flexibility similar to that provided by a corporation, with provisions for the transferability of partnership interests or units and the admission of new limited partners. A limited partnership with a minimally capitalized corporation as its only general partner can provide to all its participants the protection of limited liability offered by incorporation if the corporation, and thus the limited partnership, is managed by persons who are not limited partners. It has been held that if an individual who is a limited partner is also a director, officer, or employee of the corporate general partner and takes part in the control of the business of the limited partnership, that limited partner loses his or her limited liability.

3. Limited liability partnerships

A limited liability partnership (LLP) is essentially a cross between a general partnership and a limited partnership. Similar to a general partnership and a limited partnership, the assets of an LLP can be looked to in order to satisfy the debts of and claims against the LLP. In contrast to a general partnership, a judgment against an LLP for negligence will not be enforceable against the personal assets of all the partners (*Act*, s. 10(2)). Only the partner who is negligent or who was negligent in supervising or controlling the employee who was negligent will have his or her personal assets exposed if the claim is successful (s. 10(3)). The *Act* specifically provides that a partner in an LLP is not a proper party to a proceeding by or against the LLP for the purpose of recovering damages or enforcing obligations arising out of the acts or omissions of the negligent partner (s. 10(4)).

In contrast to a limited partnership, a judgment based on a contract entered into by the LLP will be enforceable against both the assets of the LLP and the personal assets of the partners.

An LLP may only carry on business in Ontario for the purpose of practising a profession governed by an Act and provided the following conditions are met:

- The Act must expressly permit the LLP to practise the profession (currently, only lawyers and chartered accountants are permitted).
- The governing body of the profession requires the LLP to maintain a minimum amount of liability insurance.

- The LLP must register its firm name under the *BNA*.
- The firm name must contain the words "limited liability partnership" or "société à responsabilité limitée" or the abbreviations LLP, L.L.P., or s.r.l. (ss. 44.2–44.3).

Ontario's *Law Society Act* (*LSA*) permits lawyers in Ontario to form and practise within LLPs (*LSA*, s. 61.1(1)). The minimum insurance requirement for each partner is currently $1,000,000 (By-Law 7, made under the *LSA*, s. 1; By-Law 6, made under the *LSA*, s. 12). Pursuant to s. 2(1) of By-Law 7, law firms that change from general partnerships to LLPs must disclose the nature of the limited liability of the partners to all persons who are clients of the firm when the change in practice structure occurs.

4. Taxation of partnerships

In the case of a general partnership, a limited partnership, or a limited liability partnership, the income or loss of the business carried on by the partnership is determined at the partnership level and then allocated to the partners. Although a partnership itself is not a taxable entity, the federal *Income Tax Act* (*ITA)* provides that the income of a partner is calculated as though the partnership was a separate person resident in Canada (*ITA*, s. 96(1)). Expenses, capital cost allowance (CCA), and other deductions generally are deductions in computing the income of the partnership to determine the partnership's net income or loss. That income or loss is divided among the partners, and each partner's share of that income or loss is included in computing that partner's income for tax purposes. Various sources of income and loss (such as capital gains, interest, or incentive deductions, etc.) flow through a partnership to the partners and retain their characteristics as to source and nature. For example, a taxpayer's property income can be offset by partnership property losses. If the partner is an individual, he or she is subject to tax at the marginal tax rates applicable to individuals under the *ITA*. It should be noted that for limited partnerships, special rules apply to restrict a limited partner's deduction of business or property losses to only the partner's investment in the partnership (i.e., the partner's "at risk amount").

Like a sole proprietor, a partner must aggregate his or her share of the partnership's net income or loss with his or her income or losses from all other sources. A corporate partner will similarly be subject to tax on its share of partnership income at the applicable corporate tax rate.

With respect to a partnership's business losses, a partner can deduct his or her share of non-capital losses (i.e., business losses) from the partnership against other income in the three preceding years, the current year, and the next 20 years (the carryover periods). This extended carryforward period for a partner's non-capital losses (i.e. business losses) has changed in recent years as follows:

- The extended carryforward period (increased from 10 to 20 years) for non-capital losses (i.e., business losses) applies to business losses arising in taxation years ending after 2005.
- For business losses arising in taxation years ending between March 23, 2004, and December 31, 2005, such business losses may be carried forward only 10 years.
- For business losses arising in taxation years ending before March 23, 2004, such business losses may be carried forward only seven years.

There have been no changes to the three-year carryback period for business losses.

Similar rules apply to a partnership's capital losses (i.e., realized by a partnership from the disposition of capital assets); however, a partner's share of the partnership's capital losses may only be used by a partner to reduce the partner's other capital gains (not business or operating income). The carryover period for capital losses is three years back and forward indefinitely.

Although a partnership does not file an income tax return, s. 229(1) of the *Income Tax Regulation* requires it to file an information return (Form T5013, Statement of Partnership Income) with the Canada Revenue Agency (CRA) and also to provide a copy of this to each partner. The information return shows, among other things, the names of the partners and their share of each source of partnership income or loss. While the CRA has an administrative policy providing that certain partnerships are not required to file a return, it may be advisable for partnerships to file a return in order to ensure the assessment time in s. 152(1.4)(b) commences so that partners are not subject to reassessment for an indefinite period of time.

Partnerships, including limited partnerships, are frequently used instead of corporations in the creation of "tax shelters," which are vehicles for providing investors with income tax deductions to "shelter" their income from tax. Partnerships are used for this purpose because taxation at the level of the individual partner allows net tax losses or large tax deductions associated with the nature of the partnership business to "flow through" the partnership to the partners and so reduce the partners' taxable income from other sources. In limited partnership situations, this reduction in taxable income and also in tax payable is limited to the cost that the partner has invested or committed to the partnership. It

is called the partner's "at risk amount." Any tax losses taken reduce the effective cost of the investment (i.e., the investor's or partner's adjusted cost base (ACB)) until it is reduced to zero, at which point no further losses can be utilized without an increase in the investment, i.e., through future profits. If a corporation were to be used, generally speaking, there would be no "flow through" of the corporation's losses or deductions to the shareholders, and therefore no "sheltering" of the shareholder's other income from tax could occur.

5. Partnership agreements

At a minimum and to avoid the default provisions of the *Act*, a well-drafted partnership agreement should address the following issues.

5.1 Scope of the business

The business of the partnership should be carefully defined in order to limit the liability of the partners and encompass all of the activities of the partnership.

5.2 The firm name

Once the name has been chosen, it may acquire a goodwill of its own, a situation that may make it undesirable to change. Therefore, the partnership agreement should contemplate whether the firm name would change upon the withdrawal, death, or retirement of a partner.

5.3 Restrictions on carrying on a competing business

While s. 30 of the *Act* addresses the issue of a partner competing with the firm while still a partner, partners may wish to include a restrictive covenant in the partnership agreement limiting a departing partner's ability to carry on a competing business. Care should be taken to ensure that any such covenant is enforceable. The test is whether the restraint is reasonable in area and time, is not contrary to the public interest, and is no more restrictive than necessary to protect the business interests of the persons in whose favour it runs.

5.4 Requirements for the admission of new partners

Absent a partnership agreement, the rules set out in s. 24 of the *Act* will govern the admission of new partners. Of note, para. 7 provides that "[n]o person may be introduced as a partner without the consent of all existing partners." The partnership may wish to impose substantive requirements before a person may be considered for admission, such as five years' professional experience; procedures for admission (for example, approval by at least 75% of the partners); and requirements on admission, including capital contributions.

5.5 Tax treatment of partnership income

Of great importance to the prospective partner is the treatment of partnership income under the *ITA*. So long as a worker is in receipt of salary or wages from employment, income is computed on a calendar-year basis and deductions are limited to those specifically set out in s. 8 of the *ITA*. Employment is defined in s. 248(1) of the *ITA* to mean the position of an individual in the service of some other person. Since a general partner is normally held to be incapable of being in his or her own service, the remuneration received by a partner will not be treated as employment income. The result is that many more deductions are available to a partner.

In the past, several large professional firms have structured their compensation arrangements so that relatively junior members can be treated as partners for tax purposes but not for decision-making purposes. Care must be taken to ensure that the arrangement will still be characterized as a "partnership" for income tax purposes. Normally, the general partners do not want to split profits with a junior "partner" to any significant extent but realize that a junior partner must have a base salary. The solution is the payment of a pre-determined salary plus a minuscule percentage of profits. Normally, where a salary is paid to a person in addition to a share of profits, it is strong evidence that the relation between the two is that of employer and employee rather than that of partners. However, case law has accepted that a partner, for tax purposes, may be paid a flat salary and not be responsible for losses.

5.6 Management

The default rule contained in s. 24 of the *Act* focuses on the numerical majority of the partners involved. This is normally modified in the partnership agreement to reflect the economic interests of the partners where levels of participation or economic interest are not equal.

In partnerships involving a large number of participants, management is often done by a committee appointed by the majority of the partners in economic interest.

5.7 Capital contributions

Normally, the new partner will make a capital contribution, which may increase the firm's capital or, more likely, be used to pay back some of the capital contributions or entitlements of existing partners. Capital contributions are commonly made in the same ratio as income distributions, i.e., a partner who receives 5% of the profits must contribute 5% of the equity capital.

If a partner contributes assets other than cash to the partnership (for example, real property, machinery, equipment, goodwill), the tax consequences of such contributions should be considered since such contributions will normally be considered a disposition for tax purposes and may therefore give rise to income and/or capital gains or losses to the partner (*ITA*, s. 97(1)). However, in such circumstances it may be advisable for the partners and partnership to consider utilizing the provisions in s. 97(2) of the *ITA*, which provides a rollover of property to a Canadian partnership (and which adopts the tax rollover rules in s. 85(1) of the *ITA* applicable to rollovers of property transferred to a Canadian corporation) and requires the joint filing of an election to effect this rollover.

5.8 Retirement and dissolution

Subsection 33(1) of the *Act* provides that subject to any agreement among the partners, the partnership is dissolved by the death or insolvency of any partner.

This is a particularly unfortunate rule, since it is usually not desirable from the point of view of the partners who are still alive and solvent. While provision must be made for what happens on the death or insolvency of a partner, a successful ongoing business should not automatically terminate. Virtually all properly drafted partnership agreements deal with the question of automatic termination, normally by providing that the partnership shall not be dissolved by the death, retirement, or bankruptcy of any partner or by the admission of a new partner or partners. Similarly, as a result of s. 26 of the *Act*, a specific provision is normally included to say that no partner may dissolve the partnership by notice to the other partners.

If the partnership is not to be dissolved, there must be some formula for the remaining partners to compensate a withdrawing partner, whether such withdrawal is caused by death or retirement. At the very least, the withdrawing partner will expect to be repaid his or her capital contribution. In many partnership agreements, a withdrawing partner is also entitled to be paid for his or her share of the goodwill or work-in-progress and may also be entitled to share in any increase in value of the basic assets of the organization. Furthermore, in the case of death, remaining partners may wish to address provision for the deceased partner's family.

Retirement is a particularly difficult problem. Partners may wish to consider mandatory retirement provisions, any ongoing annual remuneration for retiring partners, a retirement allowance or lump-sum payment and the corresponding impact on partnership profits or assets, mandatory registered retirement savings plan, and the return of capital contribution. In addition, for partners who have practised for many years with the firm, some formula for a lifetime retirement pension may be appropriate. The income tax consequences of retirement payments must be considered.

5.9 Splitting of profits

The *Act* provides that in the absence of any agreement to the contrary, all partners are entitled to share equally in the profits (s. 24). In the usual case, the partners readily agree to the initial division when the partnership is formed. But how that division should change as the workload of the individual partners changes and as the partnership income changes should also be addressed.

The lawyer drafting the partnership agreement should ask the client which factors are important in determining changes in the profit split. From these factors, one can prepare a list of parameters to consider. Those parameters can then be ranked in order of importance; it may be possible to agree on a method of weighting each factor.

5.10 Work-in-progress

Every law firm has on its books a sizeable quantity of docketed hours that have not yet been billed. The partnership agreement should address whether a new partner entering the firm will be required to pay for a share of the work-in-progress proportionate to the share of the profits the partner will enjoy. If no charge will be made for the work-in-progress, the new partner should not receive a windfall and should not participate in the work-in-progress on the books at the time the person enters.

Chapter 17

Taxation of corporations and their shareholders

1. Taxation of corporations

1.1 Introduction

A corporation is a distinct legal entity from its owners, the shareholders. Corporations, like individuals, are subject to both federal and provincial income taxes. The taxation of corporations differs from the taxation of individuals in two ways.

First, a corporation may be subject to a provincial tax on capital.

Second, whereas individuals are subject to progressive income tax rates, corporations are subject to flat rates of tax. The rates of tax applicable to a corporation depend on the type of corporation and the types of income earned.

1.2 Tax on a corporation's income and its distribution of dividends

Earning income through a corporation may result in two levels of taxation: first, at the corporate level, and second, when the after-tax profits of the corporation are distributed to its shareholders in the form of dividends. Shareholders are subject to tax on that dividend income.

The federal *Income Tax Act* (*ITA*) deals with these two levels of taxation by integrating the corporate and individual income tax systems.

2. Integration

2.1 General

Perfect integration between the corporate and individual tax systems occurs if the amount of income tax that an individual would pay if he or she earned that income directly is equal to the amount of income tax that is paid when the income is first earned by a corporation and then the after-tax profits of the corporation are paid to the individual shareholder in the form of dividends.

2.2 Taxation of dividends

Integration of the corporate and individual tax systems for active business income (ABI) is accomplished by reducing the amount of tax paid by individual shareholders on the receipt of dividends. The tax payable by an individual is reduced by the dividend gross-up and tax credit mechanism.

Integration of a corporation's passive (i.e., investment type) income is accomplished by a combination of reducing the amount of tax paid by individual shareholders on dividends and a refund of tax to the corporation on payment of dividends.

In the case of corporate shareholders, dividends are generally received tax-free by reason of the inter-corporate dividend deduction.

2.3 Why perfect integration does not occur

Perfect integration does not occur due to various factors. These factors include changing federal corporate tax rates that depend on the type of corporation and its type of income, as well as different (and changing) provincial tax rates and surtaxes.

2.3.1 Perfect integration

In order for perfect integration to exist, the federal and provincial combined corporate tax rate must be 20%, there must be no surtaxes, and the individual must have a provincial tax rate that is equal to 50% of the federal tax rate. If these conditions exist, there will be no difference between earning business income through a corporation and having it earned directly by an individual. See Example 1, below, "Perfect Integration."

2.3.2 Over-integration and under-integration

Over-integration or under-integration will depend on the extent to which the actual income tax rates differ from the theoretical tax rates used in Example 1.

If the combined corporate income tax rate and/or individual income tax rates are lower than the ones used above, then earning income through a corporation will likely result in less total tax than earning income directly by an individual. In this case, the tax system is said to result in over-integration.

If the federal and provincial combined corporate tax rate is higher than 20%, then earning income through a corporation will likely result in a greater amount of total income tax being paid. In this case, the tax system is said to result in under-integration. See Examples 2 and 3, below, reflecting over- and under-integration in 2011 and 2012 (assuming no federal or Ontario changes to the small business or personal income tax rates in 2012).

Example 4 below, reflects under-integration in 2012 assuming no further reductions to the general corporate rate reductions already taking effect on January 1, 2012 (federal), and July 1, 2012 (Ontario), and no changes otherwise to the personal income tax rates (federal and Ontario) in 2012.

Example 1 — Perfect integration: old DTC (dividend tax credit) rules
(Assumes the individual is in the highest marginal tax bracket and provincial tax is 50% of federal tax)

	Active business income earned directly by an individual	**Active business income earned through a corporation**
Corporate income		$100.00
Less corporate tax (@ 20%)		20.00
After-tax profits		$80.00
Individual income		
Business profits	$100.00	
Dividend		$80.00
Dividend gross-up (25% x $80)		20.00
Individual taxable income	$100.00	$100.00
Federal tax at 29%	$29.00	$29.00
Dividend tax credit (2/3 x $20)		(13.33)
Provincial tax at 50% (of federal tax)	14.50	7.83*
Total individual tax	$43.50	$23.50
Corporate tax		20.00
Total tax on $100 income	$43.50	$43.50
*$29.00 - (13.33) = $15.67 x 50% = 7.83		

Example 2 — Over-integration in 2011 and 2012: existing DTC rules and $100 of corporate ABI with SBD (small business deduction)
(Assumes individual is Ontario resident in the highest marginal tax bracket and corporate tax rate is 15.5% (11% federal + 4.5% Ontario) since July 1, 2010)

	Active business income earned directly by an individual	**Active business income earned through a corporation**
Corporate income		$100.00
Less corporate tax @ 15.5% (SBD)		15.50
After-tax profits		$84.50
Individual income		
Business profits	$100.00	
Dividend		$84.50
Dividend gross-up (25% x $84.50)		21.13
Individual taxable income	$100.00	$105.63
Federal tax at 29%	$29.00	$30.63
Federal dividend tax credit (2/3 x $21.13)		(14.09)
Ontario tax at 11.16%	11.16	11.79
Ontario DTC at 4.5%		(4.75)
Ontario surtax at 56%	6.25	3.94
Total individual tax	$46.41	$27.52
Corporate tax		15.50
Total tax on $100 income	$46.41*	$43.02*
*$3.39 tax savings ($46.41 minus $43.02) if ABI eligible for SBD is earned in corporation and after-tax earnings paid as non-eligible dividend to individual shareholder		

Example 3 — Under-integration in 2011: new DTC rules and $100 of corporate ABI with no SBD
(Assumes individual is Ontario resident in the highest marginal tax bracket and corporate tax rate is 28% (16.5% federal + 11.5% Ontario) at July 1, 2011)

	Active business income earned directly by an individual	**Active business income earned through a corporation**
Corporate income		$100.00
Corporate tax @ 28% (no SBD)		28.00
After-tax profits		$72.00
Individual income		
Business profits	$100.00	
Dividend		$72.00
Dividend gross-up (41% x $72.00)		29.52
Taxable income	$100.00	$102.52
Federal tax at 29%	$29.00	$29.44
Federal dividend tax credit (13/23 x $29.52)		(16.69)
Ontario tax at 11.16%	11.16	11.33
Ontario DTC at 6.40%		(6.50)
Ontario surtax at 56%	6.25	2.70
Total individual tax	$46.41	$20.28
Corporate tax		28.00
Total tax on $100 income	$46.41*	$48.28*
*$1.87 tax cost ($46.41 minus $48.28) if ABI not eligible for SBD is earned in corporation and after-tax earnings paid as eligible dividend to individual shareholder		

Example 4 — Under-integration in 2012: new DTC rules and $100 of corporate ABI with no SBD
(Assumes individual is Ontario resident in the highest marginal tax bracket and corporate tax rate is 26% at July 1, 2012 (15.0% federal as of January 1, 2012 + 11.0% Ontario as of July 1, 2012 Ontario)

	Active business income earned directly by an individual	**Active business income earned through a corporation**
Corporate income		$100.00
Corporate tax @ 26% (no SBD)		26.00
After-tax profits		$74.00
Individual income		
Business profits	$100.00	
Dividend		$74.00
Dividend gross-up (38% x $74.00)		28.12
Taxable income	$100.00	$102.12
Federal tax at 29%	$29.00	$29.61
Federal dividend tax credit (6/11 x $28.12)		(15.34)
Ontario tax at 11.16%	11.16	11.40
Ontario DTC at 6.40%		(6.54)
Ontario surtax at 56%	6.25	2.72
Total individual tax	$46.41	$21.85
Corporate tax		26.00
Total tax on $100 income	$46.41*	$47.85*
*$1.44 tax cost ($46.41 minus $47.85) if ABI not eligible for SBD is earned in corporation and after-tax earnings paid as eligible dividend to individual shareholder		

2.3.3 Deferral where the corporate tax rate is less than the individual's tax rate

It should be noted that even if the corporate tax rate were greater than 20%, the use of a corporation would still have the advantage of deferring tax as long as this corporate tax rate is lower than the individual shareholder's marginal income tax rate. The corporation can retain after-tax profits until they are distributed by way of dividends to the shareholders. In this way, income tax is deferred at the shareholder level. This income tax deferral advantage can be significant where the shareholder does not require the funds for several years. See Example 3, above, where the general corporate tax rate of 28.0% (in 2011 and reduced to 26.0% in 2012) is less than the top personal marginal tax rate of 46.41%.

2.3.4 Integration tax observations for 2011 and 2012

In Example 2, above, where the ABI (eligible for the SBD) is earned in a corporation, the following may be observed:

(a) Tax deferral observation: ABI earned in a corporation offers a tax deferral (if income is left in

the corporation) of 30.91% (15.50% corporate tax rate vs. 46.41% personal tax rate).

(b) Tax savings observation: Generally speaking, there is a tax savings (3.39%) if ABI eligible for the SBD is flowed through a corporation and paid as non-eligible dividends to individual shareholders.

In Example 3, above, where the general corporate income tax rate (ABI not eligible for the SBD) is used, the following may be observed:

(a) Tax deferral observation: ABI earned in a corporation also offers a tax deferral (if income is left in the corporation) of 18.41% (28% corporate tax rate vs. 46.41% personal tax rate).

(b) Tax cost observation: Generally speaking, there is a tax cost (1.88%) if high-rate corporate income (not eligible for the SBD) is flowed through a corporation and paid as eligible dividends to individual shareholders.

In Example 4, above, where the general corporate income tax rate (ABI not eligible for the SBD) is used, the following may be observed:

(a) Tax deferral observation: ABI earned in a corporation also offers a tax deferral (if income is left in the corporation) of 20.41% (26% corporate tax rate vs. 46.41% personal tax rate).

(b) Tax cost observation: Generally speaking, there is a tax cost (1.44%) if high-rate corporate income (not eligible for the SBD) is flowed through a corporation and paid as eligible dividends to individual shareholders.

2.3.5 Summary

In determining whether it is appropriate from an income tax perspective to earn income through a corporation, the following should be kept in mind:

(1) Is the aggregate income tax paid at the corporate and shareholder level

- equal to;
- greater than; or
- or less than

the income tax that would have been paid had the shareholder earned the income personally? If the answer is "equal," perfect integration has been achieved. If the answer is "greater," there is a tax penalty to earning the income through the corporation. If the answer is "less," there is a tax advantage to earning the income through the corporation.

(2) Is the corporate income tax rate alone less than the shareholder's income tax rate? If the answer is yes, regardless that the answer in (1) may be greater, there may be a deferral of income tax by having the after-tax income retained in the corporation and subject to tax at the corporation's rate of income tax. If the answer is no, there is increased income tax (an income tax cost or penalty) to retaining after-tax income in the corporation. The retention of after-tax income in the corporation may be preferable to the imposition of additional tax at the shareholder level that arises on payment of a dividend.

3. Taxation of shareholders

One of the ways in which the corporate and individual income tax system is integrated is by reducing the amount of income tax paid by shareholders on the receipt of dividends. The *ITA* distinguishes between dividends received by shareholders who are individuals and dividends received by shareholders that are corporations.

3.1 Taxation of dividends to individual shareholders

The *ITA* attempts to achieve integration with income first earned by a corporation and the distribution of the corporation's after-tax income to shareholders as dividends, through the dividend tax credit (DTC) and gross-up mechanism.

The income tax payable by an individual is reduced by the dividend "gross-up" and DTC mechanism. A dividend received by an individual shareholder is grossed-up to approximate the amount of income earned before tax by the corporation. A tax credit is then given to the shareholder to approximate the amount of income tax previously paid by the corporation on its income.

3.1.1 Old "non-eligible" DTC rules

Under the old rules, the amount of the gross-up is 25% of the dividend. The federal dividend tax credit (DTC) is equal to two-thirds of the amount of the gross-up or 13 1/3% of the total taxable dividend. An example of a non-eligible dividend received by an individual resident in the province of Ontario and in the top marginal tax bracket in 2011 is shown in Example 5, below.

Only dividends received from taxable Canadian corporations are eligible for the dividend gross-up and DTC mechanism. There is a different set of rules that applies to dividends received from foreign corporations.

These old DTC rules still apply to non-eligible dividends. In 2011, the top marginal tax rate paid by individuals on non-eligible dividends received from Canadian corporations ranges from a low of 27.71% (in Alberta) to a high of 41.17% (in Prince Edward Island). For 2011, Ontario's dividend tax credit for non-eligible dividends is 4.5%.

Example 5: Old DTC rules for non-eligible dividends (the individual is resident in Ontario and is in the top tax bracket)

	2011
Dividend received:	$100.00
Dividend gross-up (25% x $100)	$ 25.00
Taxable income	$125.00
Federal tax at 29%	$ 36.25
Dividend tax credit (2/3 x $25)	(16.67)
Basic federal tax	$19.58
Federal surtax	$0.00
Total federal tax	$19.58
Provincial tax @ 11.16%	13.95
Provincial dividend tax credit (4.5%)	(5.63)
Provincial surtax (56%)	4.66
Total individual tax on dividend	$32.56

In Example 5, above, from the standpoint of the individual taxpayer, a non-eligible dividend is subject to a 25% gross-up (as opposed to the 41% gross-up for eligible dividends from taxable Canadian corporations, as discussed below) and entitled to a federal tax credit equal to 2/3 of the gross-up.

3.1.2 New "eligible" DTC rules

Draft legislation released in July 2006 by the federal government proposed to reduce the tax rate on certain dividends received after 2005 by individuals and trusts.

Since then, other developments occurred including the following:

- On October 16, 2006, the federal government released new provisions that were included in Bill C-28. These new provisions clarified the initial dividend tax proposals. These dividend tax proposals were enacted into law in early 2007.
- On October 31, 2006, the federal government announced its intention to impose income tax on flow-through entities (generally income trusts) in respect of certain distributions made to investors. Under this proposal, investors in these entities will be taxed as though the distributions were dividends beginning in 2011 for income trusts that existed on October 31, 2006 (and for income trusts first created after October 31, 2006, in tax years after 2006).

These dividend changes reduced the effective personal tax rate on eligible dividends. In 2011, the top marginal tax rate paid by individuals on eligible dividends received from Canadian corporations ranges from a low of 17.72% (in Alberta) to a high of 34.85% (in Nova Scotia). The reduced tax rate is achieved through an increase to both the dividend gross-up and the dividend tax credit on eligible dividends. Dividends that are not eligible (i.e., non-eligible dividends) continue to be taxed under the old DTC rules.

The objective of the federal changes to the gross-up and DTC mechanism is to eliminate (or reduce) the double taxation that otherwise arises when dividends are paid to individuals resident in Canada from a corporation resident in Canada whose income has been subject to the higher general (i.e., the full) corporate rate of tax.

Under the *ITA*, dividends from Canadian corporations are now treated or classified as either (i) "eligible dividends" (a defined term), or (ii) non-eligible dividends. Non-eligible dividends received by an individual taxpayer do not qualify for the reduced tax rate (i.e., are subject to gross-up and DTC under the old DTC rules).

Eligible dividends are defined as dividends received by an individual taxpayer resident in Canada and designated as eligible by the payor corporation. Generally speaking, such dividends are those that are paid out of a corporation's income that was subject to the general corporate income tax rate (i.e., not eligible for any tax incentives such as the small business deduction (SBD), the manufacturing & processing deduction (M&P deduction), etc.).

The eligible dividends rules require Canadian-controlled private corporations (CCPCs) and non-CCPCs to track their income as (1) general rate income pool (GRIP), and (2) low rate income pool (LRIP). A CCPC can pay eligible dividends to the extent it has GRIP (or a sufficient GRIP) at the end of a tax year. On the other hand, a non-CCPC can pay eligible dividends as long as it does not have a LRIP at the time the dividend is paid. A 20% penalty tax will be imposed on any corporation's excessive eligible dividend designations.

Prior to these legislative changes, when an individual shareholder received a dividend from a taxable Canadian corporation, he or she included the amount of the dividend in income plus an amount equal to one-quarter (25%) of the dividend (*ITA*, ss. 82(1)(a)(ii) and 82(1)(b)). The individual shareholder then calculated the federal income tax payable on the grossed-up dividend and subtracted the DTC (which was equal to two-thirds of the amount of the gross-up or 13 1/3% of the total grossed-up (taxable) dividend) (*ITA*, s. 121).

An example of an eligible dividend received by an individual resident in the province of Ontario and in the

top marginal tax bracket in 2011 is shown in Example 6 below.

Example 6: New DTC rules for eligible dividends (the individual is resident in Ontario and is in the top tax bracket)

	2011
Dividend received:	$100.00
Dividend gross-up (41% x $100)	$ 41.00
Taxable income	$141.00
Federal tax at 29%	$ 40.89
Dividend tax credit (13/23 x $41)	(23.17)
Basic federal tax	17.72
Federal surtax	0.00
Total federal tax	$17.72
Provincial tax @ 11.16%	15.74
Provincial dividend tax credit (@6.40%)	(9.02)
Provincial surtax (56%)	3.76
Total individual tax on dividend	$28.20

In Example 6, above, from the standpoint of the individual taxpayer, an eligible dividend benefits from a 41% gross-up (as opposed to 25% for other taxable dividends from taxable Canadian corporations) and a federal tax credit equal to 13/23 of the gross-up.

3.2 Taxation of dividends to corporate shareholders

Generally speaking, dividends received by corporate shareholders are received free from income tax (that is, income tax imposed under Part I of the *ITA*) by reason of the inter-corporate dividend deduction (*ITA*, s. 112). A separate income tax mechanism applies to the taxation of inter-corporate dividends under Part IV of the *ITA* (*ITA*, s. 186).

4. Taxation of corporations

4.1 General

The income tax treatment of corporations seeks to accomplish two main tax policy objectives:

- reduce the rate of corporate income tax so as to reduce or eliminate an income tax bias against incorporating; and
- avoid any undue tax deferral advantage, which may result if the corporate income tax rate is less than the maximum tax rate for individuals.

Corporations are subject to both federal and provincial income taxes. The rate of tax payable by a corporation will depend upon the type of corporation and the type of income earned by the corporation.

4.2 Federal income tax

The federal income tax payable by a corporation is based on the general federal corporate income tax rate and is adjusted to allow room for provincial and territorial corporate tax (provincial abatement), as well as for different tax incentives based on the type of corporation (i.e., a CCPC) with ABI (up to $500,000 annually) and for other companies carrying on manufacturing and processing (M&P deduction). The federal corporate surtax was repealed effective for 2008.

4.2.1 General federal corporate income tax rate

The general federal corporate income tax rate is 38%. To this amount is added the applicable provincial/territorial corporate tax. However, to provide room for the imposition of provincial/territorial corporate income tax, the *ITA* reduces the federal income tax rate by 10% to 28% (the basic federal rate). This 10% reduction is known as the provincial abatement.

The provincial abatement applies only to corporations earning income that is attributable to any province in Canada. If a corporation carries on business in the United States in 2011, no provincial abatement applies, no provincial corporate income tax will be payable, and the corporation will pay income tax at a federal tax rate of 38% (The former federal surtax of 4% was eliminated for all corporations effective January 1, 2008).

The basic federal corporate income tax rate of 28% (i.e., the general federal tax rate (38%) after applying the 10% provincial abatement) has been and continues to be reduced. This reduction to the basic federal corporate income tax rate on income not eligible for the SBD is summarized in the chart below. Certain income is not eligible for this income tax rate reduction including income from manufacturing and processing (M&P income) and investment income.

Federal Corporate Tax Rates

Year	Basic Federal Rate	Federal Rate Reduction	Net Federal Rate
2001	28%	1%	27%
2002	28%	3%	25%
2003	28%	5%	23%
2004 to 2007	28%	7%	21%
2008	28%	8.5%	19.5%
2009	28%	9%	19%
2010	28%	10%	18%
2011	28%	11.5%	16.5%
2012	28%	13%	15%

The net federal tax rate in 2011 and 2012 for those corporations (i.e., CCPCs) eligible for the SBD is 11% (i.e., 38% - 10% - 17%).

4.2.2 Refundable tax on investment income

An additional 6 2/3% refundable tax is imposed on the investment income of taxable Canadian corporations. Any refundable tax belonging to a corporation is refunded to the corporation at the rate of $1 for every $3 of taxable dividends paid.

4.2.3 Business losses

A corporation's net operating loss (NOL), or non-capital loss (i.e., a loss from carrying on business—the excess of expenses over revenue from the business), is fully deductible in the year it is incurred; and if unused, it may be carried back three or forward 20 years. NOLs can be applied to offset income from any source (including capital gains). This may not be the most tax effective use of a NOL, since only 1/2 of capital gains are taxable.

This extended 20-year carryforward period for non-capital losses (i.e., business losses) has changed in recent years as follows:

- The extended carryforward period (increased from 10 to 20 years) for non-capital losses (i.e., business losses) applies to business losses arising in taxation years ending after 2005.
- For business losses arising in taxation years ending between March 23, 2004, and December 31, 2005, such business losses may be carried forward only 10 years.
- For business losses arising in taxation years ending before March 23, 2004, such business losses may be carried forward only seven years.

There have been no changes to the three-year carry back period for business losses.

4.3 Ontario provincial income tax

The provincial tax on corporate income in Ontario is imposed under Ontario's *Corporations Tax Act* (*CTA*). The Province of Ontario and the federal government signed a new tax collection agreement under which the federal government (i.e., the Canada Revenue Agency (CRA)) began collecting and administering Ontario's corporate income tax in 2009. Accordingly, a separate Ontario corporate tax return is no longer required for tax years after 2008.

The basic or general Ontario corporate income tax rate is 11.5% after June 30, 2011 (and 12% before July 1, 2011). This Ontario corporate income tax rate is to be reduced to 11.0% effective July 1, 2012, and to 10.0% effective July 1, 2013.

As is the case federally, Ontario also has a low small business corporate income tax rate of 4.5% after June 30, 2010 (was 5.5% before July 1, 2010). Ontario's manufacturing and processing (M&P) profits tax rate is 10% after June 30, 2010 (was 12% before July 1, 2010).

Ontario's 2009 budget (March 26, 2009) proposed to reduce the corporate income tax rate for all types of income over a three-year period as follows:

	General	M&P	Small Business
2009	14%	12%	5.5%
July 1, 2010	12%	10%	4.5%
July 1, 2011	11.5%	10%	4.5%
July 1, 2012	11.0%	10%	4.5%
July 1, 2013	10.0%	10%	4.5%

4.4 Corporate minimum tax

Ontario also imposes a corporate minimum tax (CMT) that applies gross revenue and total asset tests to determine whether a corporation will be subject to the CMT. The CMT rate applies only to income allocated to Ontario.

Ontario's CMT, which has existed since 1994, is based on financial statement income. In 2011, CMT is levied at the rate of 2.7% (effective rate since June 30, 2010 and was 4% before July 1, 2010) on adjusted accounting net income over "regular" income. However, CMT is only payable by a corporation to the extent CMT exceeds the corporation's regular Ontario corporate income tax. CMT is creditable (carried forward and can be applied) against regular corporate income tax for up to 20 years (10 years for years ending before March 22, 2007). Corporations (or an associated group of corporations) with total assets of less than $5,000,000 and annual gross revenues less

than $10,000,000 are not subject to CMT. In addition, for tax years ending after June 10, 2010, CMT will not apply to corporations with total assets of less than $50,000,000 or annual gross revenues less than $100,000,000.

4.5 Ontario capital tax

In addition to provincial income taxes, some provinces, including Ontario (and Saskatchewan, Manitoba, Quebec, New Brunswick, and Nova Scotia), levy(ied) capital taxes on a corporation's "taxable paid-up capital." Generally, it is levied on the aggregate of a corporation's share capital, contributed surplus, retained earnings, and long-term debt. It is then pro-rated according to the percentage of gross revenue and wages relating to the particular province. Previously (i.e., before July 1, 2010), Ontario had a general capital tax rate of 0.225% for most corporations and an exemption amount of $15,000,000.

Ontario phased out its capital tax on July 1, 2010.

5. Reduction of corporate tax

5.1 Introduction

The combined federal and provincial corporate income tax rate is reduced in certain circumstances depending on the type of corporation and the type of income earned by the corporation.

There are two broad categories of income that a corporation can earn

- business income; and
- income from property, usually called "investment income."

The taxation of each category of income differs depending on the status of the corporation earning the income. There are different tax results depending on whether the corporation receiving the income is a public corporation, a private corporation, or a CCPC.

5.2 Types of corporation

The *ITA* distinguishes between three types of corporations

- public corporations;
- private corporations; and
- CCPCs.

5.2.1 Public corporation

A public corporation is defined in s. 89(1) of the *ITA* as a corporation resident in Canada whose shares are listed on a designated Canadian stock exchange. Commencing on January 1, 2008, the Minister of National Revenue (MNR) now has authority under s. 262 of the *ITA* to designate a stock exchange.

Previously (prior to 2008), a public corporation was a corporation resident in Canada whose shares were listed on a prescribed stock exchange (i.e., by regulation). Under the former *Income Tax Regulation* 3200, the Montreal, Toronto, and Tiers 1 and 2 of the TSX Venture (i.e., merged Alberta and Vancouver Stock Exchanges) were prescribed stock exchanges in Canada. As of January 1, 2008, all previously prescribed stock exchanges are "designated stock exchanges."

Certain corporations whose shares are not listed on a designated stock exchange in Canada are also included in the definition of public corporation. These include

- a corporation that does not have a class of its shares listed on a designated stock exchange and that
  - meets certain prescribed conditions; and
  - elects to be a public corporation; and
- a corporation designated by the MNR as a public corporation that meets certain prescribed conditions.

In both cases, the prescribed conditions relate primarily to a wide distribution and dispersed ownership of a corporation's shares.

A subsidiary of a public corporation is taxed in the same manner as a public corporation, although it is technically not defined as such in the *ITA*.

5.2.2 Private corporation

A private corporation is defined in s. 89(1) of the *ITA* as a corporation resident in Canada that is neither a public corporation nor controlled in any manner by one or more public corporations. For example, a Canadian corporation that is a wholly owned subsidiary of a foreign corporation listed on a foreign stock exchange is a private corporation.

5.2.3 Canadian-controlled private corporation

A CCPC is defined in s. 125(7) of the *ITA* as a private corporation resident in Canada that is not controlled in any manner whatever by

- one or more non-resident persons;
- public corporations; or
- any combination thereof.

This negative definition allows a corporation 50% owned by Canadian individuals, either directly or through other private corporations, and 50% owned by non-residents or public corporations to still qualify as a CCPC.

5.3 Types of income

5.3.1 Business income

There are two basic income tax incentives for business income earned through a corporation

- the small business deduction (SBD) and
- the M&P profits deduction.

These incentives have the effect of reducing the corporate rate of income tax.

(a) Small business deduction

A CCPC is entitled to both a federal SBD of 17% in 2011 and a lower Ontario corporate income tax rate on a certain amount of ABI earned in Canada for the year (*ITA*, ss. 125(1)–(1.1)). Generally speaking, an active business is any business carried on by a corporation other than a "specified investment business" or a "personal services business."

The SBD is and has been a tax incentive aimed at assisting smaller CCPCs. The SBD rules changed in 1994 to take the SBD away from larger CCPCs. Larger CCPCs not eligible for the SBD are those CCPCs (or an associated group of corporations) with taxable capital (i.e., calculated for Large Corporations Tax (LCT) purposes) used in Canada in excess of $10 million. The SBD starts to be taken away at that point and is completely clawed back when a corporation's taxable capital reaches $15 million. The federal government's clawback of the SBD occurs on a straight-line basis for these larger CCPCs (taxable capital between $10 million and $15 million).

Ontario had its own clawback mechanism for income subject to the small business rate (i.e., imposed by a surtax on income between $500,000 and $1.5 million, as discussed below). This Ontario corporate surtax on small business income was eliminated on July 1, 2010.

The SBD income thresholds must be pro-rated for a CCPC's tax year that does not coincide with the calendar year. As a result, the federal and Ontario small business income thresholds are as follows:

SBD income thresholds

	Federal	Ontario
2003	$225,000	$320,000
2004	$250,000	$400,000
2005	$300,000	$400,000
2006	$300,000	$400,000
2007	$400,000	$500,000
2008	$400,000	$500,000
2009	$500,000	$500,000
2010	$500,000	$500,000
2011	$500,000	$500,000

Note that prior to 2009, Ontario's small business income threshold was greater than the federal threshold. The 2009 federal budget (January 27, 2009) increased the federal limit to $500,000 for tax years ending after December 31, 2008 (and pro-rates the increased limit for 2009 tax years that straddle December 31, 2008).

For 2011, the effect of the federal SBD (38% - 10% - 17% = 11%) and the Ontario small business income tax rate (4.5% since July 1, 2010) reduces the combined federal and provincial corporate tax rate on eligible income to 15.5% (11% + 4.5%) as of July 1, 2010, for corporations whose income is attributable to the province of Ontario.

Previously, Ontario imposed a provincial surtax on a corporation's taxable income in excess of the Ontario small business income threshold (although only to a maximum of the amount of the Ontario SBD claimed). Accordingly, this provincial surtax was a clawback of Ontario's SBD and effectively reduced the benefit of the small business rate in Ontario when income exceeded a certain threshold. Ontario's surtax on excess small business income is summarized in the chart below. However, it should be noted that Ontario's 2009 budget (March 26, 2009) eliminated this surtax effective July 1, 2010.

	2008	2009	2010
Small business rate	5.5%	5.5%	4.5%
Taxable income limit	$500,000	$500,000	$500,000
Income phase out	$500,000 - $1,500,000	$500,000 - $1,500,000	N/A
Ontario surtax rate	4.25%	4.25%	N/A

CCPCs eligible for the SBD are also affected by a federal phase-out of the small business limit. The amount of taxable income eligible for the federal SBD is reduced on a straight-line basis for "larger" CCPCs (i.e., "large" being determined in reference to the LCT provisions), as discussed above.

In 2011, the first $500,000 of ABI of a CCPC is eligible for the federal SBD. The effective rate of tax (combined federal and Ontario) on this (preferentially taxed) ABI is 15.5% (i.e.; 38% - 10% - 17% + 4.5% = 15.5%).

In 2011, income in excess of $500,000 is taxed at a combined federal and Ontario corporate rate of 28%, calculated as:

- the federal corporate rate of 16.5% (i.e., 38% - 11.5% - 10.0% = 16.5%); plus
- the provincial corporate tax rate of 11.5%.

(i) Personal services business

The *ITA* specifically excludes income from a "personal services business" from the definition of ABI. This rule is aimed at incorporated employees who seek to defer and reduce tax on what is essentially employment income by incorporating and earning it through a corporation. Absent the personal services business rule, individuals would be able to take advantage of the lower corporate tax rates. As a result of the application of this rule, income earned by a corporation that is "personal services business" (PSB) income is subject to tax in 2011 at the combined federal and Ontario general corporate tax rate of 28% (i.e., 16.5% federal + 11.5% Ontario). This 28% corporate tax rate also provides a significant tax deferral on PSB income earned by a corporation, rather than by the individual personally (i.e., after-tax income left in the corporation and not paid out to an employee or shareholders).

However, the federal government (now aware of the tax advantages for a PSB—low rate of corporate tax and tax deferral of after-tax retained income) has proposed legislative changes to substantially remove these tax advantages for tax years of PSB corporations ending after October 31, 2011. The tax advantages are removed by taking away the federal corporate tax rate reduction (currently 17%) on PSB income earned in the year by a corporation. If the changes are enacted, PSB income earned by a corporation will become subject to a combined corporate tax rate of 39.5% (28% federal + 11.5% Ontario). As a result a large portion of the tax savings and deferral advantage will be removed.

A PSB is defined in s. 125(7) of the *ITA* as a business of providing personal services where both of the following are true:

- The individual who performs services on behalf of the corporation (i.e., the incorporated employee) is, or is related to, a specified shareholder of the corporation.
- The incorporated employee would reasonably be regarded as an officer or employee of the recipient of the services but for the existence of his or her own corporation.

A "specified shareholder" of a corporation is broadly defined in s. 248(1) of the *ITA* as one who owns, directly or indirectly, at least 10% of the shares of any class of that corporation (or a related corporation).

There are two important exclusions from the definition of a personal services business. Income from a business will not be income from a personal services business if either of the following are true:

- The corporation employs more than five full-time employees (including specified shareholders).
- The corporation receives payment for the subject services from an associated corporation.

In addition to having the personal services business income taxed at the top corporate income tax rate, a corporation that carries on a personal services business cannot deduct general overhead expenses such as rent and interest (*ITA*, s. 18(1)(p)). The permitted expenses generally include or are limited to the salary, wages, or other remuneration, together with any benefits paid to the incorporated employee.

(ii) Specified investment business

Also excluded from the definition of ABI is "specified investment business" income. A specified investment business is defined in the *ITA* as including a business (other than a business carried on by a credit union or a business of leasing property, except real property), the principal purpose of which is to derive income from property (including interest, dividends, rent, or royalties). Such property income earned by a corporation with more than five full-time employees is excluded from the definition of a specified investment business.

Specified investment business income is taxed at the top corporate income tax rate. However, a portion of this tax is refunded to the corporation when it pays a taxable dividend, provided the corporation qualifies as a CCPC.

(iii) Associated corporations

The low rate of corporate income tax paid by a CCPC on the first $500,000 (federal income threshold in 2011) of ABI is of considerable advantage. In order to prevent individuals from setting up several corporations in order to take advantage of the lower rate of tax on the first $500,000 of ABI, the *ITA* provides that corporations that

are "associated" must share this $500,000 small business limit (*ITA*, ss. 125(2)–(4) and 256(1)).

The *ITA* contains a complex set of rules that are used to determine whether two or more corporations are "associated." Associated corporations share the SBD by filing an agreement in prescribed form with the CRA (see also the glossary of terms in the Appendix to this chapter). Each corporation is allocated a portion of the $500,000 limit that will be taxed at the lower corporate income tax rate. The total amount allocated among the various associated corporations may not exceed the $500,000 business deduction limit.

(b) Manufacturing and processing profits deduction

Any corporation carrying on a M&P activity in Canada may be eligible for the federal M&P income tax rate reduction of 11.5% in 2011 to reduce its corporate income tax rate from 28% to 16.5% in 2011 (i.e., 38% - 10% - 11.5% = 16.5%). The federal M&P income tax rate reduction is to increase to 13.0% on January 1, 2012, such that the federal M&P corporate income tax rate will be 15.0% in 2012 (i.e., 38% - 10% - 13.0% = 15.0%). Ontario also offers a lower rate of tax on M&P income of 10% after June 30, 2010 (12% before July 1, 2010). The Ontario M&P income rate was 2% lower than the general provincial rate of 12% in 2010, is 1.5% lower than the general provincial rate of 11.5% (at July 1, 2011), will be just 1.0% lower than the general provincial rate of 11.0% (at July 1, 2012), and will be the same as the general provincial rate of 10.0% (on July 1, 2013).

(c) Effect of tax reductions on integration

The federal and provincial combined corporate income tax rate must be 20% for perfect integration to occur as discussed above. In the case of business income earned in Ontario eligible for the SBD, the tax system results in slight over-integration, since the combined corporate income tax rate is reduced to 15.5% (federal 11% and Ontario 4.5%). There is also a substantial tax deferral advantage, where the corporation's rate of tax is less than the shareholder's tax rate. In this case, taxes will be deferred as long as the income is retained in the corporation. In the case of CCPCs with income substantially over $500,000 and for the other types of corporations, the tax system does not achieve integration and a small tax disadvantage will arise from earning income (or retaining and taxing such excess income in the corporation) through a corporation. See also "Integration tax observations for 2011 and 2012," above.

5.3.2 Investment income

(a) General

The reduction in corporate income tax rates in respect of investment income earned by a corporation is accomplished in a different manner than that for ABI earned through a corporation. The system adopted for investment income is designed to prevent an undue deferral advantage in setting up a corporation to hold an individual's investments. Such a corporation is commonly known as a "holding" corporation. Briefly speaking, having investment income initially subject to the combined federal and provincial tax rate of 46.17% in 2011 (since July 1, 2011), which includes the additional 6 2/3% federal refundable tax on investment income (i.e., 38% - 10% + 6.67% + 11.5%), generally eliminates this deferral advantage for investment income (interest income excepted). In theory, absent a higher marginal tax rate for individuals (46.41% for the top marginal tax rate for an individual on interest income vs. 46.17% corporate tax rate on interest income), there should be no deferral advantage to earning investment income (holding investments) through a corporation.

(b) Dividend refund

In order to achieve integration with respect to investment income earned by a corporation, a portion of the federal corporate income tax paid is refunded to the corporation when it pays such income to its shareholders in the form of taxable dividends. This federal corporate tax refund mechanism is only available to CCPCs. There is no attempt to provide integration for investment income earned by other corporations. The amount of federal corporate tax that is entitled to be refunded to the corporation is 26 2/3% (i.e., 20% of investment income plus the additional 6 2/3% federal refundable tax). However, it should be noted that this federal refund mechanism does not result in perfect integration. What the dividend refund represents is a recovery by the corporation of all or part of the income tax it paid earlier on its investment income. In order that the corporation receives its tax refunds as dividends are paid out, the amount of tax that is available for refund to the corporation (i.e., its refundable tax amount) is added to a notional tax account known as the "refundable dividend tax on hand" (RDTOH) account (*ITA*, s. 129). To the extent a corporation pays taxable dividends, it receives a refund equal to one ($1) dollar for every three ($3) dollars of taxable dividends paid to shareholders.

(c) Part IV tax

Dividends received from Canadian corporations are not included in the definition of investment income for

purposes of computing the refundable portion of corporate income tax paid (*ITA*, s. 129(4)).

Such dividends are allowed special treatment since they flow through to the corporation tax-free by virtue of the application of the inter-corporate dividend received deduction (*ITA*, s. 112). However, these inter-corporate dividends come within the scope of the refundable tax system by another route. Part IV of the *ITA* (s. 186) levies a special tax at the rate of 33 1/3% in respect of dividends received in certain circumstances from Canadian corporations or from foreign affiliates. When Part IV tax is payable in respect of dividends, this Part IV tax is added to the corporation's RDTOH. To the extent the corporation later pays taxable dividends to its shareholders, it receives a refund equal to one-third of the dividends paid (i.e., $1 refunded in tax for each $3 of taxable dividends paid).

(d) Capital gains

A capital gain is the amount by which the proceeds of disposition of a capital asset exceed the aggregate of the adjusted cost base (ACB) of the asset and the selling costs. One-half of a capital gain (that is, the taxable capital gain) is included in income (*ITA*, s. 38(a)). Since ½ of a capital gain is the taxable capital gain, this ½ factor is often referred to as the capital gain inclusion rate. Over the years, the federal government has changed the applicable capital gain inclusion rate. Therefore, taxpayers have to pay particular attention to the various changes to the capital gain inclusion rate from time to time. For example, taxpayers have to keep accurate records to separately track and report capital gains or losses realized at various times. Since capital losses may be carried over to other years (i.e., back three years and forward indefinitely), the capital loss will be adjusted to match the inclusion rate for the tax year to which the capital loss is being applied. Changes to the capital gain inclusion rate similarly affects other tax matters, including (1) amounts included in an employee's income resulting from stock option benefits; (2) allowable business investment losses (ABILs); (3) adjustments to the rules associated with the $750,000 (for dispositions after March 19, 2007, and $500,000 for dispositions before March 20, 2007) capital gains exemption for qualified small business shares, qualified fishing property, and qualified farm property; and (4) capital gains arising from a gift of publicly traded securities. Similarly, a capital loss is the amount by which the aggregate of the ACB of the asset and the selling costs exceeds the proceeds of disposition. One-half of capital losses (that is, the allowable capital loss) are deductible against taxable capital gains. Any excess capital loss can be carried back three years and forward indefinitely, but may only be used to offset taxable capital gains. When a private corporation realizes a capital gain, it is entitled to pay out the tax-free portion (i.e., the other one-half or non-taxed portion) of such gain to its shareholders as a capital dividend provided both of the following occur:

- The directors elect under s. 83(2) of the *ITA* to treat the dividend as a capital dividend.
- An election is filed with the CRA on or before the day on which the dividend is paid.

The untaxed (or tax-free) portion of the capital gain is kept in a notional tax account known as the "capital dividend account" (CDA). The CDA will also be reduced by one-half of capital losses. At any time, a private corporation can elect to declare a tax-free dividend where there is a positive balance in its CDA. It should be noted that the CDA is computed at a particular time. Therefore, if a private corporation intends to pay a capital dividend, any capital losses should not be realized until after the payment of the capital dividend, since capital losses will reduce the positive balance of the CDA. Dividends that are treated as paid out of the CDA are not taxable dividends but are received tax-free by the shareholders as "capital dividends." By operation of ss. 184(2) and 83(2)(a) of the *ITA*, where the directors declare a capital dividend in excess of the balance in the company's CDA, the corporation is required to pay a penalty tax equal to 75% of the excess paid. There are special rules that mitigate the effect of this penalty by permitting all the individual shareholders to receive the excessive amount as a taxable dividend.

(e) Dividends

While dividends are a type of investment income, the corporate system of taxation of dividends is entirely different than the refundable tax regime applicable to other types of investment income. The reason for this is that it is recognized that income earned by a corporation should only be subject to two levels of taxation, once by the corporation that earns the income, and second, by the ultimate individual shareholder. Thus income distributed through a chain of corporations as dividends can generally flow free of tax. In theory, this provides an opportunity for abuse where an individual interposes a corporation to receive dividends on a tax-free basis.

6. Advantage and uses of incorporating businesses earning active business income

6.1 Introduction

In addition to the non-tax advantages of carrying on business through a corporation (such as limited liability and perpetual existence), there are a number of income

tax advantages that are associated with earning ABI in a corporation, as opposed to carrying on a business as a sole proprietor or in a partnership.

6.2 Lower rate of tax — tax savings and deferral

The lower rate of corporate income tax applicable to CCPCs, which qualify for the SBD, provides a substantial incentive for incorporation. The corporate tax rate for such corporations is 15.5% in 2011 (effective tax rate since July 1, 2010) on its first $500,000 of ABI earned in Ontario.

6.3 Estate planning and income splitting

Corporations earning ABI may be used for estate planning and income-splitting purposes with spouses, adult children, and other family members.

6.4 Rollovers

The *ITA* contains a number of provisions that permit the conveyance (transfer) of assets/property or a reorganization of a corporation's share capital without triggering immediate income tax consequences. These transactions facilitate the incorporation of sole proprietorships or partnerships, and the implementation of income-splitting and estate-freezing arrangements. The following is a brief outline of some of these provisions.

6.4.1 Section 85

The general tax rule is that transfers of property take place at fair market value (FMV). Consequently, any gain (either income or capital) or recapture of capital cost allowance (CCA) may be triggered, and immediate tax consequences apply.

If the requirements of s. 85 of the *ITA* are met, the transferor and the transferee can elect to have the transfer take place on a tax-deferred basis. The "elected amount" becomes

- the proceeds of disposition of the property to the transferor;
- the cost of the property to the transferee corporation; and
- the cost amount of the property the transferor receives from the transferee corporation.

The transferor and the transferee may choose an "elected amount" that will result in no immediate realization of income or gain if the elected amount is equal to the tax cost of the asset transferred. Any income or gain that otherwise would arise on the transfer at FMV will be deferred until such time as either the "transferee corporation" (recipient under the s. 85 transaction) disposes of the property or the transferor disposes of the shares owned in the transferee corporation.

In order for a transaction to be governed by s. 85(1), all of the following conditions must be met:

- The transferee corporation must be a "taxable Canadian corporation" within the meaning of the *ITA* (s. 89(1)).
- The transferor must be a "taxpayer." There is no requirement that the transferor be a resident of Canada.
- The transferor and the transferee must jointly elect in prescribed form and within the prescribed time to have the provisions of s. 85(1) apply. The time within which the election must be filed is set out in s. 85(6) of the *ITA*. The election form may be filed late (up to three years and thereafter with consent of the MNR); however, but penalties will apply.
- The transferor must receive at least one share (in the capital stock) of the transferee corporation as consideration for the transfer.
- The property that is the subject matter of the transfer must be eligible property within the meaning of the *ITA* (s. 85(1.1)).

Section 85 contains several rules that place upper and lower limits on the "elected amount" that the parties can choose. Basically, the "elected amount"

- cannot exceed the FMV of the property transferred to the transferee corporation; and
- cannot be less than the FMV of any non-share consideration (i.e., cash, promissory note, debt, or other liability assumed) received.

Where the FMV of the property transferred is lower than the FMV of any non-share consideration received, the "elected amount" is deemed to be the FMV of the transferred property. A transferor wishing to completely defer the recognition of income or gains will elect to transfer the property at its cost amount; for example, its ACB (if it is capital property) or its undepreciated capital cost (UCC) (if it is depreciable property). It is important to understand that s. 85 provides only a deferral or postponement of tax and is not an avoidance of tax. Any appreciation in the value of the property transferred (i.e., inherent gains) that is not recognized at the time of transfer will be taxed at the time the property is sold or otherwise disposed of by the transferee corporation. The same deferred gain may also be taxed when the transferor disposes of the share(s) received from the transferee corporation in exchange for the transferred property (i.e., there is always the potential risk of double taxation—on the same amount of gain when property is transferred under s. 85).

6.4.2 Sections 86 and 51

A corporation's share capital may be reorganized on a tax-deferred basis under s. 86, or a conversion privilege attached to shares may be exercised by converting these shares into a new class of shares on a rollover basis under s. 51. Both of these provisions may be used to facilitate tax planning designed to achieve estate freezes or income-splitting arrangements.

6.4.3 Section 87

Taxable Canadian corporations may combine or merge on a tax-deferred basis under either s. 87 (the amalgamation of two or more taxable Canadian corporations) or under the provisions of s. 88(1) of the *ITA* (the voluntary dissolution and winding-up of a wholly owned subsidiary into its parent).

6.4.4 Section 85.1

Certain provisions facilitate the corporate acquisition of other arm's length corporations. For example, s. 85.1 permits a share-for-share exchange, whereby the purchaser corporation exchanges its own shares for the shares of the target corporation. These exchanges may be made on a tax-deferred basis.

6.4.5 Section 55(3)

Finally, s. 55(3) permits corporations in certain circumstances to "spin off" assets on a tax-deferred basis directly or indirectly to its shareholders through a "butterfly" reorganization. The term butterfly is derived from the schematic representation of such a reorganization involving a corporation and its shareholder(s).

6.5 Employee stock options

The *ITA* contains preferential rules relating to employee stock option plans of private and public corporations.

6.5.1 CCPC

In the case of shares of a CCPC, an employee who deals at arm's length with the corporation may acquire shares of the corporation at a nominal value, compared to the shares' FMV at that time, without recognizing any taxable benefit until the shares are later sold or disposed of. The employee and the corporation granting the option must deal at arm's length. If the shares are held for at least a two-year period before a sale or disposition, only one-half of the difference between the FMV at the time the employee acquired the share and the purchase price paid by the employee is included in the employee's income as a taxable benefit from employment (This result is available as a result of the deduction under s. 110(1)(d.1) of the *ITA*.).

The full amount of the taxable benefit is added to the ACB of the shares to the employee. This is the case notwithstanding the fact that a deduction equal to one-half of the benefit may be available under s. 110(1)(d.1) of the *ITA* (i.e., if the employee satisfies the two-year holding period before disposition), with the result that only one-half of the benefit is subject to tax. The ACB is relevant to determining any gain or loss arising on the subsequent sale of the shares. On a subsequent transfer of the shares, any appreciation in value in excess of the FMV of the shares at the time the employee acquired the shares is treated as a capital gain (of which one-half is included in income as a taxable capital gain). Depending on the circumstances, the capital gain realized on the shares may be eligible for the $750,000 capital gains exemption (deduction).

6.5.2 Non-CCPCs

Where an employee of a corporation other than a CCPC acquires a share under an employee stock option plan, the employee is deemed to receive a benefit from employment equal to the difference between the FMV of the share at the time of exercise and the exercise price.

Unlike the situation involving a CCPC, the employment benefit is recognized in the year when the share is acquired. Section 110(1)(d) of the *ITA* provides for a deduction of one-half of the taxable benefit. To qualify for this deduction, the certain requirements must be satisfied, including the following:

- The share must be a prescribed share as defined in s. 6204 of the *Income Tax Regulations* (*ITR*).
- The exercise price must not be less than the FMV of the share(s) at the time the stock option was granted.
- The employee must deal at arm's length with the corporation that granted the option.

The attributes that must attach to a prescribed share are set out in s. 6204 of the *ITR*. These are essentially common shares with no right of retraction by the corporation or purchase by any other person within two years of the shares' issuance. When the employee sells or otherwise disposes of the shares, the amount by which the proceeds of disposition exceed (or are exceeded by) the aggregate of the ACB of the shares and the costs of disposition is a capital gain (or a capital loss), one-half of which is included in computing income as a taxable capital gain (or as an allowable capital loss). Depending upon the circumstances, all or a portion of the capital gain may also be eligible for the $750,000 capital gains exemption (deduction). Employee stock options may be used to advantage by owner-managers who wish to compensate key employees on a tax-deferred basis while

minimizing the out-of-pocket costs required to fund the benefit.

6.6 Allowable business investment losses

Owner-managers may provide cash to their corporations either through loans or by subscribing for shares in the capital stock of the corporation. The term "owner-manager" is intended to include those individuals who, either solely or together with other members of their family or key employees, own all the shares of a CCPC and who manage and actively participate in the ongoing business and affairs of the corporation. Loans made by an owner-manager to a corporation that qualifies as a small business corporation, that is, a CCPC with all or substantially all of its assets used in an active business carried on primarily in Canada, will be entitled to special tax treatment in the event they become uncollectible, provided certain conditions are met.

Specifically, the loan must have been incurred for the purpose of gaining or producing income. These bad debts will be treated as a business investment loss under s. 39(1)(c) of the *ITA*, one-half of which is an allowable business investment loss (ABIL). An ABIL is a more beneficial loss than a capital loss. A capital loss may only be deducted against capital gains, while an ABIL may be deducted against any income (i.e., any income including ABI, interest, dividends, rent, royalty, etc., as well as capital gains—however, using an ABIL against capital gains may not be very tax effective).

Similarly, if the owner-manager has capitalized his company by way of equity by subscribing for, say, $10,000 worth of common shares and the owner-manager subsequently disposes of these shares to an arm's length third party for a nominal amount due to the company's unprofitability, or if the corporation goes bankrupt (i.e., is completely insolvent), the owner-manager will be entitled to an ABIL equal to one-half of the purchase price of the common shares, being $5,000. This $5,000 ABIL may be deducted against all other income. However, the realization of an ABIL may limit an individual's entitlement to the capital gains exemption (deduction).

Since an ABIL is not a "business loss," its carryforward as a non-capital loss is limited to 10 years.

If the ABIL is not fully deducted at the end of its 10-year carryforward period for a non-capital loss, it becomes a net capital loss and may only be used against capital gains.

6.7 Registered pension plans and deferred profit sharing plans

The *ITA* permits corporations (i.e., employers) to register various deferred income savings plans with the CRA pursuant to which the corporation may make limited tax-deductible contributions. These contributions are allowed to accumulate on a tax-deferred basis. The actual contributions and the income earned are not taxed in the beneficiary's hands until actually paid out to him or her. The two most commonly used registered plans are a registered pension plan (RPP) and a deferred profit sharing plan (DPSP). It is no longer possible for owner-managers to benefit under a DPSP, but these plans may be used as a means of compensating other key employees. Owner-managers are entitled to participate in a RPP, provided the RPP is a money purchase plan (as opposed to a defined benefit plan). The rules relating to retirement savings changed the tax rules relating to RPPs for owner-managers. Under the rules, significant shareholders (i.e., those who own 10% or more of the employer's shares) can set up a single member RPP (commonly referred to as an individual pension plan (IPP), but defined in the *ITA* as "designated plans"). This allows shareholder-managers to shelter more salary from income tax than would be possible using an RRSP or a money purchase RPP.

7. Compensating the owner-manager

The following discussion focuses on some specific methods of compensating owner-managers.

7.1 Bonus down to $500,000

Traditionally, the most basic planning tool is to cause the first $500,000 of ABI to be taxed in a CCPC. Furthermore, to the extent possible, any income earned in excess of $500,000 should not be taxed in a CCPC. Such income will be taxed at the higher corporate rates of 28.0% (after June 30, 2011) and 26.0% (after June 30, 2012). When this after-tax income is later paid to the owner-manager by the corporation as a dividend on his or her shares in the CCPC, the dividend gross-up and tax credit mechanism will not fully credit the owner-manager for the corporate tax paid. An element of double tax (under-integration) will result—see Examples 3 and 4, above. Again, in order to minimize this element of double tax, it may be advantageous to ensure that a CCPC's taxable income (from ABI) does not exceed $500,000. The most common mechanisms for reducing corporate income include paying salaries and bonuses, as well as directors' fees to the owner-manager and other members of the owner-manager's family who are employed by the CCPC or serve as directors. These salaries, bonuses, and fees, to the extent they are reasonable, are ordinarily

deductible expenses for income tax purposes for a CCPC, thereby reducing a CCPC's income to the desired level.

It is not uncommon for CCPCs to declare year-end bonuses to owner-managers and other key family employees for several hundreds of thousands of dollars in order to reduce the corporation's ABI to the $500,000 level. However, in certain provinces some of the provincial low rate incentive on ABI may be clawed back at income exceeding $500,000. For example, in Ontario (before July 1, 2010, the date the claw back was repealed) the low tax rate incentive was clawed back for income between $500,000 and $1,500,000 (at the rate of 4.25%). Accordingly, previously (before July 1, 2010), owner-managers had to carefully consider the provincial corporate tax implications of taxing additional ABI (i.e., in Ontario over $500,000 in a CCPC). Other planning associated with the timing of income and expenses may be considered, particularly where there are personal tax implications.

The federal *ITA*'s SBD business income limit is now $500,000, (for tax years ending after December 31, 2008) and is therefore the same as Ontario's small business income threshold.

7.2 Accrue bonus

Another planning technique is for a CCPC to "accrue" the bonus in its current taxation year, but pay it in a subsequent taxation year. In this way, a CCPC obtains a current deduction reducing its ABI to the $500,000 level. In addition, the owner-manager only pays income tax on the bonus in the year in which he or she receives it—the next calendar year.

7.2.1 Reasonableness

In order that the corporation is entitled to a deduction in respect of a bonus, the amount must be reasonable in light of the circumstances. Reasonableness (being a question of fact) of the quantum of the payment may be tested by considering the nature of the services provided by the recipient of the bonus or fee and considering what such services might be worth in the open market.

To the extent that such bonuses, salaries, or fees are not reasonable, the CRA may invoke s. 67 of the *ITA*, which denies the corporation a deduction in respect of that portion of any payment that is not reasonable.

7.2.2 Legal liability to pay bonus

Another concern relating to bonuses involves the fact that, as a practical matter, a corporation's profits are often not known with any degree of precision until several months after its taxation year, when the financial statements for the corporation are finalized for the prior year.

Accordingly, it is often not possible to precisely determine the actual amount that is required to be paid to an owner-manager to reduce the corporation's income to $500,000. It is therefore necessary when declaring bonuses and where a precise amount is not available that a formula be used.

The concern relating to the deductibility of accrued bonuses is this: if an unpaid salary or bonus has been accrued at the end of the taxation year, it is deductible to the corporation in computing the income of this period only if it is a true liability at the end of a taxation year. If it is not a true liability, then it is either a contingent liability or a reserve, the deduction of which is denied under s. 18(1)(e) of the *ITA*. The best evidence of a legal obligation to pay a bonus is an employment agreement between the owner-manager and the corporation setting out a formula upon which the bonus is to be determined. This is rarely done in the case of owner-managers.

The CRA's position with respect to the deductibility of accrued bonuses is set out in Interpretation Bulletin IT-109R2, "Unpaid Amounts."

7.2.3 Timing of payment

A corporation is not entitled to deduct an accrued bonus unless the bonus is actually paid within 180 days of the end of the corporation's taxation year (i.e., by day 179). Where the bonus is not paid within this period, the corporation will not be entitled to deduct the bonus expense until it is actually paid in a subsequent taxation year.

7.3 Shareholder loans

7.3.1 General

One means of receiving funds from a corporation for personal use is by way of shareholder loans. These loans are usually made on an interest-free basis to the owner-manager or members of his or her family. These loans are attractive and useful; when properly documented, they permit the owner-manager to use the funds without being required to immediately pay tax on the principal amount loaned, as would ordinarily be the case had the funds been paid as a dividend (or as a bonus) to the owner-manager. The provisions in the *ITA* relating to shareholder loans are contained in ss. 15 and 80.4–80.5.

7.3.2 Limits — ITA, ss. 15(2)–(2.6)

Subsections 15(2)–(2.6) of the *ITA* prevent a tax-free distribution of funds of a corporation by way of loans to its shareholders (or persons connected with the

shareholder). A person is connected to a shareholder if he or she does not deal at arm's length with the shareholder within the meaning of s. 251 of the *ITA*. Loans to a shareholder are included in the shareholder's income in the year the loan is made unless it is specifically excluded from the provisions of s. 15(2). A loan that is repaid before the end of the corporation's taxation year following the year in which the loan is made is one type of exclusion. This exception to the rule will not apply where the repayment is part of a series of loans and repayments.

Example 1

Assume the corporation's taxation year ends April 30, 2011. Assume further that on January 1, 2011, the corporation made an $80,000 loan to the owner-manager. The loan remains outstanding past April 30, 2012 (company's tax year (2012) following company's tax year the loan was made (2011)). Therefore the owner-manager will be required to include the principal amount of the loan in income for his or her 2011 taxation (calendar) year and will (later) be entitled to a deduction in computing income in the year in which the loan is ultimately repaid under s. 20(1)(j) of the *ITA*.

Example 2

Assume the same fact situation as in Example 1. However, the owner-manager repays the loan (before April 30, 2012) and within a short period of time thereafter receives another loan from the corporation. In this case, s. 15(2.6) of the *ITA* may apply and require the original loan to be included in the owner-manager's income for his or her 2011 taxation (calendar) year, on the basis that the loans and repayments were part of a series of loans and repayments. The CRA's administrative position on shareholder loans is set out in the Interpretation Bulletin IT-119R4, "Debts of Shareholders and Certain Persons Connected with Shareholders."

7.3.3 Exceptions

Subsection 15(2) of the *ITA* does not apply to all loans. The excluded loans or indebtedness are

- those in respect of an employee of the lender or creditor corporation to enable or assist the borrower employee to acquire shares of the corporation or a related corporation;
- those in respect of an employee of the lender or creditor corporation to enable or assist the borrower employee to acquire an automobile to be used by him or her in the performance of his or her office or employment;
- those in respect of an employee of the lender or creditor corporation to assist the employee borrower, or his or her spouse, to acquire a dwelling for his or her habitation;
- those loans made to an employee who is not a specified employee; and
- certain loans made to trusts whose sole purpose is to acquire shares of the corporation on behalf of the employees and, at the time the loan or debt arose, *bona fide* arrangements were made for repayment within a reasonable time.

There is also an exception in s. 15(2.3). This exception applies to loans made in the corporation's ordinary course of business (i.e., lending) where *bona fide* arrangements for repayment within a reasonable time are entered into at the time the loan arises.

It is most important to note that *bona fide* arrangements for repayment must be made at the time that the loan is made, and any loans must be made because of the employee's employment relationship and not because the employee is also a shareholder.

7.3.4 Interest benefit

Assuming there is no income inclusion under s. 15(2), a taxable benefit may still arise under s. 80.4(2) where the loan is made on an interest-free or low-interest basis. Subsection 80.4(2) will apply to any loans made to a person by virtue of being a shareholder of a corporation or a person connected with the shareholder. This provision will therefore apply where a loan is made to a shareholder's spouse where the spouse is not a shareholder. Furthermore, the taxable benefit will be included in the shareholder's income, not in the income of the shareholder's spouse. The amount of the benefit that will be included in the shareholder's income will be determined as the aggregate of

- all interest for the year on all loans and debts computed at the "prescribed rate" for each loan; less
- the total of interest paid on the loan not later than 30 days after the end of the year.

The prescribed rate of interest is determined on a quarterly basis as the average yield on Government of Canada three-month Treasury Bills auctioned during the first month of the immediately preceding quarterly period (*ITR*, s. 4301).

For example, the prescribed rate for the 4th quarter of 2011 (i.e., the three months from October 1 to December 31, 2011) was 1% and was based upon three-month Treasury Bills auctioned during July 2011 (the 1st month of the preceding quarter—i.e., July 1 to September 30, 2011).

7.4 Shareholder benefits

A shareholder should be aware of the punitive provisions of s. 15(1) of the *ITA*. These provisions will apply whenever a shareholder attempts to make exclusive use of assets or property of a corporation or otherwise attempts to appropriate assets or property of a corporation for his or her own use. This section also applies wherever a corporation has conferred a benefit or advantage on a shareholder.

In these situations, the amount or value of the property appropriated or benefit conferred is included in computing the income of the shareholder for the year. The amount will not be treated as a dividend, and the corporation will receive no deduction (i.e., because the property, expense, or benefit was not provided for a business purposes—to earn income) in respect of any amount so included in the shareholder's income.

The purpose of s. 15(1) is to ensure that any transactions carried on between the shareholder and the corporation relating to assets or property used by the individual are conducted on a FMV basis. Otherwise, the value of these benefits will be taxed in the hands of the shareholder.

Since there is no tax relief (deduction) provided to the corporation in these circumstances, double taxation results. This confirms the punitive nature of s. 15(1).

Appendix

Glossary of Tax Terms

Practitioners and taxpayers in business law transactions typically encounter the tax terms described below. The statutory references are to the applicable provisions in the federal *Income Tax Act* (*ITA*).

Acquisition of control

A corporation is controlled by a shareholder or group of shareholders who own greater than 50% of the shares with voting rights. An acquisition of control of a corporation occurs (for purposes of the *ITA*) when a new shareholder or group of shareholders acquire(s) enough shares to give the shareholder(s) voting control of a corporation.

When an acquisition of control of a corporation occurs, the corporation's (current) taxation year is deemed to end on the day immediately before the day on which control is acquired. This deemed year-end would necessitate the preparation and filing of corporate financial statements and an income tax return. The deemed year-end may also result in a taxation year of less than 365 days with the result that certain tax deductions must be pro-rated (i.e., capital cost allowance on depreciable assets) and the short tax year being counted as a full tax year for purposes of the loss carryforward provisions of the *ITA*.

There may be additional consequences, for example, where shares are sold to a non-resident person and the seller of the shares wants to claim the capital gains exemption. In this case, the exemption may not be available if the corporation ceased to be a Canadian-controlled private corporation (CCPC) at the commencement of the day the shares are sold. To alleviate this, the 2009 federal budget (January 27, 2009) proposed that for acquisitions of control after 2005, the deemed acquisition of control at the commencement of the day will not apply for purposes of determining the status of a corporation as a CCPC or a small business corporation (SBC).

The *ITA* also contains a number of rules that restrict the ability of a corporation to deduct losses and unused charitable donation deductions (as well as gifts of property) following an acquisition of control. In addition, certain accrued but unrealized losses (i.e., inherent losses on assets) are considered to be realized and available following the acquisition of control (subject, however, to the loss carryover use/restrictions referred to above).

Adjusted cost base (ACB)

A taxpayer's ACB of a capital asset is its tax cost and the starting point for determining whether a capital gain or capital loss will be realized on the disposition (actual or deemed) of that asset. The ACB of an asset is the aggregate of its acquisition cost and related expenses (for example, a taxpayer's ACB for a share of Bell Canada bought on the stock exchange would be the cost of the share plus the brokerage commission). The ACB of an asset may be further adjusted (i.e., increased or reduced) by the provisions of s. 53 of the *ITA* (i.e., as a result of certain events or transactions).

Allowable business investment loss (ABIL)

A "business investment loss" arises on the sale or disposition of either

- a share of a small business corporation (SBC); or
- a debt owing by a certain SBC

when the proceeds of disposition are less than the taxpayer's ACB of the share or the principal amount (i.e., face value) of the debt. The ABIL is one-half of the business investment loss. An ABIL is valuable for income tax purposes because it is fully deductible by the taxpayer against any other income (or capital gains) in the year realized. If it is not deducted in that year, it may be treated as a non-capital loss (see below, "Non-capital loss"). Since an ABIL is not a "business loss," its carryforward as a non-capital loss is limited to 10 years (not 20 years, which is the carryforward period for business losses).

If the ABIL is not fully deducted at the end of the carryforward period for a non-capital loss, it becomes a net capital loss (see below, "Net capital loss") and may only be used against capital gains. However, the realization of an ABIL may limit an individual's entitlement to the capital gains exemption (deduction).

Amalgamation

An amalgamation (sometimes called a merger) is the combination of two or more corporations to form one corporation. The assets and liabilities of all predecessor corporations flow through to the amalgamated corporation, and the shareholders of each predecessor corporation become shareholders of the amalgamated corporation (except for the parent corporation in a vertical amalgamation). An amalgamation may be "vertical" (parent and subsidiary corporation) or "horizontal" (two corporations with a common parent

corporation, or two unrelated corporations). An amalgamation triggers a year-end of each predecessor corporation for income tax purposes. The income tax rules governing amalgamations are set out in s. 87 of the *ITA*.

Butterfly

A "butterfly transaction" is a divisive reorganization, where the assets of a corporation are distributed *pro rata* to one or more shareholders. The term "butterfly" comes from the diagram of the series of transactions. Special rules set out in s. 55 of the *ITA* must be satisfied in order to effect a butterfly transaction.

Canada Border Services Agency (CBSA)

In December 2003, the customs and trade matters of the Government of Canada were removed from the Canada Customs and Revenue Agency (CCRA) and are now dealt with by the Canada Border Services Agency (CBSA).

Canada Customs and Revenue Agency (CCRA)

The CCRA became the Canada Revenue Agency (CRA) on December 12, 2003. The CCRA was a federal agency created on November 1, 1999, to manage tax, customs, and trade matters on behalf of the federal government. The CCRA replaced the former Revenue Canada, Taxation (RCT).

Canada Revenue Agency (CRA)

The CRA became the replacement agency for the CCRA (see "Canada Customs and Revenue Agency," above) on December 12, 2003 (although the enabling legislation only officially came into force on December 15, 2005). The CRA remains the federal agency that manages and administers tax matters on behalf of the Government of Canada and for most provinces and territories. The CRA also continues to manage and administer certain social and economic benefit and incentive programs delivered through the tax system. A 15-member Board of Management, 11 of whom are nominated by the provinces and territories, three nominated by the Minister of National Revenue (MNR), and one Commissioner (who is the current Deputy MNR), manages the CRA. The Board of Management oversees the organization and business management of the CRA, but does not oversee the administration or enforcement of the CRA's business (i.e., the administration and enforcement of the *ITA*).

As an agency, the CRA is more flexible and is able to deliver more tax services; for example, it has the ability to offer collection of provincial sales taxes at international border crossings and administer provincial workers' compensation benefit programs (for Nova Scotia) and provincial child benefit programs (for Alberta, Saskatchewan, Nova Scotia, Newfoundland, and the Northwest Territories).

Canadian-controlled private corporation (CCPC)

A CCPC is a Canadian corporation that is not controlled, directly or indirectly, by non-resident persons or by public corporations. CCPC status is a prerequisite for many special incentive provisions in the *ITA*, including the preferential small business deduction (SBD) or low tax rate on a certain amount of active business income of a corporation), the $750,000 (for dispositions after March 19, 2007, and $500,000 for dispositions before March 20, 2007) capital gains (deduction) exemption for shares of an SBC, and the deferred recognition of stock option benefits to taxpayers (employees).

Canadian corporation

A Canadian corporation is generally a corporation that has been incorporated and is resident in Canada. A corporation that is incorporated under the laws of Canada or a province is generally deemed for tax purposes to be resident in Canada.

Canadian partnership

A Canadian partnership is one in which all the partners are resident in Canada.

Capital cost allowance (CCA)

For financial statement purposes, accountants deduct depreciation in computing profit from a business. This depreciation is designed to reflect the decline in value of a capital asset over its useful life.

CCA is "depreciation" for tax purposes. For tax purposes, special rules in the regulations to the *ITA* apply. CCA is used as an incentive deduction, and the rates for CCA to be claimed by a taxpayer may not necessarily reflect the useful life of an asset. CCA is a discretionary deduction (in other words, a taxpayer is not required to claim CCA).

CCA is based on the undepreciated capital cost (UCC) of an asset (or class of assets) and may be claimed at a rate that is a percentage of that asset's or (class of assets') UCC. The difference between the original cost of an asset and its UCC (or tax cost) represents CCA that has already been claimed. If an asset is sold for a price greater than its tax cost (or UCC), CCA previously claimed will be "recaptured" (but only up to the original cost) and included in the income of the seller. A capital gain will also be realized if the asset is sold for more than its original cost. If the asset is the only asset in the class and it is sold for a price less than its UCC, the seller will realize a "terminal loss" (see below). A terminal loss may be deducted against any other income of a taxpayer (i.e.,

it represents the fact the taxpayer did not claim and deduct enough CCA for the asset).

Capital dividend

A capital dividend is a dividend that the directors elect (i.e., treat for income tax purposes) to be paid out of a private corporation's "capital dividend account" (CDA). Generally speaking, the amounts that are included in a private corporation's CDA are the untaxed portion of realized capital gains, less the corresponding amount in respect of capital losses. The proceeds received by a private corporation under a life insurance policy (i.e., the death benefit paid under a policy), less the policy's adjusted cost basis, is also added to the CDA. The directors must elect to treat the payment of a dividend as a capital dividend. This special election must be made by the corporation and filed with the CRA when a capital dividend is paid. Failure to file this election will expose the corporation to substantial penalties. Capital dividends are received by Canadian resident shareholders tax-free.

Capital gain/capital loss/capital gains exemption (deduction)

A capital gain is realized when a taxpayer sells (or disposes) of a capital asset for an amount greater than its ACB. A capital loss arises when the sale price is less than the ACB. One-half of the capital gain is free of tax. The remaining one-half of the capital gain (called the "taxable capital gain") is included in the income of the seller and taxed at the taxpayer's applicable tax rate.

Capital losses may only be used (or can be deducted) against capital gains. Generally speaking, an "allowable capital loss" (one-half of a realized capital loss) may be carried back three years to offset capital gains realized in any of those prior years. If there is no capital gain to offset in those years, the capital loss may be carried forward indefinitely to offset future capital gains (see "Net capital losses" below).

If the capital gain inclusion rate (and allowable capital loss) applicable in such carryover year(s) is different (i.e., is either higher or lower) than the applicable capital gain inclusion rate for the year the capital loss is realized, an adjustment to the amount of the capital loss being carried over is necessary to match the applicable inclusion rate in the year the capital loss is being applied.

An individual taxpayer resident in Canada may be entitled to claim the capital gains exemption (deduction) of $750,000 (for dispositions after March 19, 2007, and $500,000 for dispositions before March 20, 2007) and therefore shelter from tax the capital gain arising on the sale of (1) qualified farm property, (2) qualified fishing property, or (3) qualified small business corporation shares (QSBC shares).

Capital property

A capital property is property that on a sale or disposition would generate a capital gain or loss. A capital property can be depreciable property (i.e., machinery used in a business) or non-depreciable property (i.e., either (1) land, (2) a partnership interest, or (3) shares in a corporation). Capital property does not include property that is inventory.

Clearance certificate (s. 116)

When a non-resident of Canada sells or disposes of property that is "taxable Canadian property" (TCP), the non-resident person must obtain a clearance certificate under s. 116 of the *ITA*. If a purchaser of the property from the non-resident does not receive a clearance certificate on closing, the purchaser must

- withhold 25% or 50% of the purchase price; and
- remit the amount withheld to the CRA on account of the non-resident seller's Canadian tax liability within 30 days after the end of the month in which the purchase occurred (unless the non-resident delivers the clearance certificate to the purchaser prior to that date).

Failure to either obtain the certificate or withhold and remit will result in the liability of the purchaser for the non-resident person's Canadian tax.

In certain cases, gains and/or income realized by a non-resident are not taxable in Canada due to treaty protection (i.e., not taxable by Canada under a bilateral tax treaty with another country). In these circumstances, a new relieving provision from the clearance certificate exists (i.e., notification to Canadian tax authorities is applicable for certain dispositions of property beginning in 2009). This relief is available for "treaty-protected property." In such cases, a purchaser may not need to withhold part of the purchase price provided all of the following are true:

- The purchaser is satisfied after reasonable inquiry that the vendor is a resident of a country that has a tax treaty with Canada.
- The property is treaty-protected under this treaty, i.e. gains/income are exempt from Canadian tax under the treaty.
- The purchaser notifies the MNR within 30 days of acquiring the property.

For example, this notification provision (CRA Form 2062C, "Notification of an Acquisition of Treaty-Protected Property from a Non-resident Vendor") may be applicable in the case of a non-resident person's sale of shares of a private Canadian company or a non-resident

person's receipt of a capital distribution from a trust or estate.

Cumulative eligible capital (CEC) account

A taxpayer's cumulative eligible capital account is three-quarters of the aggregate of all amounts paid to acquire goodwill (i.e., customer lists, a franchise, concession, licence, or patent with an indefinite useful life, etc.) less the proceeds from selling any goodwill. A taxpayer is entitled to claim a deduction in computing income equal to 7% of this account, on a declining-balance basis. Under the *ITA*, the treatment of a taxpayer's eligible capital property (i.e., goodwill) and the CEC account balance is analogous to a taxpayer's depreciable property and the UCC for depreciable capital property, since (excess) deductions are subject to recapture (on sale or disposition of the property) and, where the proceeds of disposition exceed the original cost, such gains are treated as a capital gain.

Previously, the *ITA* rules provided that no reserve can be claimed under the *ITA* for any proceeds not yet received from the sale of eligible capital property (i.e., goodwill). However, a recent amendment to s. 14 of the *ITA* (*ITA*, s. 14(1.01) election) and the CRA's written views on this (i.e., CRA views letter 2002-0133797) confirm that if payment is received over time, the capital gain may be brought into income over time as well (i.e., a reserve claimed on the disposition of eligible capital property). Specifically, the election has to be made to treat the disposition of the eligible capital property as a capital gain, and then the reserve can be claimed. Any expenses incurred by the seller in selling eligible capital property can be deducted from the sale proceeds.

As the capital gains inclusion rate is now one-half, special tax rules (i.e., adjustments) apply to the sale of goodwill to ensure that the proper income and or capital gain is calculated on the sale of goodwill. The untaxed portion of any capital gain is also added to the CDA of a private corporation. Generally speaking, the following rules apply on the sale or disposition of eligible capital property by a taxpayer:

- Three-quarters of the sale proceeds are still deducted from the CEC pool balance to ensure there is full recapture of prior "depreciation" claimed on the CEC pool. Consequently, the recapture will be determined as the lesser of
  - three-quarters of the sale proceeds less the CEC pool balance, and
  - the amount of "depreciation" previously claimed on the CEC pool.
- Where the three-quarters of the sale proceeds exceeds three-quarters of the original cost of the property, an "adjustment" is necessary to reduce the this three-quarters excess amount to ensure the correct amount of the capital gain is determined, i.e., reduce three-quarters of the excess to reflect a gain that matches the capital gain inclusion rate of one-half.
- The adjustment factor applied to the 3/4 excess amount ensures that it matches the current 1/2 capital gain inclusion rate is 2/3 (i.e., 3/4 of excess amount x 2/3 adjustment factor = 1/2, so the proper amount of the excess is treated as a capital gain).
- Where a private corporation sells eligible capital property, this adjustment also ensures the correct amount is credited (i.e., the non-taxed portion of the gain in excess of the original cost of the eligible capital property) to the corporation's CDA. A positive balance in a private corporation's CDA permits the corporation to elect to treat the future payment of dividends to shareholders as tax-free capital dividends (but only to the extent the private corporation has a positive CDA balance).

Ensuring that the tax treatment of a taxpayer's eligible capital property (i.e., goodwill) and the CEC account balance is consistent or analogous with the tax treatment of other depreciable capital property facilitates and encourages tax compliance by taxpayers.

Cumulative net investment loss (CNIL)

An individual taxpayer's CNIL is the aggregate of all of his or her investment expenses in excess of investment income after 1987. A taxpayer cannot use the lifetime capital gains exemption unless the taxpayer's capital gain is in excess of his or her CNIL account balance.

Depreciable property

Depreciable property is a type of capital property in respect of which the taxpayer is entitled to claim CCA. Depreciable property/assets are grouped into separate classes by the *Income Tax Regulations* (*ITR*). Different rates of CCA are applied depending on the class to which property or an asset is allocated (*ITR*, s. 1100(1) and Schedule II).

Dividend tax credit (DTC)

The DTC is designed to reflect the fact that a Canadian corporation paying a dividend has already paid Canadian income tax on the corporation's income (profit) that is later distributed to the shareholders (as a dividend). The *ITA* attempts to achieve integration with income first earned by a corporation and the distribution of the corporation's after-tax income to shareholders as dividends, through the DTC and gross-up mechanism. The amount of the federal DTC is different for eligible dividends (i.e., in 2011 it is 13/23, and in 2012, it will be 6/11 of the gross-up amount) and non-eligible dividends (it is 2/3 of the gross-up amount) received from Canadian corporations.

Eligible capital expenditure (ECE)

An eligible capital expenditure is an amount paid to acquire goodwill, customer lists, or a franchise, concession, licence, or patent with an indefinite useful life. Generally speaking, three-quarters of the aggregate of all eligible capital expenditures, less the deductions claimed (7% annually of the balance) in respect of such expenditures, and the proceeds of sale of eligible capital property form the taxpayer's CEC account.

General anti-avoidance rule (GAAR)

GAAR is contained in s. 245 of the *ITA*. If the CRA determines that a transaction results in a reduction, deferral, or avoidance of tax that is not in accordance with tax policy objectives (defined as a "tax benefit" in the GAAR provisions), the CRA may apply GAAR to tax the transaction so as to deny the tax benefit. The GAAR applies to the provisions (and amendments) of the *ITA*, the *ITR*, the *Income Tax Application Rules*, tax treaties, and any other enactment that is relevant in computing tax under the *ITA*.

In order for GAAR to apply, the following three requirements must be present:

(1) A tax benefit must result from the transaction or part of the series of transactions.

(2) The transaction must constitute an avoidance transaction, i.e., not undertaken or arranged primarily for a *bona fide* purpose other than the tax benefit.

(3) The transaction is abusive, i.e., the tax benefit is not consistent with the object, spirit, or purpose of the *ITA*.

In GAAR cases, taxpayers carry the burden of proof to refute (1) and (2), and for the Minister to establish (3).

Merger

See "Amalgamation" above.

Net capital losses

A taxpayer's net capital losses are the aggregate of allowable capital losses less taxable capital gains, plus allowable business investment losses (ABIL) not deducted by the 10th carryforward year (i.e., since ABILs are treated as non-capital losses, but not business losses). Net capital losses may be carried back three years or forward indefinitely, but can only be used to reduce or offset taxable capital gains.

Non-capital loss (net operating loss (NOL))

A taxpayer's non-capital loss, or net operating loss, is a loss from carrying on business (i.e., the excess of expenses over revenue from the business, but excluding an ABIL). NOLs are fully deductible in the year they are incurred; if unused, they may be carried back three or forward 20 years. NOLs can be applied to offset income from any source (including capital gains—however that may not be the most tax effective use of a NOL, since only 1/2 of capital gains are taxable). Although an ABIL is a non-capital loss, it is not a "business loss" and therefore can only be carried forward 10 years (not 20 years like a business loss).

Paid-up capital (PUC)

PUC is a tax law concept. Although the calculation of PUC starts with corporate law stated capital, the *ITA* sets out adjustments that generally reduce PUC below stated capital (i.e., as a result of certain tax transactions). In particular, where shares of a corporation are issued in exchange for the corporation receiving property (as on a transfer of property to a corporation under a s. 85 rollover), the PUC of the shares may be less than the shares' stated capital for corporate law purposes.

PUC is important to shareholders since it generally represents an amount that can be returned by a corporation to a shareholder free from income tax. PUC is also important to determine whether (and of course the amount of) a dividend may (i.e., is deemed to) arise on the redemption or repurchase of shares by a corporation. On the redemption of shares (which includes a corporation purchasing shares for cancellation), a dividend is deemed to arise (and is taxable) to a shareholder equal to the difference between the redemption amount paid for the shares and the PUC of the share(s) (*ITA*, s. 84(3)).

Preferred shares

The *ITA* contains special rules that taxes transactions involving certain types of preferred shares. Shares that are common shares for corporate law purposes may be considered preferred shares for certain tax purposes. In particular, if there is any agreement relating to a share that may limit the shareholder's loss, guarantee a return (dividend) on the share, or guarantee the redemption of the share, that share may be considered a preferred share for tax purposes.

Generally speaking, the preferred share rules do not apply to shareholders who are individuals.

Private corporation

A private corporation for tax purposes is more restricted than a private corporation for corporate law purposes.

For tax purposes, a corporation is a private corporation if it is resident in Canada (although not necessarily a Canadian corporation), is not a public corporation, and is not controlled by one or more public corporations.

Public corporation

A public corporation for tax purposes includes any corporation that is a public (issuing) corporation for corporate and securities law purposes. In addition, a corporation resident in Canada may elect (or could be designated by the MNR) to be a public corporation for tax purposes if it meets certain conditions.

Qualified small business corporation shares (QSBC shares)

In order to be QSBC shares (and therefore eligible for the $750,000 (for dispositions after March 19, 2007, and $500,000 for dispositions before March 20, 2007) capital gains exemption/deduction), the shares must

- be shares of a Canadian-controlled SBC that at the time the shares are sold or disposed of uses 90% or more of its assets in an active business carried on in Canada or in another corporation that does so;
- be owned by a taxpayer, his/her spouse or common-law partner, or a partnership related to the taxpayer;
- not be owned by anyone other than the taxpayer or a person related to the taxpayer in the 24-month period prior to the sale or disposition.

During the 24-month ownership period, at least 50% of the SBC's assets must have been used principally in carrying on an active business or used to finance a connected active business.

Redemption

A redemption of shares for tax purposes occurs whenever a corporation acquires shares from a shareholder. Redemption can lead to a deemed dividend (see "Paid-up capital," above) and a capital gain or loss. Redemption is initiated by a corporation.

Retraction

Retraction for tax purposes is the same as redemption. However, a retraction of shares is initiated by a shareholder.

Rollover

A rollover is a tax-deferred transfer of property. Under a rollover, one asset is exchanged for another (i.e., a share for share exchange, or a transfer of property to a corporation in exchange for shares) or property is transferred to another person at the original tax cost of the transferor (i.e., a spousal rollover on death, where the surviving spouse acquires property at the deceased spouse's tax cost).

Under a rollover, although there is a disposition of property, the tax on the appreciation in value (i.e., inherent gain on transferred property) is deferred until the property is sold by the transferee (i.e., recipient of the property).

To be effective as a rollover, all normal incidents of transfer of title to property must occur. All commercial requirements attendant on the transfer of the property must be satisfied. For example, on a rollover of a business's assets into a corporation (a s. 85 rollover), the transferor must obtain *Bulk Sales Act* consents, if applicable, and must register all conveyances and transfer documents for the assets as if the sale was to an arm's length third party.

Small business corporation (SBC)

In order to qualify as an SBC, "all or substantially all" of the fair market value of the assets of a CCPC must be attributable to assets principally used in an "active business carried on primarily in Canada" by that CCPC or by a related corporation. If the CCPC is a holding company, it may still qualify as a SBC if all or substantially all of the fair market value of its assets is attributable to shares or debt obligations of other SBCs to which the holding company is connected (i.e., has more than 10% of the voting shares). The phrase "all or substantially all" means, in the CRA's view, at least 90%, and the term "primarily" means at least 50%.

Shares of a SBC may be eligible for the $750,000 (for dispositions after March 19, 2007, and $500,000 for dispositions before March 20, 2007) capital gains exemption (deduction).

Small business deduction (SBD)

Corporations that are a CCPC throughout a tax year are eligible for the federal SBD (as well as a lower Ontario corporate income tax rate). The federal SBD is a tax rate reduction (i.e., in 2011, the rate reduction is 17%) on a specified amount of ABI (which ABI amount has been increasing in recent years) earned in Canada for the year. The SBD must be shared among CCPCs that are associated for income tax purposes. As an incentive to assist smaller CCPCs, the tax rules take away the SBD from larger CCPCs (i.e., companies having larger amounts of taxable capital).

Taxable Canadian corporation

A taxable Canadian corporation is a "Canadian corporation" that is not exempt from tax by virtue of some statutory provision. In order to defer tax on a transfer of assets under s. 85 of the *ITA*, the transferee corporation (recipient of the transferred assets) must be a taxable Canadian corporation. In addition, the rollovers available on an amalgamation or a wind-up require all corporations to be taxable Canadian corporations. Dividends paid by taxable Canadian corporations are

eligible for the DTC to be claimed and deducted by individual taxpayers against federal income tax.

Taxable Canadian property (TCP)

Taxable Canadian property is property owned by non-residents of Canada that on disposition gives rise to either a capital gain or loss that must be recognized for Canadian tax purposes. TCP includes real property in Canada, shares of private corporations (but not public corporations, unless the non-resident, alone or with non-arm's length persons, owns at least 25% of the issued shares of any class), and interests in trusts resident in Canada. A non-resident person who proposes to dispose of TCP should obtain a "clearance certificate" under s. 116 of the *ITA* prior to the sale.

The 2010 federal budget amended the definition of TCP (see paragraph (d) of the definition of TCP in s. 248(1)) to exclude from TCP (effective as of budget day March 4, 2010) shares of corporations (and certain other interests) whose value is not principally derived from

- real or immovable property located in Canada;
- Canadian resource or timber properties; and
- options in respect of the above properties.

This amendment removed the s. 116 clearance certificate requirement for these types of properties and brings Canada's tax rules in line with its tax treaties and the tax laws of Canada's major trading partners.

Taxable dividend

All dividends, unless excluded, are taxable dividends. The major exclusion is capital dividends. Taxable dividends paid by taxable Canadian corporations are eligible for the "dividend tax credit."

Terminal loss

See "Capital cost allowance (CCA)," "Depreciable Property," and "Undepreciated capital cost."

Treaty-protected property

Treaty-protected property is property from which any income or gain from its disposition (by a taxpayer at that time) would be exempt from Canadian income tax (under Part I of the *ITA*) under a tax treaty Canada has with another country.

Undepreciated capital cost (UCC)

UCC is the tax cost of depreciable property. The UCC of an asset is its original cost less the CCA claimed in prior taxation years. If the asset is sold for an amount greater than its UCC, but less than its original cost, there will be "recapture" of CCA previously claimed. This recaptured CCA must be included in income. If the sale price of the asset exceeds the original cost, all CCA previously claimed will be recaptured, and the portion of the price exceeding the original cost will generally be considered a capital gain. If the asset is sold for an amount that is less than the UCC and the asset is the only asset in the class, a terminal loss will result. A terminal loss may be deducted against income.

Wind-up

For tax purposes, a wind-up occurs whenever a voluntary dissolution, liquidation, or a winding-up occurs for corporate law purposes. A wind-up can result in a rollover of assets to a shareholder corporation if that corporate shareholder owns at least 90% of the shares of each class (*ITA*, s. 88(1)). Otherwise, a wind-up will result in the corporation being deemed to have disposed of all its assets at their fair market values, paying a dividend, and returning capital to its shareholders (*ITA*, s. 88(2)).

Chapter 18

Income tax administration and enforcement

1. Introduction

Income taxes are imposed in Canada by both the federal and the provincial and territorial governments. Income taxes apply to persons both resident and non-resident in Canada. The Canadian income tax system is founded on the principle of self-assessment, that is to say a person is to determine his/her/its income, calculate and pay the taxes payable/owing, and report this information to the tax authorities administering Canada's income tax rules (the Canada Revenue Agency (CRA)). In specific instances, this is facilitated by also imposing reporting obligations on certain taxpayers associated with payments they make to other taxpayers (i.e., employers, partnerships, non-resident taxpayers, and the payers of interest and dividends).

With respect to the Harmonized Sales Tax (HST), HST applies in Ontario effective July 1, 2010 (i.e., Ontario is now referred to as a "harmonized" province). As of July 1, 2010, businesses that were registrants for the Goods and Services Tax (GST) (imposed under Part IX of the *Excise Tax Act* (*ETA*)) are now required to collect the HST. Generally speaking (and subject to certain transitional rules), HST applies in Ontario to amounts paid or payable for goods or services provided after June 30, 2010, at a blended rate of 13% (i.e., the former GST of 5% plus the former Ontario Retail Sales Tax (RST) of 8%). HST registrants are agents of the federal government, responsible for charging HST on taxable supplies and remitting the net HST to the Receiver General of Canada along with fulfilling certain reporting obligations. The HST is administered by the CRA.

1.1 Federal income taxes

Federal income taxes are imposed under Canada's *Income Tax Act* (*ITA*) and the *Income Tax Regulations*. The *ITA* not only enumerates the obligations of taxpayers, but also provides the CRA with rights and powers to enforce the *ITA* and ensure compliance by taxpayers. The *ITA* imposes income tax on the worldwide income of individuals, corporations, and trusts resident in Canada and on the Canadian source income of non-residents (*ITA*, ss. 2–3).

The CRA has several explanatory publications including

- information circulars (ICs) setting out its procedural and administrative practices;
- interpretation bulletins (ITs) setting out its interpretation of particular areas of the *ITA*; and
- advance tax rulings (ATRs), which are disguised summaries of certain income tax rulings given.

The CRA will also issue (for a fee) specific income tax rulings in respect of proposed transactions so that taxpayers and their advisors may proceed with certainty as to the tax consequences. The CRA also responds to inquiries from taxpayers and their advisors for technical interpretations of the *ITA*. These may be obtained through the *Access to Information Act* or from commercial publishers who reproduce the CRA letters (often referred to as the CRA's "view" letters by tax practitioners).

1.2 Provincial income taxes

Ontario imposes income taxes under the authority of the provincial *Income Tax Act*, which applies to individuals and trusts, and the *Corporations Tax Act* (*CTA*), which applies to any corporation incorporated in Canada that has a "permanent establishment" (or PE) in Ontario.

For individual taxpayers, Ontario's income tax system is administered by the federal taxation authorities (the CRA), and a separate provincial individual income tax return is not required or filed.

For corporate taxpayers, Ontario's corporate income tax is now (since 2009) administered and collected by the federal tax authorities (CRA). This means there is no longer a separate Ontario corporate income tax return to be filed for corporate taxation years ending after December 31, 2008, but rather a single corporate tax return is filed, and combined (federal and Ontario) tax payments are made to the CRA. Since Ontario's corporate income tax is now administered by the CRA, objections and appeals are also being administered by the CRA as follows:

- As of April 3, 2008, the CRA is administering most objections filed to Ontario corporate tax assessments and finalizing any objections as of that date that are in process with the Ontario Ministry of Revenue.
- The CRA will also handle appeals arising from objections originally processed by Ontario's Ministry of Finance (except for appeals already in process on April 3, 2008, with the Ontario Ministry of Revenue).

With respect to appeals of Ontario corporate tax assessments to court (i.e., after objection and appeal has initially been dealt with by the CRA), corporate taxpayers will continue to file tax appeals with the Ontario Superior Court of Justice (not the Tax Court of Canada). A copy of the notice of appeal that is filed is however to be served on the Minister of National Revenue (MNR) by sending it via registered mail to the attention of the Assistant Commissioner, CRA, Appeals Branch in Ottawa. The corporate taxpayer's filing of the notice of appeal and serving a copy of this appeal on the MNR must be completed within 90 days from the date the CRA has confirmed an assessment or has reassessed the taxpayer.

2. Assessments and appeals

The *ITA* rules for

- the filing of income tax returns;
- the payment of interest, penalties, and taxes;
- the assessment of returns; and
- the filing of appeals from assessments and reassessments

are found in Division I of Part I of the *ITA* (ss. 150 and 151).

2.1 Returns

Since Canada's income tax system is a self-assessing and self-reporting one, the *ITA* imposes an obligation on taxpayers to determine their income, file returns, and estimate and pay all amounts of tax payable.

2.1.1 Corporations

Corporations (other than registered charities, which have to file both a registered charity information return (Form T3010A) and a public information return within six months of their year-end) are required to file income tax returns within six months of their year-end (*ITA*, s. 150(1)(a)).

2.1.2 Individuals

Individual taxpayers are required to file individual (personal) income tax returns by April 30 each year in respect of the preceding taxation year (calendar year). No income tax return has to be filed if there is no tax payable, unless any of the following is true (*ITA*, s. 150(1)(d)):

- No tax is payable due to a share purchase or scientific research tax credit claim(ed).
- The individual disposed of a capital property in the year.
- The individual received prepayment of a child tax credit benefit (CTB) in the year.
- The MNR requires a return to be filed.

Individuals with business income have until June 15th of the following year to file their tax returns, although interest will accrue on any tax owing that is not paid by April 30th of that year.

2.1.3 Deceased individual, trust, or estate

For deceased individual taxpayers who die after October in the year and before May in the following year, income tax returns for the year of death must be filed not later than six months after the date of death. The return for an estate or trust must be filed within 90 days from the end of the trust's taxation year (*ITA*, ss. 150(1)(b)–(c)). The year-end of an *inter vivos* trust is December 31 (calendar-year fiscal period). The taxation year of a testamentary trust cannot exceed 12 months (s. 104(23)). If a deceased individual has failed to file a previous year(s) tax return as required, persons dealing with the property, business, estate, or income of that person (the legal representatives of such taxpayers, including a trustee, trustee-in-bankruptcy, receiver, committee, etc.) are required to file the tax return (*ITA*, s. 150(3)).

The failure or delay in filing an income tax return may result in the imposition of penalties and the assessment of interest on unpaid tax by the defaulting taxpayer (*ITA*, ss. 161 and 162). (See the CRA's Information Circulars IC00-1R2, "Voluntary Disclosures Program"; IC07-1, "Taxpayer Relief Provisions"; and IC92-2, "Guidelines for the Cancellation and Waiver of Interest and Penalties.")

2.2 Assessments

Under the *ITA*, the MNR is required to examine a taxpayer's return of income once it has been filed and assess the tax, interest, and penalties, if any, payable (*ITA*, s. 152(1)).

Since the Canadian income tax system is self-assessing and self-reporting, a taxpayer's liability for income tax is not affected by either a defective assessment or where no assessment has been made. After a taxpayer has filed an income tax return, there is an obligation on the MNR to assess the income tax return "with all due dispatch."

Where the MNR issues a nil assessment (where there is no income tax, interest, or penalties payable by the taxpayer), no appeal can be made from this assessment by a taxpayer. A taxpayer may request the MNR to determine the amount of any non-capital loss, net capital loss, restricted farm loss, or limited partnership loss, and the MNR is required to issue a notice of determination in respect of such losses to the taxpayer. Afterwards, the provisions of the *ITA* dealing with taxpayers' appeals from assessments apply to the MNR's determination (*ITA*, ss. 152(1.1)–(1.3)).

2.3 Reassessments

In the absence of fraud or misrepresentation attributable to neglect, carelessness, or wilful default on the part of a taxpayer, the MNR is precluded from reassessing after three years (four years in certain cases) from the day of mailing of the original notice of assessment (that is, the normal reassessment period) (*ITA*, ss. 152(4)(c) and (3.1); *Regina Shopper's Mall Ltd. v. MNR*). The MNR may reassess more than three years after the normal reassessment period where a taxpayer carries back (to a prior tax year) certain amounts, such as a loss carryover, an investment tax credit, or a foreign tax credit (*ITA*, s. 152(4)(b)).

The MNR may also reassess at any time where a taxpayer has provided a waiver to the MNR within the normal reassessment period and not more than six months have passed since the waiver was revoked (*ITA*, ss. 152(4)(a)(ii) and (4.1)). It should be noted for corporate taxpayers, that even if a waiver has been filed, the MNR cannot reassess statute-barred years in order to refund overpayments of tax. However, the MNR has the discretion to make refunds to individuals and testamentary trusts of overpaid income tax for taxation years back to 1985 where a return is filed for the first time or a reassessment is requested (*ITA*, s. 152(4.2)) (see also the CRA's Information Circular IC92-3, "Guidelines for Refunds Beyond the Normal Three-Year Period").

2.4 Objections

2.4.1 Generally

The first step in the income tax appeal process is the filing of a notice of objection to an assessment. The notice of objection must be served on the MNR, setting out the reasons for the objection and all relevant facts. Where the taxpayer is an individual or a testamentary trust, the notice of objection must be filed on or before the later of

- the day that is one year after the balance due day of the taxpayer for the year (the "balance-due day" of an individual is defined in s. 248(1) of the *ITA*); and
- the day that is 90 days after the day of mailing of the notice of assessment.

In any other case, the notice of objection must be filed on or before the day that is 90 days after the day of mailing of the notice of assessment (*ITA*, ss. 165(1)(a)–(b)).

The *ITA* limits the right of taxpayers to object to certain extraordinary reassessments made outside the normal reassessment period so that a taxpayer may not put matters in dispute that are not affected by the reassessment.

In most cases, the filing of a notice of objection prevents the MNR from attempting to collect tax, penalties, or interest assessed until after confirmation of the assessment. However, s. 164(1.1) of the *ITA* requires large corporations (i.e., defined as having taxable capital employed in Canada of more than $10 million) to pay 50% of the disputed amount when filing a notice of objection. In addition, the MNR can now proceed with collection before the expiry of the 90-day waiting period if the corporation is a large corporation (*ITA*, ss. 225.1(7)–(8)). At the same time, it should be noted that a taxpayer is bound by a written waiver of the right of objection or appeal (*ITA*, ss. 165(1.2) and 169(2.2)).

It should also be noted that the Appeals Branch of the CRA generally resolves a high proportion of all objections filed by taxpayers before the Tax Court of Canada (TCC) appeal stage.

2.4.2 How and where to file a notice of objection

There is no longer a prescribed form for a notice of objection. While the once mandatory CRA Form T400A, "Objection — *Income Tax Act*" can be obtained from the CRA and this form may be used as an objection form or guideline with respect to the information that should be set out in a letter, the *ITA* requirements are only that a notice of objection be in writing and set out the reasons for the objection and the relevant facts (*ITA*, s. 165(1)).

In the case of large corporations (i.e., having taxable capital in excess of $10 million), the notice of objection must reasonably describe each issue to be decided, specify the relief sought, and provide facts and reasons in respect of each issue. Compliance with these requirements is a prerequisite to the objection and appeal in respect of the issues raised (*ITA*, ss. 165(1.11)–(1.14) and 169(2.1)).

One copy of the notice of objection is served on the MNR by being addressed to the Chief of Appeals at a CRA District Tax Services Office or Taxation Centre for the area of Canada in which the taxpayer resides. The notice of objection may be delivered or mailed, by regular or registered mail.

2.4.3 Extension of time — application to the MNR

If a notice of objection is not filed within the stipulated time limitation period, a taxpayer may apply to the MNR, within one year of the time otherwise provided by the *ITA* for objecting, for an extension of time within which to file an objection (*ITA*, s. 166.1).

Generally speaking, an extension will be granted if the MNR determines that it would be just and equitable in

the circumstances (*ITA*, s. 166.1(7)(b)(ii)) and provided the application for extension was brought

- within one year after the expiration of the time limitation under the *ITA* (s. 166.1(7)(a)); and
- as soon as practicable.

A taxpayer must demonstrate an inability to act or instruct another person to act within the time limitation period provided for objecting and a *bona fide* intention to object (*ITA*, ss. 166.1(7)(b)(i)(A)–(B)).

There is substantial tax jurisprudence with respect to when applications for extensions of time will or will not be granted.

2.4.4 Extension of time — application to the Tax Court of Canada

A taxpayer may apply to the TCC to have the extension of time granted after either

- the MNR has refused the application; or
- 90 days have elapsed after service of the application for extension (to file a notice of objection) on the MNR and the MNR has not notified the taxpayer of its decision.

However, no application for an extension may be made after the expiration of 90 days after the day on which notification of the decision was mailed to the taxpayer. The same conditions must be satisfied on an application to the TCC as on an application to the MNR (*ITA*, ss. 166.2(1) and (5)).

2.4.5 Duties of the MNR

Upon receipt of the notice of objection, the MNR must reconsider and either vacate, confirm, or vary the assessment (*ITA*, s. 165 (3)(a)). Ordinarily, a CRA appeals officer will attempt to resolve the objection directly with the taxpayer.

If the MNR has not notified a taxpayer within 90 days that he or she has either vacated or confirmed the assessment or reassessed (varied), the taxpayer may proceed with an appeal to the TCC (*ITA*, s. 169(1)(b)). If the MNR fails to act "with all due dispatch" after receiving an objection to an assessment, the taxpayer's only remedy is to appeal—see *Apfelbaum v. MNR*. If the MNR has reassessed or makes an additional assessment, the taxpayer may, without filing a notice of objection to the reassessment or additional assessment, appeal directly to the TCC (*ITA*, s. 169(1)(a)).

2.5 Appeals

2.5.1 Generally

Generally speaking, a taxpayer may appeal an income tax assessment to the TCC within 90 days after the day of mailing of the notice of reassessment or notification of confirmation issued by the MNR following the taxpayer's notice of objection (*ITA*, s. 169(1)). If an appeal is not filed within this 90-day period, a taxpayer may, within a further one-year period, apply to the TCC for an order extending the time within which an appeal may be filed to the TCC (*ITA*, s. 167(5)(a)).

At the hearing of this application (for an order extending the time to file an appeal to the TCC), the taxpayer must

- satisfy the same requirements as on an application to extend the time for objecting to an assessment (see "Extension of time — application to the MNR," above); and
- demonstrate that there are reasonable grounds for the appeal.

A taxpayer may also appeal where 90 days have elapsed after service of the notice of objection and the MNR has neither notified the taxpayer that the MNR has vacated or confirmed the assessment nor reassessed (varied).

In cases concerning the meaning of legislation, the CRA's administrative policy as set out in interpretation bulletins is entitled to weight and can be an important factor.

In most cases, an appeal to the TCC prevents the MNR from attempting to collect tax, penalties, or interest assessed until the day of mailing of the TCC's decision to the taxpayer (*ITA*, s. 164(1.1)). However, the TCC may impose a penalty on a taxpayer if it concludes that both of the following are true:

- There were no reasonable grounds for an appeal.
- One of the main purposes for instituting the appeal was to defer the payment of an amount of tax payable under the *ITA*.

In deciding an appeal, the TCC may dismiss it or allow it and either

- vacate the assessment;
- vary the assessment; or
- refer the assessment back to the MNR for reconsideration and reassessment (*ITA*, s. 171(1); *Shairp v. MNR*).

2.5.2 Burden of proof

In appealing an assessment of income tax, the burden of proof is on the taxpayer to disprove the assumptions of fact (i.e., a reverse onus of proving the assessment is incorrect since in a self-assessing and self-reporting tax system the taxpayer has knowledge and control of all income tax information) on which the assessment is based, provided that the assumptions are disclosed in the pleadings filed on behalf of the MNR and it is not contested that the assessment was in fact based on those

assumptions. An assumption of the MNR can be correct, even if it was made for a wrong reason.

On the other hand, the MNR has the burden of proving fraud or misrepresentation attributable to neglect, carelessness, or wilful default if the taxpayer was assessed outside the normal reassessment period (although the burden may not exist if the matter has not been raised in the notice of appeal). The MNR also has the burden of proving the correctness of the assessment of certain penalties provided for in the *ITA*.

Prior to the decision of the Supreme Court of Canada (SCC) in *Continental Bank of Canada v. Canada*, the burden of proof simply shifted to the Crown when it sought to uphold an assessment of tax upon an alternative basis, i.e., upon a basis different from that upon which the assessment under appeal was raised.

In *Continental Bank,* a majority of the SCC held that the MNR should not be allowed to advance a new basis for reassessing after the limitation period for making reassessments under the *ITA* expires. Prior to the SCC decision in *Continental Bank*, the MNR could advance alternative arguments in support of an assessment, provided that the evidentiary record from the hearing was complete enough to support the alternative argument and no prejudice was occasioned to the taxpayer.

As a result of this SCC decision, s. 152(9) of the *ITA* was amended, applicable to appeals disposed of on or after June 17, 1999, effectively overturning the SCC decision and returning the law to its pre-*Continental Bank* state.

With respect to reassessments based upon the general anti-avoidance rule (GAAR) in s. 245, it is worth recalling that the CRA may apply GAAR to tax a transaction that results in a reduction, deferral, or avoidance of tax that is not in accordance with tax policy objectives (defined as a "tax benefit" in the GAAR provisions).

In order for GAAR to apply, the following three requirements must be present:

(1) A tax benefit must result from the transaction or part of the series of transactions.

(2) The transaction must constitute an avoidance transaction, i.e., not undertaken or arranged primarily for a *bona fide* purpose other than the tax benefit.

(3) The transaction is abusive, i.e., the tax benefit is not consistent with the object, spirit, or purpose of the *ITA*.

In GAAR cases, taxpayers carry the burden of proof to refute (1) and (2), and the MNR must establish (3).

2.5.3 Tax appeals instituted after December 31, 1990

On January 1, 1991, and under s. 12(1) of the *Tax Court of Canada Act* (*TCCA*), the TCC acquired exclusive original jurisdiction over income tax appeals. There are two appeal procedures available in the TCC:

- the informal procedure; and
- the general procedure.

(a) Informal procedure

The informal procedure provisions of the *TCCA* apply in the following circumstances (*TCCA*, s. 18):

- The aggregate of federal tax and penalties in issue is equal to or less than $12,000 (previous limit was $7,000 for appeals before September 1, 1993).
- The amount of a loss in issue is equal to or less than $24,000 (previous limit was $14,000 for appeals before September 1, 1993).
- The only subject matter of an appeal is an amount of interest, and the taxpayer has elected in the notice of appeal or at a later time in accordance with the rules of the court that the informal procedure provisions of the *TCCA* apply.

Under the informal procedure rules, the TCC is not bound by any legal or technical rules of evidence in conducting a hearing, and all appeals are to be dealt with by the TCC as informally and expeditiously as the circumstances and considerations of fairness permit (*TCCA*, s. 18.15(4)).

Unless there are exceptional circumstances, the TCC must fix a date for hearing that is no later than 90 days after the time allowed for filing of the MNR's reply to the taxpayer's notice of appeal (*TCCA*, s. 18.17(1)) (normally 45 days) and render its judgment or decision not later than 60 days after the day on which the hearing was concluded (*TCCA*, ss. 18.16(1) and 18.22(1)).

An informal procedure judgment does not have any precedential value (i.e., is not to be treated as a precedent for any other case) (*TCCA*, s. 18.28) and is not open to question or review except on a limited appeal under s. 27(1.1) of the *Federal Courts Act* (*FCA*).

Under the informal procedure rules, costs may be awarded to the taxpayer in accordance with the rules of the court when the taxpayer succeeds by more than one-half of the amount in issue in the appeal. There is no provision in these rules for an award of costs to the Crown.

(b) General procedure

The general procedure appeal rules of the *TCCA* apply to all other income tax appeals instituted after December

31, 1990 (*TCCA*, s. 17) (except for trial *de novo* appeals instituted in the Federal Court (FC)).

Under the general procedure rules, the TCC has the full panoply of rules governing its practice and procedure as are found in provincial superior courts, as well as a number of special rules that apply to income tax appeals.

Under the general procedure rules in the *TCCA*, costs may be awarded to or against a taxpayer (*Tax Court of Canada Rules (General Procedure)*, s. 147(2)). However, it should be noted that where an appellant makes a written offer to settle and obtains a judgment as favourable as or more favourable than the terms of the offer to settle, the appellant is entitled to party-and-party costs to the date of service of the offer and substantial indemnity costs after that date (s. 147(3.1)).

A further appeal (the appeal must be filed within 30 days of the TCC judgment or order) may be taken to the Federal Court of Appeal (FCA) (*TCCA*, s. 17.6.) and, with leave, to the SCC. Leave to appeal from a judgment of the FCA must be applied for and obtained from the SCC. In determining whether to hear an appeal, the SCC will consider whether the question in any case

- is of public importance;
- involves an important issue of law or mixed law and fact; or
- is, for any other reason, of such a nature and significance as to warrant a decision by the SCC.

2.5.4 References

Under the TCC's general procedure rules, a taxpayer and the MNR can agree in writing to refer a question of law, fact, or mixed law and fact for determination by the court (*ITA*, s. 173(1)).

The MNR can also apply to the TCC for the determination of a question of law, fact, or mixed law and fact common to two or more taxpayers. (*ITA*, s. 174(1)) This determination requested by the MNR is also made under the general procedure rules, unless the TCC grants a request made by the Attorney General of Canada or by any taxpayer in respect of whom the application is made to have the informal procedure apply.

2.5.5 Recent developments

The recently enacted *Courts Administration Service Act* created a single courts administration service to serve the administrative needs of the FC, the FCA, the TCC, and the Court Martial Appeal Court.

Under this legislation, the TCC is constituted as a superior court of record.

3. Administration and enforcement

Part XV (ss. 220-244) of the *ITA* deals with administration and enforcement of income taxes in Canada (See also A.C. Tari, "*Audit, Enforcement and Collection,*" 2003 Ontario Tax Conference, Canadian Tax Foundation, Toronto; and "*Income Tax Enforcement, Compliance and Administration*" in 1998 Corporate Management Tax Conference Canadian Tax Foundation, Toronto).

3.1 Collection proceedings

All amounts payable under the *ITA* are debts due to Her Majesty in right of the Crown, and any amount that has not been paid may be certified by the MNR and registered in the FC (*ITA*, ss. 222 and 223(2)–(3)). The MNR may also require third parties who are or will become liable within 90 days to make a payment to a tax debtor to make the payment to the Receiver General of Canada on account of the tax debtor's liability. Furthermore, the MNR may, upon 30 days' notice, seize goods and chattels of a defaulting taxpayer (*ITA*, ss. 224(1) and 225).

Notwithstanding the broad collection powers of the MNR, no formal collection proceedings may be instituted during the 90-day period immediately following an assessment or reassessment of a taxpayer (*ITA*, s. 225.1(1)). If a taxpayer files a notice of objection within the 90-day period, formal collection proceedings are further delayed until 90 days after the notice is mailed to the taxpayer that the MNR has either confirmed or varied the assessment (*ITA*, s. 225.1(2)). Effective April 1, 2007, this 90-day waiting period was eliminated so that the MNR can proceed with collection proceedings by way of set-off or deduction (i.e., the MNR can offset a current tax refund against a prior year's tax balance even if it is subject to a notice of objection).

For a large corporation taxpayer, the MNR may immediately collect one-half of the assessed amount. If an appeal is made to the TCC within 90 days from assessment or a reference is made, the formal collection proceedings are again delayed until after the TCC renders its decision, unless the corporation is a large corporation (i.e., taxable capital in Canada in excess of $10 million) (*ITA*, ss. 225.1(3) and (8)).

If the taxpayer loses one appeal and institutes another, the taxpayer will be required to pay the amount of income tax in dispute or, alternatively, post security for the amount of the income tax in dispute.

Earlier collection action is permitted where eventual collection of the amount in question would be jeopardized by a delay in collection (a "jeopardy

assessment") (*ITA*, s. 164(1.2)). A taxpayer has the right to a judicial review of the CRA's determination that the eventual collection of tax would be so jeopardized (*FCA*, s. 18.1).

3.2 Investigations and demands for information

The MNR has broad investigative powers of a taxpayer's affairs both directly and through third parties (*ITA*, ss. 231–231.3) (see also C. Campbell, *Administration of Income Tax*, Carswell, 2007, Toronto; M. Quigley, *Controlling Tax Information; Limits to Record-Keeping and Disclosure Obligations*, Canadian Tax Journal 1999, Vol. 47, No. 1, Canadian Tax Foundation, Toronto; and A.C. Tari, "*Audit, Enforcement and Collection,*" 2003 Ontario Tax Conference, 19:1–37, Canadian Tax Foundation, Toronto).

3.2.1 Inspections

A person authorized by the MNR may examine books, records, and property of a taxpayer for purposes relating to the administration of the *ITA*. To make the examination, the authorized person may enter any premises (other than a dwelling house) or a place where a business is carried on or property is kept. However, the MNR no longer has the right to keep documents seized during the course of an audit, unless judicial authorization is obtained.

The MNR may also obtain a search warrant to enter a dwelling house from a judge on an *ex parte* application, provided the judge is satisfied that there are reasonable grounds to believe the dwelling house is a place of business, entry is necessary for a purpose relating to the administration or enforcement of the *ITA*, and entry has been refused or is likely to be refused (*ITA*, ss. 231.1(1) and (3)).

3.2.2 Demands for information

One of the more important investigative powers of the MNR is the ability to require third-party persons to provide information or documents "for any purpose related to the administration or enforcement of the *Act*" (*ITA*, s. 231.2(1)).

Under the *ITA*, the MNR is prohibited from demanding information from a third party with respect to unnamed persons without prior judicial authority. This authority is only given upon satisfaction of specific tests; in particular, a court must be satisfied of all of the following on information provided under oath:

- The person or group is ascertainable.
- The demand is made to verify compliance with the *ITA*.
- It is reasonable to expect that the person or any person in the group may have or will fail to provide the information or to comply with the *ITA*.
- The information or documents are not otherwise readily available (*ITA*, s. 231.2(3)).

The recent decision of the SCC in *Redeemer Foundation v. MNR* offers additional insight into s. 231.1. In the course of auditing the taxpayer, Redeemer Foundation, the CRA requested and obtained information on donors and subsequently reassessed certain donors. The taxpayer applied for judicial review of the information requested on the donors without prior judicial authorization. The majority of the SCC held (in a narrow 4:3 decision) that the requirement to obtain judicial authorization under s. 231.2(2) did not apply because the donor information was requested in order to verify the taxpayer's compliance with the *ITA* (i.e., the MNR was entitled to obtain the information as part of the MNR's broad power to inspect, audit, and examine the taxpayer's records under s. 231.1(1) to determine the validity of its status as a registered charity). On the other hand, in the opinion of the minority, the MNR was not entitled to request the donor information without first obtaining judicial authorization in accordance with s. 231.2(2). In their view, to hold otherwise allows the MNR to obtain information about unnamed persons under its audit powers and therefore renders s. 231.2(2) redundant.

The SCC decision in *McKinlay Transport Limited v. R.* established that the required production of records pursuant to s. 231(1) of the *ITA* was a "seizure" within the meaning of s. 8 of the *Canadian Charter of Rights and Freedoms* (*Charter*). In balancing the public interest in monitoring compliance with the self-assessing and self-reporting mechanism of Canada's income tax system against an individual's privacy interest, the SCC decided that such a seizure is not unreasonable, particularly as a taxpayer's privacy interest with regard to documents that may be relevant to the filing of an income tax return is relatively low *vis-à-vis* the interests of the MNR.

Notes taken by a CRA auditor from the working paper file of a taxpayer's accountant without the accountant's permission cannot be considered to have been taken by the auditor in a manner authorized by s. 231.1(1) of the *ITA*.

It is clear that once an income tax audit by the CRA turns into a criminal or quasi-criminal investigation, a taxpayer is entitled to protection under the *Charter*.

A more recent decision released on November 1, 2011, by the FC in *MNR v. RBC Life Insurance Company* dealt with motions by various life insurance companies to set aside *ex parte* orders obtained under s. 231.2(3) in prior

years. The *ex parte* orders had required each of the life insurance companies to provide information and documents related to their so-called "10-8 leveraged life insurance strategy" plan holders including taxpayer names, social insurance numbers, business numbers, and trust numbers. While the insurance companies provided details about their 10-8 strategy (and prior to the *ex parte* orders), most of the insurance companies did not give information on the plan holders.

The *ex parte* orders were challenged by the insurance companies on several grounds including that the MNR did not make full and frank disclosure to the court at the time the *ex parte* orders were obtained. In setting aside the *ex parte* orders, the FC commented on the evidence (although previously available to the MNR, it was not provided to the court issuing the *ex parte* orders) including the MNR's failure to disclose

- information in its possession related to an ATR request on the 10-8 strategy;
- discussions on the 10-8 strategy by the GAAR committee (including its discussions that the strategy likely complied with the *ITA* and GAAR could not be successfully applied); and
- a questionnaire the CRA had developed for 10-8 plan holders.

The arguments to set aside the *ex parte* orders posed three questions to the FC (the first two questions of which the court answered in the negative):

1. Was full and frank disclosure made to the court on obtaining the *ex parte* orders?
2. Was the real purpose of the MNR's *ex parte* orders to ensure compliance with the *ITA*?
3. Does s. 231.2(3) infringe s. 8 of the *Charter*?

Cancellation of an *ex parte* order for failure to make full and frank disclosure to the court is not automatic, but rather the non-disclosure must be material and of a nature that had it been disclosed would have affected the judge's exercise of discretion. The FC found that full and frank disclosure was not made (i.e., see above and particularly the GAAR committee discussion that suggested the strategy complied with the *ITA* if not the spirit of the *ITA* and the fact that the insurers had provided significant information to the CRA on their 10-8 strategies in advance of the *ex parte* orders).

The FC also found that the MNR's reason for the *ex parte* orders was not to ensure compliance with the *ITA*, but rather have a chilling effect on the 10-8 plan business of the insurance companies and to this end noted that the Federal Department of Finance had already refused to amend the *ITA* (i.e., internal government emails now before the FC revealed that policyholder taxation was long overdue for attention but the Department did not want to act). Accordingly, it was not for the MNR to say that the purpose of the *ex parte* orders was to ensure compliance with the *ITA*, when in fact the evidence revealed it was to chill the 10-8 business of the insurance companies and to try and do indirectly what the Department of Finance had refused to do.

In light of answering questions 1 and 2 in favour of the insurance companies and setting aside the *ex parte* orders, the court did not have to deal with the third question.

3.3 Search and seizure

After the enactment of the *Charter*, various court decisions have held that certain sections of the *ITA* empowering the MNR to search and seize documents are *ultra vires* as unreasonable. As a result of the various court decisions, the *ITA* was amended to provide that a warrant might be issued by a judge upon being satisfied as to the existence of several conditions, which are specified in s. 231.3 of the *ITA*. See also Warnock J., "*Current Cases,*" Canadian Tax Journal 2003, Vol. 51, No. 1, Canadian Tax Foundation, Toronto.

3.4 Solicitor-client privilege

It is important for practitioners to be reminded of solicitor-client privilege not only in business law, but also in regard to Canadian income tax matters. The *ITA* provides rules and procedures that are to be followed when a claim of solicitor-client privilege has been made in respect of documents about to be seized or examined (*ITA*, s. 232(3)).

Since the solicitor-client privilege is a right belonging to a client, a lawyer is not released from this privilege unless the client waives the privilege. Privilege may also be lost, for example, on account of fraud or when documents are disclosed, even inadvertently.

However, inadvertent disclosure of privileged documents does not always result in the loss of privilege.

Canadian courts have not recognized a privilege similar to the solicitor-client privilege in respect of communications between an accountant and client. The *ITA*'s definition of "solicitor-client privilege" clarifies that "for the purposes of ... [s. 232] an accounting record of a lawyer, including any supporting voucher or cheque, shall be deemed not to be such a [privileged] communication."

3.5 Offences

There are a number of offences that are committed or deemed to be committed under the provisions of the *ITA* if certain other provisions are not complied with or if tax is evaded. The commission of these offences may result in penalties, summary conviction liability, or imprisonment (*ITA*, ss. 238(1) and 239).

In addition, an officer, director, or agent of a corporation may be held liable for being a party to an offence by a corporation under the *ITA* where that person directed, authorized, assented to, acquiesced in, or participated in the commission of the offence (*ITA*, s. 242).

3.6 Directors' liability

Directors of a corporation are also jointly and severally liable with the corporation for certain income tax arrears of a corporation and for a corporation's failure to withhold or remit certain amounts on account of income taxes.

Once a director's liability is assessed, the provisions of the *ITA* governing reassessments apply. A director is not liable unless one of the following is true:

- Execution with respect to the amount of or on account of income tax(es) owing has been returned unsatisfied.
- The corporation is liquidating or dissolving.
- The corporation has made an assignment.
- A receiving order has been made against the corporation under the federal *Bankruptcy and Insolvency Act*.

As a relieving provision, there is no director liability if proceedings to recover the amount of income tax(es) owing are commenced more than two years after a director has ceased to be a director (*ITA*, ss. 153, 215, and 227.1). This same relieving rule applies if the director can show that he or she "exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances," i.e., establish a due diligence defence (*ITA*, s. 227.1(3)). See also E.G. Kroft, "The Liability of Directors for Unpaid Canadian Taxes" in *Report of the Proceedings of the Thirty-Seventh Conference of the Canadian Tax Foundation*, Toronto; and R.L. Campbell, "The Supreme Court's Decision in *Peoples*: A New Standard of Directors' Liability," Canadian Tax Journal, 2007 Vol. 55, No. 3, Canadian Tax Foundation, Toronto. A similar due diligence defence (or test) is provided in the various corporate law statutes such as Ontario's *Business Corporations Act* (*OBCA*) and the *Canada Business Corporations Act* (*CBCA*) with respect to the standard of care imposed upon a director (*OBCA*, s. 134(1); *CBCA*, s. 222(1)).

Practitioners wishing, or who are asked by clients, to serve as nominee directors on a corporation's board should carefully consider the possibility of personal liability even if they are not active directors. It is also possible that lawyer-directors may be held to a higher standard of care because they possess special skills. Where the corporate law statute permits shareholders to limit the powers, liabilities, and duties of directors under a unanimous shareholder agreement (USA), the shareholders assume the same powers, liabilities, and duties. It is less than clear whether a USA will exonerate a director from the imposition of personal income tax liability (for the corporation's income tax liability) under the *ITA* in all cases.

Directors may consider reducing this potential personal income tax liability under the *ITA* by having the corporation purchase directors' errors and omissions insurance on their behalf (*OBCA*, s. 136(4); *CBCA*, s. 124(4)). This insurance may be difficult to obtain and costly.

3.7 Civil penalties for misrepresentations of tax matters by third parties

Under s. 163.2 of the *ITA*, civil penalties may be imposed in certain cases on tax advisors and other third parties who have been found to have engaged in "culpable conduct." Information Circular IC01-1, "Third-Party Civil Penalties," sets out the CRA's guidelines in applying these penalties.

Chapter 19
The creation of the corporation

1. Introduction

This chapter is intended to provide a basic overview of the major issues facing solicitors retained to incorporate a business. The focus will be on Ontario's *Business Corporations Act* (*OBCA*). The corresponding sections of the *Canada Business Corporations Act* (*CBCA*) are noted in some but not all cases and are substantially in accord with the *OBCA* sections. That being said, solicitors should take care to note any subtle differences in the wording of the respective sections.

2. Where to incorporate

Having chosen the corporation as the appropriate form of business organization, one must consider in which jurisdiction to incorporate. Generally, an Ontario solicitor will incorporate a business "provincially" under the *OBCA* or "federally" under the *CBCA*. In some cases, incorporation in another jurisdiction may be appropriate, for example, to avoid extra-provincial licensing requirements.

The following considerations may be relevant in advising where to incorporate.

2.1 Ability to carry on business in different jurisdictions

A federally incorporated corporation has the right to carry on business and use its name in all provinces. By contrast, a corporation incorporated under the *OBCA* can only carry on business in Ontario unless it obtains a licence under the extra-provincial licensing statute of another province. Unlike the situation with a *CBCA* corporation, this registration or licence may not be granted if the name of the Ontario corporation is not acceptable in the province where application for the registration of licence is being made. Under the Ontario *Extra-Provincial Corporations Act*, a federal corporation is entitled to carry on business in Ontario without an extra-provincial licence.

2.2 Filing and other requirements

All provinces regulate the activities of federal corporations by virtue of laws of general application, requiring registration, returns, and/or fees for every corporation doing business in that province.

In addition to the filing requirements contained in the *CBCA*, pursuant to ss. 3 and 4 of the *Corporations Information Act* (*CIA*), a federal corporation having its registered office or carrying on business in Ontario must file with the Ministry of Government Services an initial notice setting out the prescribed information as of the date of filing and from time to time in relation to certain changes in the information contained in the initial notice.

Furthermore, corporations must comply with s. 2 of the *Business Names Act* (*BNA*), which states that no corporation shall carry on business or identify itself to the public under a name other than its corporate name unless the name is registered.

2.3 Directors' meetings

Except where the articles or by-laws of the corporation provide otherwise, the majority of the meetings of the directors of an Ontario corporation in any year must be held in Canada, pursuant to s. 126(2) of the *OBCA*. There is no similar *CBCA* requirement.

2.4 Prestige of federal incorporation

Where the corporation will be carrying on business outside of Canada, it may be preferable to incorporate federally, since foreign parties may be unfamiliar with Canada's federal structure and the powers of the provinces in matters of commerce.

3. Incorporation procedure

Incorporation under either the *OBCA* or the *CBCA* is available as a matter of right and is accomplished by filing articles of incorporation in the form prescribed by the regulations with the appropriate government department, together with the required supporting material and fees. On receipt, a certificate of incorporation shall be issued (*OBCA*, s. 6; *CBCA*, s. 8). The corporation comes into existence on the date shown in the certificate of incorporation (*OBCA*, s. 7; *CBCA*, s. 9)).

Preparation of the articles is reasonably straightforward. Subsection 5(1) of the *OBCA* simply provides that the articles shall follow the prescribed form and set out the prescribed information. The corresponding provisions of the *CBCA* are found in ss. 6–9 inclusive.

3.1 Name

Finding an acceptable name can be a time consuming step in incorporating. The use of a number name will expedite incorporation and may be acceptable to a client where the corporation will not be carrying on business in

the public domain or where a corporation is needed without there being sufficient time to be satisfied as to whether the proposed name is legally acceptable.

Incorporation is permitted under a number name with the number determined by the Director (*OBCA*, s. 8(2); *CBCA* s. 11(2)). Depending on the jurisdiction of incorporation, the words "Ontario" or "Canada" will be included in the number name.

Under s. 10(1) of the *OBCA* and s. 10(1) of the *CBCA*, the word "Limited," "Limitée," "Incorporated," "Incorporée," or "Corporation" or the corresponding abbreviations "Ltd.," "Ltée," "Inc.," or "Corp." and, as further provided under the *CBCA*, "Société par actions de régime fédéral" or "S.A.R.F." shall be part, in addition to any use in a descriptive or figurative sense, of the name of every corporation. In addition, s. 10(1.1) of the *CBCA* permits the use of the expression "Société commerciale canadienne" or its abbreviation "S.C.C." in the name of a company incorporated before the day on which the subsection came into force.

The onus of ensuring that the proposed corporate name complies with Ontario law is on the applicant (or the applicant's solicitor). When incorporating other than with a number name, the incorporator must submit an original Ontario biased or weighted computer printed search report from the automated name search system (**NUANS**) maintained by Industry Canada, dated no more than 90 days prior to the date of submission, together with any appropriate consents (*General*, R.R.O. 1990, Reg. 62, made under the *OBCA*, s. 18(1)).

Under both the *OBCA* and the *CBCA*, the proposed corporate name cannot be the same as or similar to that of any known entity if the use of that name would be likely to deceive or be deceptively misdescriptive (*OBCA*, s. 9(1); *CBCA*, s. 12(1)). Since the responsibility for selection of a name, particularly for an *OBCA* corporation, is placed upon the applicant, and because Industry Canada will only consider the availability of the name to a limited extent, great care must be taken to ensure compliance with the statutory provisions.

In respect of Ontario corporations, *General*, sets out a number of rules governing the selection of names pursuant to the *Act* including

(1) when the use of a name would be likely to deceive;

(2) matters the Director may consider when determining whether a proposed name is contrary to s. 9 of the *OCBA*;

(3) circumstances in which a corporation may have a name similar to that of another corporate entity;

(4) certain words that cannot be used in a corporate name, including but not limited to the following:

  (a) words that are obscene, scandalous, immoral, or contrary to public policy;

  (b) "amalgamated" unless the corporation is the result of an amalgamation;

  (c) "architect," "architectural," "engineer," "engineering," or any variation thereof that suggests the practice of the profession, except with the written consent of the appropriate body;

  (d) "association," "condominium," "co-operative," or "council"; and

  (e) "college," "institute," or "university" if it leads to the inference that the corporation is one of these institutions;

(5) certain words that suggest a connection to any level of government, university, or association of professionals or financial intermediary, without the consent of the appropriate party; and

(6) words or expressions that connote a connection to a political party or leader.

Part 2 of the *Canada Business Corporations Regulations, 2001* provides certain similar rules governing the selection of an appropriate name for a federal corporation.

When incorporating, the following should be noted:

- Depending upon the name, two computer searches made on the same day for the same name may reveal different results. This is because some names are characterized as "weak" names in that they are over-used. Examples of weak words include "Maple Leaf," "Imperial," "National," "United," "General," "Canadian," and "Associated."
- The presence or absence of hyphens in a name or periods between initials may result in different names being shown on different computer searches.
- Although trade-marks will be shown in the computer printout, partnership names, sole proprietorships, business or style names, and many foreign names will not necessarily appear in the computer printout.

Therefore, the following steps should be taken by the solicitor:

- Obtain explicit instructions as to the desired name and any alternatives in order of preference.
- Determine whether the name conforms to the applicable statutory provisions.
- Review the telephone book, **Might's Directory**, or any other pertinent directories that may contain similar names.
- Conduct searches under the *BNA* for business names or styles to determine if there are any other similar names registered. (Although registrations under the *BNA* are now generally included in the computer printout obtained from Industry Canada,

there is a time lag between the date of the registration and the date the registration is recorded in the **NUANS** automated computer name search system.)

- Obtain a computer search of the name, and if the name is a "weak" name, consider whether it would be desirable to submit variations of the name or, perhaps, obtain a second computer search.

A corporation can change its name by filing articles of amendment (*OBCA*, ss. 168(1)(a) and (4); *CBCA*, ss. 173(1)(a) and (3)).

3.2 Address

Under the *OBCA*, a corporation must at all times have a registered office at the location specified in the articles (s. 14(1)). The location of the registered office can be changed by a resolution of the board of directors in the case of a change within the same municipality or geographic township (s. 14(3)), or by a special resolution of the shareholders in the case of a different municipality or geographic township (s. 14(4)).

3.3 Directors

Both the *OBCA* and *CBCA* permit one director to manage and supervise the affairs of the corporation, unless the corporation is an offering corporation in which case it must have at least three directors (*OBCA*, s. 115(2); *CBCA*, s. 102(2)). Directors must be individuals who are at least 18 years of age, sane, and not bankrupt (*OBCA*, s. 118(1); *CBCA*, s. 105(1)).

The *OBCA* and *CBCA* contain provisions respecting the duties and powers of directors (ss. 115 and 102, respectively) and prescribing their standard of care (*OBCA*, s. 134; *CBCA*, s. 122) and their liabilities (*OBCA*, ss. 130–131; *CBCA*, ss. 118–119).

Under the *OBCA*, at least one-third of the directors of an offering corporation must not be officers or employees of the corporation or any of its affiliates (*OBCA*, s. 115(3)).

Twenty-five percent of the directors of a corporation governed by the *OBCA*, other than a non-resident corporation, shall be resident Canadians, but where a corporation has less than four directors, at least one director shall be a resident Canadian (*OBCA*, s. 118(3)).

A corporation may have a fixed or variable number of directors, but may only change the number or minimum or maximum number of directors by articles of amendment.

3.4 Restrictions

The *OBCA* and *CBCA* provide that a corporation has the capacity and rights, powers, and privileges of a natural person. Each *Act* also contains a provision giving the applicants for incorporation, directors, and shareholders the right to restrict the nature of the corporation's business (*OBCA*, s. 17(2); *CBCA*, s. 16(2)).

3.5 Share capital

Where a corporation has only one class of shares, the rights of the holders are equal in all respects and include the right to vote at any meeting of shareholders of the corporation and to receive the remaining property of the corporation on dissolution (*OBCA*, s. 22(3); *CBCA*, s. 24(3)). In addition, the *CBCA* provides, as a basic right, the right to receive dividends when declared.

A corporation's articles may provide for more than one class of shares, with the rights, privileges, restrictions, and conditions attaching to the shares of each class set out therein. In such a case, each of the rights set out above must be attached to at least one class of shares, but all of the rights are not required to be attached to any one class (*OBCA*, s. 22(4)(b); *CBCA*, s. 24(4)(b)).

In certain circumstances, both the *OBCA* and *CBCA* grant voting rights to non-voting shares (*OBCA*, s. 170(3) and *CBCA*, s. 176(5) for variations of shareholder rights; *OBCA*, s. 176(3) and *CBCA*, s. 183(3) for amalgamations; *OBCA*, s. 182(4) for arrangements; *OBCA*, s. 184(6) and *CBCA*, s. 189(6) for sales or leases of all or substantially all of the corporation's assets).

The number of shares of each class that a corporation may issue will be unlimited unless a maximum number is specified in the articles. Neither jurisdiction restricts the manner in which the shares of any class or series may be designated, and except as outlined above, neither attaches mandatory rights or conditions to any class of shares.

A corporation must maintain a separate stated capital account for each class and series of shares it issues (*OBCA*, s. 24(1); *CBCA*, s. 26(1)). Upon the issuance of any share, the full amount of the consideration received must be added to the appropriate stated capital account (*OBCA*, s. 24(2); *CBCA*, s. 26(2)). There is an exception for non-arm's length transactions, allowing a corporation to allocate a portion of the amount of any consideration received for an issued share, in appropriate circumstances, to a contributed surplus account (*OBCA*, s. 24(3); *CBCA*, s. 26(3)).

Both the *OBCA* and *CBCA*, in ss. 23 and 25(3), respectively, require that the full consideration for the shares must be received in the form of money, property, or past services before the shares are issued.

The articles may authorize the issuance of a class of shares in one or more series and may authorize the directors to fix the number of shares in and to determine

the designation, rights, privileges, restrictions, and conditions attaching to the shares of each series (*OBCA*, s. 25(1); *CBCA*, s. 27(1)).

3.6 Share transfer restrictions

If the corporation's securities are not to be widely offered or distributed to the public, restrictions on the transferability of such securities requiring approval of the board of directors or the shareholders should be included in the articles in order to allow the corporation to rely on the "private issuer" exemption contained in s. 2.4 of National Instrument 45-106, *Prospectus and Registration Exemptions*.

3.7 Additional provisions

Anything that could be the subject matter of a by-law may be put in the articles of an Ontario corporation. It has been customary to include in the articles of Ontario and federal corporations borrowing powers and the powers to mortgage, charge, and hypothecate property by reason of the provisions of *An Act respecting the special powers of legal persons* of Quebec (which permits a corporation, when so authorized by its charter, to mortgage property in Quebec). Concern has been expressed that without an appropriate clause in the articles, a company would be precluded from charging its Quebec property.

Other matters that might be included in the articles of an *OBCA* corporation are the following:

- pre-emptive rights of shareholders (s. 26);
- requirement of greater majority to perform any act by directors or shareholders (s. 5(4));
- cumulative voting for election of directors (s. 120);
- limitation on the right to purchase shares (ss. 30–31); and
- lien on shares of shareholders indebted to the corporations (s. 40(1)).

3.8 Approvals

Certain applications for incorporation may require approval by other government departments and/or administrative agencies before they are filed to ensure that requisite licences will be granted. Examples include real estate brokers and insurance agents. Certain statutory requirements are relevant, for example, in respect of the incorporation of professional corporations.

3.9 Filing

Because incorporation is a matter of right, on receipt of the articles of incorporation, a certificate of the incorporating authority will be issued, thereby bringing the corporation into existence as of the date set out in the certificate (*OBCA*, ss. 7 and 273(3)). A very cursory review will be made of the articles in order to ensure that, for example, the proper statutory form has been used and that it is properly executed. The solicitor filing is responsible to ensure the correctness of the content of the articles filed.

4. Organization

Both the *OBCA* and *CBCA* require that certain corporate records must be kept, including a copy of the articles, by-laws, and all amendments thereto, a copy of any unanimous shareholder agreement known to the directors, minutes of meetings and resolutions of shareholders, a register of directors, a securities register, adequate accounting records, records containing the minutes of meetings and resolutions of the directors and any committee thereof, and a register of transfers (*OBCA*, ss. 139–141; *CBCA*, ss. 20, 22 and 50(1)).

4.1 By-laws

Although not required by legislation, a corporation's by-laws regulate its business and affairs including the procedures for meetings of directors and shareholders, signing authority, directors' remuneration, and indemnification. To be effective, the by-laws and any amendments or repeals must first be approved by the directors, then passed by the shareholders at their next meeting (*OBCA*, s. 116(2)).

It is normal practice to prepare, as By-Law Number 1 of the corporation, a general by-law dealing with meetings, notice, quorum, officers, proxies, execution of documents, and other matters of a continuing nature. The purpose of this general by-law is to fix the rules governing the operation of the corporation, to the extent permitted by the governing statute and articles, and to take advantage of the flexibility permitted. It may also constitute a general rule book for the client and for this purpose may reiterate provisions in the governing statute or articles. By-laws may contain not only general by-law matters, but also virtually any matter of importance to a corporation.

While there are precedents in a number of form books and manuals and while some legal stationers have their own standard forms, as is the case with all precedents, the content of the standard forms should be reviewed with the client to ensure that the incorporating directors and shareholders are not adopting unnecessary or unwanted procedures.

4.2 Resolutions

Other business of a corporation is carried out by way of resolution passed as required by

- a simple majority of the directors, e.g., the election of the president, appointment of officers, approval of financial statements, allotment and issue of shares, and declaration of dividends; or
- by a simple majority of shareholders, e.g., the election of directors and the appointment of auditors.

In some instances, including amendment of the articles, amalgamation, or sale of all or substantially all of the assets of a corporation, a "special resolution" is required. A special resolution is a resolution passed by a majority of not less than two-thirds of the votes cast by the shareholders who voted in respect of that resolution.

There are also resolutions that require unanimous written approval of shareholders, including those not otherwise entitled to vote (e.g., dispensing with auditors (*OBCA*, s. 148)).

4.3 Written resolution in lieu of meetings

The directors or shareholders may, in lieu of a meeting, pass a resolution with the consent in writing of all of the directors or all of the shareholders entitled to vote at the meeting (*OBCA*, ss. 129(1) and 104(1); *CBCA*, ss. 117 and 142), and such resolutions have the same effect as if passed at a duly constituted meeting.

4.4 Officers and agents

The officers and agents of the corporation act for the corporation on the authority given to them by the applicable statute, articles, and by-laws; by resolution of the directors; and, in the absence of stated authority, by delegation or instructions from the president or chief executive officer who is often given broad powers in the by-laws to manage the day-to-day affairs of the corporation.

However, the authority to declare dividends, the right to redeem shares, and the amending of corporate by-laws may not be delegated to officers or agents or even to a committee of directors (*OBCA*, ss. 127(3) and 133).

4.5 Seal

Corporations governed by the *OBCA* and the *CBCA* may have a seal (for use where a seal is required by law or custom), but neither statute requires a seal (*OBCA*, s. 13; *CBCA*, s. 23).

4.6 First meeting — directors

Organizational proceedings are usually carried out by resolutions in writing.

There are cases, however, where a series of meetings will be held. If such meetings are to be held, the directors named in the articles or in the notice of directors (in the case of a federal corporation) should waive notice (*OBCA*, s. 264; *CBCA*, s. 255) and pass the resolutions necessary to

- enact the by-laws;
- adopt the forms of share certificates;
- allot and authorize the issuance of shares;
- appoint officers; and
- adopt any pre-incorporation contracts.

A majority of the number of directors or the minimum number of directors required by the articles constitutes a quorum at any meeting of the directors, but in no case can the quorum be less than 2/5 of the number of directors or minimum number of directors (*OBCA*, s. 126(3)). Further, a meeting of directors will not be properly constituted unless 25% of those present are resident Canadians in the case of a *CBCA* corporation (*CBCA*, s. 114(3)). There is no similar residency provision in the *OBCA*.

4.7 Second meeting — shareholders

Once the initial directors' meeting has been held, notice should then be given to, or written waiver of notice received from, each of the shareholders, directors, and the auditor (if appointed) (*OBCA*, ss. 96, 98, and 151(1)) of a meeting of shareholders called in accordance with the by-laws to

- confirm the by-laws passed earlier by the directors;
- appoint the auditor or, if pursuant to s. 148 of the *OBCA* no auditor is required, appoint accountants; and
- appoint the directors for the remaining fiscal year.

5. Post-organization and share certificates

The records and registers required under ss. 140–141 of the *OBCA* should then be completed. If the organizational proceedings result in a change of directors for an Ontario corporation, Form l under the *CIA* must be submitted within 15 days of the change. Even if there is no such change, within 60 days of incorporation under the *OBCA*, a return must be filed pursuant to s. 2 of the *CIA* setting out required information about the corporation. A *CBCA* corporation carrying on business in Ontario must also make filings under the *CIA* (s. 3(1)). Where a corporation is in default of a requirement under the *CIA* to file a return or notice, or has unpaid fees or

penalties, the corporation cannot maintain a proceeding in an Ontario court without leave of the court (s. 18(1)).

Further, using Form 6, "Changes Regarding Directors," a *CBCA* corporation must also advise Industry Canada of a change in directors within 15 days. All such filings are available for public inspection.

Banking documents in the form required by the corporation's bank should be completed and, together with certified copies of the appropriate resolutions adopted, filed with the branch of the bank in which the company will maintain its accounts.

Every shareholder is entitled to a share certificate (*OBCA*, ss. 54–56). This certificate is evidence of a number of shares of that class or series held by the shareholder and registered in his or her name in the shareholder ledger kept by the corporation.

The auditor or accountant, as the case may be, should be given notice of his or her appointment (*OBCA*, s. 149(9)) and should be advised of the date and jurisdiction of incorporation, names of directors and officers, authorized and issued share capital, fiscal year, and location of the head office where records are kept.

Once the corporation is organized, directors will often meet regularly to receive reports from employees (who may or may not be directors or officers) to consider the corporation's financial situation and generally to supervise and plan the management of its business and affairs. Even when directors meet irregularly, it is customary for them to meet once a year prior to the annual shareholder meeting to approve the corporation's financial statements so that they can be presented to the shareholders. The shareholders would then meet to receive the financial statements, elect new directors, and appoint auditors (if required) for the ensuing year. Thereafter, the newly elected directors would meet to elect the officers.

Subject to s. 104(1) of the *OBCA*, s. 94 requires the directors of a corporation to call an annual meeting of the shareholders not later than 18 months after the date the corporation comes into existence and subsequently not later than 15 months after the holding of the last preceding annual meeting.

6. Special situations

A number of special situations are regulated.

6.1 Continuing under another jurisdiction

Both the *OBCA* and *CBCA* contemplate two methods of continuance: import and export. An importing continuance is used when a corporation not governed by the statute wishes to be governed by the statute. By contrast, exporting is when a corporation wishes no longer to be governed by the statute and instead be governed by the corporate laws of some other jurisdiction. Generally, the reason for wishing to import or export would be to amalgamate with another corporation not governed by the same legislation, since statutory amalgamations require that the parties to the amalgamation are governed by the same legislation.

While importing is relatively simple (*OBCA*, s. 180), exporting is not as straightforward for the following reasons:

- The proposed continuance cannot adversely affect creditors or shareholders of the corporation.
- The corporation may not be continued under the laws of another jurisdiction unless the laws of that jurisdiction provide that the property, liabilities, and obligations of the corporation would continue unaffected.
- Notice of the proposal to export must be given to shareholders, and this notice must state that any dissenting shareholder is entitled to be paid the fair value (which may be in excess of the market value) of his or her shares. A shareholder may dissent if a corporation resolves to be continued under the laws of another jurisdiction. The mere possibility of a right of appraisal may discourage a proposed export (*OBCA*, s. 181).

6.2 Amalgamations

Pursuant to ss. 174–179 of the *OBCA*, two or more corporations governed by the *OBCA* may amalgamate and continue as one corporation. Upon the articles of amalgamation becoming effective, they are deemed to be the articles of incorporation of the amalgamated corporation, and the certificate of amalgamation is deemed to be the certificate of incorporation of the amalgamated corporation (*OBCA*, s. 179(d)). It is important to note that the amalgamating corporations continue and, therefore, are subject to the same liabilities and, except for inter-corporate shareholdings and book debts, retain the same assets as prior to the amalgamation.

Chapter 20

Directors, officers, and shareholders of a corporation

1. Introduction

This chapter deals with a corporation's three main parties: its directors, officers, and shareholders. Each of these groups has its own sphere of activity within the corporation, and the powers and responsibilities of each are set out in the governing statutes (Ontario's *Business Corporations Act* (*OBCA*) or the *Canada Business Corporations Act* (*CBCA*)). Both provide some flexibility as to how authority to direct a corporation's activities may be divided.

2. Directors

2.1 Duties and responsibilities

The directors of a corporation are required to manage or supervise the management of the business and affairs of the corporation (*OBCA*, s. 115(1); *CBCA*, s. 102(1)). This power of management can only be restricted, in whole or in part, by a unanimous shareholder agreement (USA) (*OBCA*, s. 108(3)). A similar situation is obtained indirectly under the *CBCA* through a combination of ss. 102(1) and 146(1).

There are two general types of obligations imposed upon directors in connection with their management of a corporation's business and affairs (*OBCA*, s. 134(1); *CBCA*, s. 122(1)):

- a fiduciary duty to act honestly, in good faith, and with a view to the best interests of the corporation; and
- a duty to exercise the care, diligence, and skill of a reasonably prudent person in comparable circumstances.

2.2 Qualifications

In order to be a director of a corporation, there are four basic qualifications (*OBCA*, s. 118(1); *CBCA*, s. 105(1)). The director must be

- an individual;
- at least 18 years old;
- of sound mind; and
- not bankrupt.

Subsection 115(3) of the *OBCA* requires that at least one-third of the directors of an offering corporation not be officers or employees of the corporation or any of its affiliates. Subsection 102(2) of the *CBCA* states that in the case of a distributing corporation, there shall be not fewer than three directors, at least two of whom shall not be officers or employees of the corporation or its affiliates.

Prior to August 1, 2007, a majority of the directors of every *OBCA* corporation, other than a "non-resident corporation," had to be "resident Canadians." Where an *OBCA* corporation had less than three directors, the sole director or at least one of the two directors, as the case may be, had to have been a resident Canadian (*OBCA*, s. 118(3)). As a result of amendments to the *OBCA* that came into effect on August 1, 2007, the resident director requirement was reduced to 25% (*OBCA*, s. 118(3)).

A "resident Canadian" is defined in s. 1(1) as an individual who is a Canadian citizen ordinarily resident in Canada, a Canadian citizen not ordinarily resident in Canada who is a member of a prescribed class of persons, or a permanent resident within the meaning of the *Immigration and Refugee Protection Act* and ordinarily resident in Canada. The *CBCA* (s. 105(3)) requires that only 25% of directors of a *CBCA* corporation (or if fewer than four directors, one director) be resident Canadians.

2.3 Election of directors

The first directors of a corporation are those named in its articles pursuant to s. 119(1) of the *OBCA* (*CBCA*, s. 106) and hold office until the corporation is organized, either by way of written resolutions executed by all shareholders or by resolution passed at the first meeting of shareholders. At this juncture and at subsequent annual meetings, the shareholders elect the directors by ordinary resolution for a subsequent term. It is not necessary that all directors elected at a meeting of shareholders hold office for the same term. Terms may be staggered, provided that no director's term exceeds three years. A director not elected for an expressly stated term ceases to hold office at the close of the first annual meeting of shareholders following his or her election. If no directors are elected at a meeting of shareholders, s. 119(7) of the *OBCA* and s. 106(6) of the *CBCA* provide that the incumbent directors continue in office until their successors are elected.

Unless the articles of a corporation provide otherwise, each share of a corporation entitles its holder to one vote at a meeting of shareholders pursuant to s. 102(1) of the *OBCA*. Accordingly, voting shareholders who collectively hold more than 50% of the votes can cast those votes so as to elect all the directors of the corporation.

Minority holders of voting shares are able to elect directors to the board in proportion to their interest if a cumulative voting system is employed. Section 120 of the *OBCA* (*CBCA*, s. 107) permits cumulative voting if it is provided for in the articles of a corporation and imposes certain safeguards to ensure that the proportional results that occur with cumulative voting cannot be circumvented.

2.4 Number of directors

The number of directors of a corporation or the minimum and maximum numbers of directors of a corporation are stipulated in the corporation's articles. Pursuant to s. 115(2) of the *OBCA* (*CBCA*, s. 102(2)), non-offering corporations are required to have at least one director and offering corporations at least three directors. If the articles provide for cumulative voting, the number of directors must be fixed in the articles. Otherwise, a corporation's articles may authorize either a fixed number or a maximum and a minimum number of directors. This latter arrangement permits the number of directors to be altered within the range set out in the articles without the need to amend the articles with a shareholder vote for approval.

Any change in the directors will necessitate a filing of notice of the change under s. 4(1) of the *Corporations Information Act* or, in the case of the *CBCA* company, s. 113 of the *CBCA*. Some jurisdictions in which a corporation does business may also require the filing of notice of any change in directors.

2.5 Quorum of directors

Subject to the corporation's articles and by-laws, a majority of the number of directors constitutes a quorum at any meeting of directors, but in no case can quorum be less than two-fifths of a corporation's directors. Where there are only one or two directors, all must be present to constitute quorum (*OBCA*, ss. 126(3)–(4)).

In addition to the quorum requirements, the *CBCA* contains Canadian residency standards that must be complied with in order to transact business at a directors' meeting (*CBCA*, ss. 114(3)–(4)). The *OBCA* does not contain similar residency standards in addition to the quorum requirements.

Under the *CBCA*, directors, other than directors of a corporation referred to in s. 105(4), shall not transact business at a meeting of directors unless (*a*) if the corporation is subject to s. 105(3), at least 25% of the directors present are resident Canadians or, if the corporation has less than four directors, at least one of the directors present is a resident Canadian; or (*b*) if the corporation is subject to s. 105(3.1), a majority of the directors present are resident Canadians or, if the corporation has only two directors, at least one of the directors present is a resident Canadian.

Subsection 114(4) of the *CBCA* states that despite subsection (3), directors may transact business at a meeting of directors where the number of resident Canadian directors, required under that subsection is not present if

> (*a*) a resident Canadian director who is unable to be present approves in writing, or by telephonic, electronic or other communication facility, the business transacted at the meeting; and
>
> (*b*) the required number of resident Canadian directors would have been present had that director been present at the meeting.

2.6 Vacancies in the board of directors

Unless the articles or by-laws of a corporation provide otherwise, if there is a vacancy in the board of directors, the remaining directors may exercise all of the powers of the board as long as there is a quorum (*OBCA*, s. 126(5)). The same result is achieved indirectly through s. 114(2) of the *CBCA*.

If there is no quorum of directors or if the shareholders have failed to elect the required number of directors, the remaining directors must call a special meeting of shareholders to fill the vacancy (*OBCA*, s. 124(3); *CBCA*, s. 111(2)).

2.7 Transaction of business

Directors act by passing resolutions, which is done either at a meeting of the board of directors or by way of written resolution signed by all of the directors. A resolution passed by the latter method is as valid as if it had been passed at a meeting of directors or committee of directors.

Section 126 of the *OBCA* and s. 114 of the *CBCA* govern meetings of directors. Directors' resolutions may be passed at a meeting of the board of directors at which a quorum of directors is present and at which the required percentage of the directors present are resident Canadians.

Meetings of the board of directors are to be held at the corporation's registered office. The by-laws may permit such meetings to be held elsewhere. Under s. 126(2) of the *OBCA*, a majority of directors' meetings in each financial year must be held within Canada (unless this requirement is removed by provisions in the articles or by-laws, or the corporation is a non-resident corporation.) There is no similar requirement under the *CBCA*.

Subject to the corporation's by-laws, s. 126(13) of the *OBCA* and s. 114(9) of the *CBCA* provide that if all the directors participating in a meeting of directors consent or a committee of directors consents, a meeting may be held by telephone, electronic, or other communication facilities. If a majority of the directors participating in this kind of meeting are in Canada, the meeting is deemed to have been held in Canada.

Notice of meetings of the board of directors should be sent to each director in accordance with a corporation's by-laws, giving the time and place of the meeting. Subsection 126(8) of the *OBCA* requires that if a quorum of directors calls a meeting, the general nature of any business to be transacted must be specified in the notice. The *CBCA* does not require the nature of a directors' meeting to contain a description of the business to be transacted at the meeting, unless the by-laws otherwise provide or the business relates to a special matter identified in s. 115(3). It is very common for a notice of a directors' meeting to contain an agenda of the matters to be discussed. It is also standard practice to circulate to the directors documentation that relates to the subjects to be considered at the meeting, whether or not technically required.

The amount of notice to be given to directors of a meeting is usually specified in a corporation's by-laws. Subsection 126(9) of the *OBCA* provides that if the by-laws are silent on this point, the notice must be sent 10 days or more before the date of the meeting to each director at the director's latest address as shown on the records of the corporation. A director may in any manner waive notice of a meeting of directors. Attendance of a director at a meeting of directors is a waiver of notice of a meeting, except where a director attends a meeting for the express purpose of objecting to the transaction of any business on the grounds that the meeting is not lawfully called. If notice of a meeting of directors is not given to or waived by a director, the meeting is not duly constituted, and any action taken at such a meeting is invalid.

Subsection 127(1) of the *OBCA* and s. 115(1) of the *CBCA* authorize the board of directors to appoint a managing director or a committee of directors. The *CBCA* requires the managing director to be a resident Canadian. The board of directors may then delegate to the managing director or to the committee any of the powers of the directors, other than the power to deal with specified matters. The matters that may not be delegated are set forth in s. 127(3) of the *OBCA*:

- submitting to shareholders any matter requiring approval of the shareholders;
- filling a vacancy among the directors or the office of auditor;
- appointing or removing any of the chief executive officers, the chief financial officer, the president, or the chair of an *OBCA* corporation;
- issuing securities except in the manner and on the terms authorized by the directors;
- declaring dividends;
- purchasing, redeeming, or otherwise acquiring shares issued by the corporation;
- paying a commission regarding the purchase of shares of the corporation;
- approving a management information circular, take-over bid circular, issuer bid circular, or directors' circular;
- approving financial statements;
- for *OBCA* corporations, approving amalgamations or amendments to articles regarding the creation of series of shares and the change of a corporation's name from a number name, which approvals may be given by all directors; and
- adopting, amending, or repealing by-laws.

2.8 Remuneration

Section 137 of the *OBCA* and s. 125 of the *CBCA* authorize the directors to fix the remuneration of the directors, officers, and employees of the corporation. The directors' discretion in this regard may be limited by provisions in the articles, the by-laws, or a USA and, of course, by the directors' fiduciary duty and duty of care.

2.9 Ceasing to be a director

Subsection 121(1) of the *OBCA* and s. 108(1) of the *CBCA* provide that a person ceases to be a director of a corporation if he or she resigns, dies, becomes disqualified, or is removed. A director's written resignation becomes effective at the time it is received by the corporation if the resignation is to be effective immediately or at the time specified in the resignation, whichever is later. A director's resignation cannot be effective prior to the time it is sent to the corporation. Until the first meeting of shareholders, a first director named in the corporation's articles may not resign unless, at the time the resignation is to become effective, a successor is elected or appointed.

Subject to the rules against removing a director elected by cumulative voting, the shareholders of a corporation may, by ordinary resolution passed at a special meeting duly called for that purpose (and an annual meeting in the case of an *OBCA* corporation), remove any directors from office and elect a replacement for the remainder of the term. Where a class or series of shares carries the exclusive right to elect one or more directors, no director so elected may be replaced except by an ordinary resolution at a meeting of the shareholders of that class

or series pursuant to s. 122 of the *OBCA* and s. 109 of the *CBCA*.

3. Officers

3.1 Appointment, duties, and responsibilities

Under s. 133 of the *OBCA* and s. 121 of the *CBCA*, the directors of a corporation, subject to the articles, the by-laws or a USA, are authorized to designate the offices of the corporation, appoint officers, specify their duties, and delegate to them powers to manage the business and affairs of the corporation under the supervision of the directors, except for certain important decisions that the statutes prohibit the directors from delegating at all. The offices of the corporation and the duties associated with those offices are usually specified in the general by-law of the corporation.

Officers of a corporation are subject to the same fiduciary duty, duty of care, and duty to disclose interests in material contracts or transactions as are imposed upon the directors. Unlike directors, officers do not have the benefit of the statutory provisions permitting reliance on financial statements and reports of independent experts (*OBCA*, s. 135(4); *CBCA* s. 123(4)).

3.2 Qualifications

The only officer of a corporation who must have any special qualification to serve as such is a managing director. While there is no requirement to appoint a managing director, if one is appointed, he or she must be a resident Canadian, pursuant to s. 115(1) of the *CBCA*.

3.3 Term of office

Neither the *OBCA* nor the *CBCA* deal expressly with the issue of the term of office. It is common to specify in a corporation's by-laws that while the board of directors may by resolution remove any officer of the corporation at any time, each officer appointed by the directors otherwise holds office until he or she resigns or a successor is appointed. Without such provision, the board of directors may be required to confirm the appointment of officers after each shareholder meeting.

3.4 Authority of officers

The duties and authority of an officer are set out in numerous sources, including the articles, by-laws, directors' resolutions, or USA. Because most of these documents are not accessible to the public, s. 128 of the *OBCA* (*CBCA*, s. 116) protects persons dealing with directors and officers of a corporation by providing that acts done by them are valid notwithstanding any defect that may be discovered afterwards in their appointment, election, or qualification. Sections 17–19 of the *OBCA* (and corresponding ss. 16–18 of the *CBCA*) provide additional protection to such persons.

3.5 Indoor management rule

The above provisions act as a statutory broadening of the indoor management rule. A person dealing with a corporation need not review all available public documents about the corporation nor make inquiries to ensure that all proper steps have been taken to authorize the actions of a director, officer, or agent for a corporation, as long as it seems usual for such a person to be doing the act in question and there is no reason why such a person ought to have knowledge to the contrary.

3.6 Indemnification and insurance for directors and officers

A corporation may, in certain circumstances, indemnify a director or officer of the corporation, a former director or officer, or a person who acts at the corporation's request as a director or officer of another corporation of which the first corporation is or was a shareholder or creditor (*OBCA*, s. 136; *CBCA*, s. 124). Such a director or officer has an absolute right to be indemnified in respect of all costs, charges, and expenses incurred in the defence of any action to which he or she is made a party by reason of being a director or officer, if all of the following conditions are met:

- He or she was substantially successful.
- He or she acted honestly and in good faith with a view to the best interests of the corporation.
- In the case of a criminal or administrative action that is enforced by a monetary penalty, he or she had reasonable grounds for believing that his or her conduct was lawful.

Since these statutes permit but do not require a corporation to indemnify its directors and officers, a person should ensure that such an indemnity is available when asked to be a director or officer. It is common for such an indemnity to be included in the by-laws of a corporation.

A corporation is also authorized to purchase and maintain liability insurance for a director or officer, a former director or officer, or a person acting at the corporation's request as a director or officer of another corporation of which the first corporation is or was a shareholder or creditor, against any liability incurred by such a director or officer, in his or her capacity as such, if he or she acted honestly and in good faith with a view to the best interests of the corporation.

4. Shareholders

4.1 Becoming a shareholder

A person becomes a shareholder when shares are issued to him, her, or it (in the case of a corporation) in exchange for money paid, property transferred, or past services rendered to the corporation. Shares may also be acquired by purchasing them from another person who already owns them or by transmission of the shares from a deceased shareholder.

Under s. 141(1) of the *OBCA* and s. 50 of the *CBCA*, a corporation is required to keep a securities register that includes a listing of the shares issued, together with the name, address, and number of shares held by each shareholder and the date and particulars of the issue of each share. A separate register of securities transfers is also to be maintained pursuant to s. 141(2) of the *OBCA*. Subject to certain exceptions, a corporation may treat the registered owner of a share as the person exclusively entitled to vote, to receive notices, to receive any dividend or other payments in respect of the share, and to exercise all the other rights and powers of an owner of the share.

Section 28 of the *OBCA* and s. 30 of the *CBCA* prohibit a corporation from owning shares in itself or in its holding body corporate, except in certain limited instances. These exceptions include a corporation holding shares in itself as a legal representative for someone else but not as a beneficial owner, holding shares in itself as security for the purposes of a transaction entered into in the ordinary course of a business that includes the lending of money, and holding shares in itself to enable the corporation to qualify for benefits based upon a specified level of Canadian ownership or control.

4.2 Rights, powers, and duties

4.2.1 Election and removal of directors

The shareholders are the "owners" of a corporation, while normally the directors manage or supervise the management of the corporation. Therefore, one of the most important rights of those shareholders who own voting shares is the right to elect and remove directors from office.

4.2.2 Right to receive financial statements

The financial statements are typically the most important source of information available to shareholders regarding their investment in the corporation. A corporation governed by the *OBCA* or the *CBCA* is required to keep financial statements and to present those financial statements to the shareholders at each annual meeting of shareholders. They must be accompanied by the report of the corporation's auditor/accountant. Also accompanying the financial statements is any further information respecting the financial position of the corporation and the results of its operations required by the articles, by-laws, or USA.

4.2.3 Appointment of auditor

To ensure that the financial statements are prepared in accordance with required accounting principles, s. 149 of the *OBCA* and s. 162 of the *CBCA* provide that the voting shareholders have a right to appoint an auditor at each annual meeting of shareholders. The auditor acts as the shareholders' representative or watchdog. He or she is required to make such examinations as he or she considers necessary in order to be able to report to the shareholders about the financial statements. An "unqualified report" from the auditor to the shareholders will state that the auditor is of the opinion that the financial statements present fairly the financial position of the corporation at its financial year-end, as well as the results of its operations and the changes in its financial position for each fiscal year in the last five years in accordance with the appropriate accounting principles applied on a consistent basis. If the shareholders receive a qualified report, which means that in certain instances indicated by the auditor an unqualified report cannot be given, they should consider seeking an explanation from the management at the annual meeting or from the auditor. The auditor has the right pursuant to s. 151(1) of the *OBCA* and s. 168(1) of the *CBCA* to attend any shareholders' meeting and to be heard. Any director or shareholder, whether or not entitled to vote, may require the auditor or a former auditor of the corporation to attend a shareholders' meeting and to answer questions. As part of the recent move toward better corporate governance, it has been suggested that auditors should not provide non-audit services, such as consulting, tax, or legal, to a corporation because this makes the auditors too reliant on management and may affect auditor independence.

The Accounting Standards Board (AcSB) adopted International Financial Reporting Standards (IFRS) as Canadian generally accepted accounting principles (GAAP) for publicly accountable enterprises. The Public Sector Accounting Board required government business enterprises to adopt the IFRS for fiscal years beginning on or after January 1, 2011. Entities with rate-regulated activities have the option to defer their changeover to IFRS by one year to January 1, 2012. For investment companies and segregated accounts of life insurance enterprises, the AcSB agreed to extend the option to defer their changeover by two years to January 1, 2013, because of the timing of the related International

Accounting Standards Board project. This change proposed by the AcSB is expected to be issued into the Canadian Institute of Chartered Accountants (CICA) Handbook – Accounting in March 2011. Private enterprises were given the option to adopt IFRS or the new Canadian standards developed specifically to meet the needs of users of their financial statements for fiscal years beginning on or after January 1, 2011. Not-for-profit organizations may also choose to adopt IFRS for fiscal years beginning on or after January 1, 2012.

Under the *OBCA* and *CBCA*, an offering corporation must, not less than 21 days before each annual meeting of shareholders, send a copy of the financial statements, the auditor's report, and any further information required by the articles, the by-laws, or a USA to each shareholder, except to a shareholder who has informed the corporation in writing that he or she does not wish to receive a copy of these documents. In the case of a non-offering corporation, s. 154(4) of the *OBCA* provides that the time limit is 10 days.

Section 156 of the *OBCA* requires an offering corporation to file with the Ontario Securities Commission (OSC) the financial statements that a reporting issuer is required to file under the *Securities Act*. Reporting issuers must also file a copy of quarterly interim financial statements and a copy of the annual financial statements and auditors' report in accordance with NI 51-102, *Continuous Disclosure Obligations*. Financial statements so filed are normally available to the public. A corporation that is not an offering corporation need not file financial statements with the OSC.

4.2.4 Approval of fundamental changes

Both the *OBCA* and the *CBCA* provide that the shareholders must approve certain fundamental changes affecting a corporation by a special resolution. A special resolution is a resolution that is either passed at a special meeting of shareholders of the corporation by a majority of not less than two-thirds of the votes cast or consented to in writing by each shareholder of the corporation entitled to vote on the resolution.

Furthermore, certain fundamental changes must be approved by not less than two-thirds of the shares of each class and series of shares, even if a class and series is ordinarily non-voting.

Shareholders who oppose certain fundamental changes set forth in s. 185(1) of the *OBCA* or s. 190(1) of the *CBCA* may also dissent and require the corporation to purchase their shares if the fundamental change occurs.

Fundamental changes that give rise to dissent rights include the following:

- certain amendments to the articles (*OBCA*, s. 168; *CBCA*, ss. 173 or 174);
- an amalgamation, other than a "short form" amalgamation (*OBCA*, ss. 175–176; *CBCA* s. 184);
- a continuance (*OBCA*, s. 181; *CBCA*, s. 188);
- the sale, lease, or exchange of all or substantially all of the property of the corporation other than in the ordinary course of business (*OBCA*, s. 184(3); *CBCA*, s. 189(3));
- an arrangement (*OBCA*, s. 182); and
- a going-private transaction or squeeze-out transaction.

4.2.5 Shareholder proposals

Any shareholder who is entitled to vote at an annual meeting of shareholders can initiate a proposal to amend the articles of a corporation (*OBCA*, s. 169(1); *CBCA*, s. 175(1)). The notice of a meeting of shareholders at which a proposal to amend the articles is to be considered must set out the proposed amendment and, where applicable, state that a dissenting shareholder is entitled to be paid the fair value of the shareholder's shares.

Section 99 of the *OBCA* and s. 137 of the *CBCA* also permit any shareholder entitled to vote at a meeting of shareholders to submit to the corporation notice of a matter that the shareholder proposes to raise at a meeting of shareholders (the proposal) in order to discuss the matter at the meeting. Notice of the proposal and a statement in support of the proposal must be circulated in the management information circular unless any of the following occurs:

- If the matter is proposed to be raised at an annual meeting, the proposal is not submitted to the corporation at least 60 days before the anniversary date of the last annual meeting.
- If the matter is proposed to be raised at a meeting that is not an annual meeting (often referred to as a special meeting of shareholders), the proposal is not submitted to the corporation at least 60 days before such a meeting.
- It clearly appears that the proposal is submitted by the shareholder to enforce a personal claim or redress a personal grievance against the corporation or any of its directors, officers, or security holders or for a purpose that is not related in any significant way to the business or affairs of the corporation.
- The proposal was circulated in connection with a meeting of shareholders within the two preceding years and not presented by the shareholder at the meeting or was presented and defeated.

Subsection 99(4) of the *OBCA* and s. 137(4) of the *CBCA* provide that a proposal may include a nomination for the election of directors if it is signed by holders of not less

than five per cent of the shares in the aggregate or five per cent of the shares of any class or series of shares entitled to vote at the meeting.

If the corporation refuses to circulate a proposal, it must notify the shareholder who submitted the proposal of its decision and its reasons for the refusal. The shareholder may then apply to a court, and the court may restrain the holding of the shareholders' meeting or make any other order it thinks fit. The corporation is also free, as is "any person aggrieved by a proposal," to apply pursuant to s. 99(9) of the *OBCA* to a court for an order permitting the corporation to refuse to circulate the proposal. A court may make such an order as it thinks fit if the proposal falls within one of the four categories listed above.

The power to call a meeting of shareholders is vested in the directors. Therefore, the directors need not call a special meeting of shareholders to consider a proposal, but they must put a proposal before a special meeting of shareholders if one has been called and the proposal is one that qualifies for circulation to the shareholders. Directors must call an annual meeting of shareholders under s. 94 of the *OBCA* and s. 133 of the *CBCA* not later than 18 months after the corporation comes into existence and subsequently not later than 15 months after holding the preceding annual meeting. As a result, a shareholder proposal must be considered at the next annual meeting at the latest. Shareholders may also requisition a meeting of shareholders, as described below.

A shareholder proposal gives a shareholder a method of bringing a matter directly to the attention of other shareholders and of by-passing the board of directors of the corporation. Shareholder proposals are not very common for the simple reason that if shareholders have the voting power to pass a shareholder proposal, they will also have the voting power to change the composition of the board of directors. The new directors can then initiate any action required. However, a shareholder proposal may be appropriate if the shareholder making the proposal believes the requisite majority of shareholders will support the proposal but would not support a change in the composition of the board of directors.

4.3 Meetings of shareholders

Sections 93–98 of the *OBCA* (*CBCA*, ss. 132–136) contain the substantive provisions dealing with meetings of shareholders. The powers of the shareholders are exercised at meetings of the shareholders or by written resolutions signed by all the shareholders.

4.3.1 Nature of meetings

There are two types of shareholders meetings: annual and special. The first annual meeting must be held within 18 months of incorporation, and subsequent annual meetings are required no later than 15 months after the preceding annual meeting. Annual meetings must consider the following:

- minutes of the previous shareholders' meeting;
- financial statements;
- auditor's report;
- election of directors; and
- appointment of auditors.

The directors may call a special meeting of shareholders at any time. All business transacted at a special meeting of shareholders and any business transacted at an annual meeting of shareholders other than described above is deemed to be special business. In order to avoid the expense of additional shareholders' meetings, the directors of corporations often attempt to deal with special business at the same time as annual business at a single meeting entitled an "Annual and Special Meeting of Shareholders."

4.3.2 Place of meetings

Subject to the provisions of the articles or a USA, the directors of a corporation are permitted to determine the location of a meeting (*OBCA*, s. 93). Failing any such determination or provision, meetings must be held at the place where the registered office of the corporation is located. Section 132 of the *CBCA* requires that a shareholders' meeting for a *CBCA* corporation be held in Canada unless the articles specify a place outside of Canada or all shareholders entitled to vote agree to that place.

4.3.3 Notice period for meetings and record dates

The *OBCA* provides for various minimum and maximum notice periods for shareholder meetings pursuant to s. 96(1), depending on whether the corporation is offering or non-offering. These notice periods can be waived by the shareholders (*OBCA*, s. 98).

Subsection 95(2) of the *OBCA* and s. 134 of the *CBCA* stipulate that directors may fix a record date to determine which shareholders are entitled to receive notice of the meeting. If one is fixed, all those shown on the books of the corporation as at the record date are entitled to notice of the meeting even if there are transfers between the record date and the meeting. The statutes require that notice of the record date, if fixed, has to be advertised at least seven days before the record

date by publication in a newspaper distributed in the location of the corporation's registered office and wherever its transfer agents are located. Notice has also to be given to each stock exchange on which the corporation's shares are listed. These requirements may only be waived by the written consent of all affected shareholders on or before the fixed record date.

If there is no fixed record date, the record date for determination of shareholders entitled to notice is deemed to be either the close of business on the day preceding the day on which notice is given or, if notice is not given, the day of the meeting.

4.3.4 Form and content of notice of meetings

Notices are required to be in writing and must state the time and place of the meeting. When the meeting is a special one (in whole or in part), the notice must state the nature of the special business in sufficient detail to permit a shareholder to form a reasoned judgment about it and the text of any special resolution or by-law to be presented to the meeting (*OBCA*, s. 96(6); *CBCA*, s. 135(6)).

Unless the by-laws provide otherwise, no notice is required of an adjourned meeting if an adjournment is for less than 30 days and the date of an adjourned meeting is announced at the original meeting. In the event that the meeting is adjourned for an aggregate of 30 days or more by one or more adjournments, the same notice is required as for the original meeting.

4.3.5 Other materials to be circulated prior to meetings

Corporations are also required to provide their shareholders with certain documentation in addition to the notice of meeting. In the case of an annual meeting, unless shareholders inform the corporation that they do not wish to receive copies, *OBCA* (and *CBCA*) corporations are required to mail to the shareholders

- the financial statements;
- auditor's report; and
- any other required financial information for the last completed fiscal year of the corporation.

Moreover, it is mandatory for *OBCA* offering corporations having 15 or more shareholders and for *CBCA* corporations having more than 50 shareholders to solicit proxies, that is, to provide a form of proxy to each voting shareholder to permit a shareholder not able to attend the meeting in person to exercise her or his voting rights through a proxyholder (*OBCA*, ss. 111–112, *CBCA*, s. 149(1)). These corporations are also obliged to issue an information circular to each shareholder entitled to notice of the meeting; the circular provides certain information that the regulations under each statute require be provided to shareholders in connection with the matters to be determined at the forthcoming meeting.

A person, other than the management of a corporation, who solicits proxies, that is, asks for shareholders to vote by proxy against a management proposal or for that person's proposal at a meeting, is known as a "dissident." A dissident must provide an information circular, the form and contents of which are prescribed by regulation. A dissident is not required to supply a form of proxy with the dissident's information circular.

A shareholder who makes a proposal may require the corporation to include in the management information circular, or attach thereto, a statement by the shareholder (not exceeding the maximum number of words) in support of the proposal, along with the name and address of the shareholder, pursuant to s. 99(3) of the *OBCA* and s. 137(3) of the *CBCA*.

4.3.6 Who may call a shareholders' meeting

Under normal circumstances, the right to call shareholders' meetings is vested in the board of directors.

In certain situations, shareholders have the right to requisition shareholders' meetings. Under s. 105 of the *OBCA* and s. 143 of the *CBCA*, holders of at least 5% of the shares entitled to vote at meetings may require the directors to call a meeting. If the directors do not do so within 21 days following receipt of the shareholders' written requisition, any shareholder who made the original request may call the meeting in the usual way. The right to requisition a meeting is not absolute. The directors need not call a meeting if a record date for a meeting has already been fixed and notice of it given, if the directors have already called a shareholders' meeting and have given notice of it, or if the matters to be discussed at the meeting are of such a nature that the corporation would not be required to circulate a shareholder proposal.

It is also possible for a court pursuant to s. 106 of the *OBCA* and s. 144 of the *CBCA* to call a meeting of shareholders upon the application of a director or a shareholder entitled to vote at the meeting

- if it is impracticable to call a meeting of shareholders;
- if it is impracticable to conduct the meeting in the manner prescribed by the by-laws, the articles, or the *Act*; or
- for any other reason the court thinks fit.

4.3.7 Conduct of meetings

Subject to statutory rules dealing with quorums and voting, elements of procedure at a meeting of shareholders are governed by provisions in the by-laws or by rules of parliamentary and municipal practice.

4.3.8 Voting by proxy

Under s. 110 of the *OBCA* and s. 148 of the *CBCA*, any shareholder entitled to vote at a meeting of shareholders has the right to appoint a person, who need not be a shareholder, to represent the shareholder and vote in the shareholder's stead at any meeting by executing a form of proxy. Corporate shareholders are represented by proxy. A form of proxy may be revoked at any time before the transaction of the business to which it relates, and attendance in person also revokes the proxy.

4.3.9 Resolutions in writing

A resolution in writing signed by all the shareholders entitled to vote at a meeting of shareholders is as valid as if it had been passed at a meeting of the shareholders (*OBCA*, s. 104(1); *CBCA* s. 142(1)) The only occasions when a written resolution may not be used are when the shareholders deal with the resignation, removal, or replacement of a director or the auditor, and the director or auditor submits to the corporation a written representation on the matter.

4.4 Principles governing voting rights

The *OBCA* and the *CBCA* make it clear that when shareholders vote on a matter before them, the will of the required majority governs. While the courts have long held that shareholders are free to vote in their own self-interest, there has been controversy over whether shareholders should still be able to vote as shareholders solely in their own self-interest when they have a personal interest in the matter being voted upon quite apart from their interest in the transaction as shareholders. The general rule at common law is that shareholders may vote in their own self-interest, even if they have a personal interest in the transaction apart from their position as shareholders, as long as the action taken was not of a fraudulent character or beyond the powers of the corporation.

Where a USA is in place, shareholders must remember that they are required to act with a view to the best interests of the corporation when exercising directorial power.

4.5 Shareholders' remedies

4.5.1 Introduction

There are a number of ways shareholders can ensure the protection of their rights and interests, including the following:

- personal actions for the infringement of a personal right such as the right to receive notice of, or to vote at, a shareholders' meeting;
- applications for winding-up (*OBCA*, ss. 207–208; *CBCA*, s. 214);
- right of dissent and appraisal (*OBCA*, s. 185; *CBCA*, s. 190);
- investigations (*OBCA*, s. 161; *CBCA*, s. 229); and
- compliance orders (*OBCA*, s. 253; *CBCA*, s. 247).

The two most common methods are the derivative action and actions for oppression.

4.5.2 Derivative actions

A shareholder may be injured indirectly if a wrong is done to the corporation, and the *OBCA* and *CBCA* now provide shareholders with an expanded statutory right to bring a derivative action (*OBCA*, ss. 246–247; *CBCA*, ss. 239–240).

With leave of the court, a derivative action may be brought by a "complainant," which includes shareholders and former shareholders; directors, officers, or former directors or officers of the corporation or any of its affiliates; or any other person who in the discretion of the court is a proper person to bring the action (*OBCA*, s. 245; *CBCA*, s. 238). The court will grant leave where four conditions are satisfied:

- The shareholder gives 14 days' notice to the directors of the corporation of their intention.
- The directors of the corporation will not bring, diligently prosecute, defend, or discontinue the action.
- The shareholder is acting in good faith.
- The proposed action appears to be in the best interest of the corporation.

At any time, a court may make any other order it thinks fit, including an interim order for relief, an order giving the complainant or any other person control of the action, an order giving directions for the conduct of the action, or an order requiring the corporation or its subsidiary to pay reasonable legal fees and any other costs reasonably incurred by the complainant in connection with the action pursuant to s. 247 of the *OBCA* and s. 240 of the *CBCA*.

4.5.3 Oppression

The circumstances in which relief may be obtained have been broadened considerably from those available at common law by the provisions in s. 248 of the *OBCA* and s. 241 of the *CBCA*. These sections give a complainant the right to apply to a court for relief if any act or omission by a corporation or any affiliate or by the directors is oppressive or unfairly prejudicial to or unfairly disregards the interests of any security-holder, creditor, director, or officer or if the business or affairs of the corporation or any affiliate are conducted in a manner that has this effect. The term "complainant" is defined in the same broad manner as in the case of a derivative action. Under the *OBCA*, the Director and, in the case of offering corporations, the OSC may also apply under s. 248.

While a broad range of persons may be able to commence an oppression remedy action, the range of protected persons is narrower.

A court is free to make any interim or final order it thinks fit in order to remedy an oppressive or unfair situation pursuant to s. 248(3). A court may also make an order that the corporation or any subsidiary pay the complainant's interim costs, including legal costs, but the complainant may be held accountable for such interim costs upon a final disposition of the matter.

The oppression remedy is so broad that many matters that might have been litigated in the past by means of a personal action or a derivative action may now be remedied under the oppression section. This is because of the breadth of more effective remedial orders that can be made under the oppression remedy. The cases decided to date suggest that the courts will interpret the section as broadly as it was drafted. If the oppression remedy is used to grant relief to minority shareholders where directors or shareholders carry out acts that are unfair to the minority, the result will be to force directors and majority shareholders to act with a degree of fairness towards the minority similar to that which would have been required if they had owed a fiduciary duty to such shareholders. While this principle has not been imposed upon majority shareholders at common law, the oppression remedy subsumes fiduciary claims.

Chapter 21
Shareholder agreements

1. What is a shareholder agreement?

A shareholder agreement is first and foremost a contract and, as such, must have all of the fundamental requirements for a binding, legal agreement. There must be offer and acceptance, consideration, capacity, and a *bona fide* legal purpose.

Shareholder agreements are a class of contracts that relate specifically to the relationship between some or all of the shareholders of a corporation and, often (although not necessarily), between those parties and the corporation.

As well as being dealt with by the common law, some, but not all, shareholder agreements are addressed in Ontario's *Business Corporations Act* (*OBCA*). Section 108 of the *OBCA* authorizes shareholder agreements to deal with either or both of the following matters:

- A written agreement between two or more shareholders may set out the manner in which voting rights attributable to the shares held by each party to such agreement shall be exercised (s. 108(1)).
- A unanimous shareholder agreement (USA) is a written agreement among all of the shareholders of a corporation (or among all of the shareholders and one or more persons who are not shareholders) that restricts, in whole or in part, the powers of the directors to manage the business and affairs of the corporation (ss. 1(1) and 108(2)).

A USA is also deemed to exist where a person who is the registered owner of all the issued and outstanding shares of a corporation makes a written declaration that restricts, in whole or in part, the powers of the directors to manage the corporation's business and affairs (s. 108(3)).

Where the principals of a corporation own their shares through holding companies or trusts, it may be prudent for such principals to also be made direct parties to the shareholder agreement to contractually "guarantee" that their holding companies will perform their obligations as shareholders of the corporation.

2. What do shareholder agreements do?

A shareholder agreement dealing with voting rights is typically an agreement by which the parties have agreed to vote their shares in a particular manner and/or to provide for proxies or powers of attorney that would result in their shares being voted in a particular manner (i.e., to elect as a director a nominee of a particular shareholder).

A shareholder agreement may also attempt to grant other rights to the parties with respect to the shares held by them. These rights may include

- limiting share transfers to the transactions permitted by the agreement and/or providing for certain rights of first refusal on any disposition of shares governed by the shareholder agreement;
- giving existing shareholders a pre-emptive right to purchase securities issued from treasury before they can be issued to other persons or entities;
- giving a shareholder (or group of shareholders) with a significant interest in the corporation approval rights over fundamental transactions such as a sale of the corporation or any of its material assets or the incurring of indebtedness; and
- receiving certain financial and other information regarding the corporation beyond the minimum disclosure obligations of the applicable corporate statute.

All rights granted in a shareholder agreement should always be viewed as subject to the provisions of the corporation's articles of incorporation. For example, the articles will provide for a certain size of the board of directors, and that restriction would not be supplanted by any provision in a shareholder agreement.

A USA is distinct from other shareholder agreements in that it must initially be signed by all of a corporation's shareholders. It is also the only contractual mechanism by which the powers of the directors to manage the business and affairs of the corporation can be restricted.

A USA governs

- the manner in which the directors manage the business and affairs of the corporation;

and may also address other matters including

- the manner in which all shareholders may vote their shares;
- the manner in which all shareholders may transfer or otherwise dispose of or encumber their shares;
- the manner in which the corporation may issue new securities from treasury;
- mandatory transfers in the event of disability, death, bankruptcy or insolvency, or other negotiated circumstances; and
- dispute resolution in the event of conflict.

In any corporation subject to a USA, the provisions of s. 108(5) of the *OBCA* apply and give a shareholder who is a party to the USA "all the rights, powers, duties and liabilities of a director of a corporation, *whether arising under this Act or otherwise*" (emphasis added), including any defences available to the directors, to the extent the USA restricts the powers of the directors.

This attribution of duties and liabilities has broad application and could include, for example, a director's liability to employees for unpaid wages. Care must be taken in drafting USA provisions to ensure that the shareholders do not unknowingly acquire liability that would ordinarily vest in directors with respect to certain aspects of the management and supervision of the corporation's business. The implications for shareholders who acquire directorial liability are potentially expansive and severe pursuant to both the common law and various statutes. The foregoing is also important for new shareholders of a corporation in that ss. 108(4) and (7)–(8) of the *OBCA* provide that any new shareholder (i.e., any shareholder who acquires shares from a corporation or purchases shares from an existing shareholder) of a corporation that is the subject of a USA then in effect will be deemed to be bound by the terms of the USA unless, at the time of acquisition of such shares, such new shareholder acquired the shares for value and did not have notice of the USA, in which case ss. 108(7) and (9)–(11), as applicable, provide such shareholder with a right of rescission and/or certain other remedies.

3. Common provisions of a unanimous shareholder agreement

The USA can be the most comprehensive shareholder agreement that may be prepared for a corporation and its shareholders.

There are many forms of shareholder agreements, and no one agreement should be considered a prototype, but many agreements will deal with some or all of the matters set out below.

3.1 The parties

For a USA to be effective, all of the shareholders must be party to the agreement. It is common practice to have the corporation be a party to the agreement.

3.2 Affairs of the corporation

A USA will stipulate how the management of the business and affairs of the corporation by the directors is to be restricted, and the agreement may therefore mandate certain matters (e.g., that a particular bank will be the banker of the corporation) and may require that certain actions can only be taken with the consent of the shareholders or a particular majority of the shareholders (e.g., the issuance of additional securities, the incurring of debt by the corporation, the pledge of the corporation's assets as security for any debt, the corporation entering into any material agreement and/or any agreement outside of its normal course of business, or any change to the corporation's articles or by-laws). If the consent of shareholders or a particular majority of shareholders is to be required with respect to certain fundamental actions of a corporation that would normally fall under the authority of the board of directors to determine and the corporation is not subject to a USA, such restrictions will need to be set out in the corporation's articles in order to be enforceable.

3.3 Loans and guarantees

In many shareholder agreements, consideration is given to the financing of the corporation, and an agreement may deal with the sources of financing (both at start-up and in the future) and any obligation of shareholders to contribute to that financing.

3.4 Share issuances and transfers

A principal objective of most shareholder agreements, including a USA, is to control the issuance of shares by the corporation and the transfer of shares among its shareholders. This is usually accomplished by prohibiting share issuances and transfers (including, for example, pledges of shares by shareholders) except as specifically permitted by the agreement. Common mechanisms used to control dispositions of shares are pre-emptive rights, shotgun clauses, rights of first refusal, piggy-backs, and drag-alongs.

3.4.1 Pre-emptive rights

A pre-emptive rights clause gives existing shareholders (or each shareholder holding a minimum specified number or percentage (and often specific class) of shares) the first right to purchase any new shares that a corporation proposes to issue. This right allows a shareholder to limit the dilutive effect of treasury offerings if the shareholder chooses to purchase shares that would otherwise be issued to other persons. For example, a shareholder who owns 10% of the shares of a corporation and who has pre-emptive rights pursuant to a shareholder agreement would typically have the right to purchase 10% of any new issuance of shares before such shares could be issued to any other shareholder or a non-shareholder. If provided for in the shareholder agreement, the shareholder could also have a right of over-subscription that would permit the shareholder to purchase more than the shareholder's initial 10% allocation to the extent that other shareholders do not exercise their own full *pro rata* pre-emptive rights.

3.4.2 Shotgun clauses

A shotgun (or buy-sell) clause provides a mechanism whereby any shareholder can attempt to sell his or her shares or acquire the shares of any other shareholder.

In a simple shotgun/buy-sell arrangement, the triggering shareholder fixes the price per share for a purchase of another shareholder's shares, or for a sale of the triggering shareholder's shares, in a notice that is delivered to the other shareholder. This notice can be a notice of an offer to buy or a notice of an offer to sell. The other shareholder/recipient of the offer can choose to buy the shares of the shareholder who has given the notice, or sell the recipient shareholder's own shares, at the price per share fixed by the "offer."

A shotgun/buy-sell provision generally only works equitably where each of the parties has sufficient financial capacity to exercise a purchase under the shotgun. Where the parties are not of equal financial capacity, this type of clause can work an unfairness against the party of limited means. To try to address such possible unfairness, some agreements provide a specific time delay before any shareholder can use the shotgun/buy-sell provision.

In some shotgun/buy-sell provisions, a "penalty" clause is included. In the event the purchasing party fails to complete the share purchase in accordance with the procedural requirements of the applicable clause, a penalty is invoked to allow for the transfer of the shares of the defaulting shareholder to the non-defaulting shareholder at a significant discount.

3.4.3 Rights of first refusal

Rights of first refusal are frequently used in shareholder agreements and provide shareholders with a first right to purchase shares from another shareholder who has received a written offer from an arm's length third party to purchase that shareholder's shares, which that shareholder is willing to accept. In other words, before a shareholder can sell its shares to a third party (which could be another existing shareholder of the same corporation), such selling shareholder must first offer to sell such shares to the other shareholders before the selling shareholder can complete any transaction with the third party. The purchase would be made on the same terms and conditions as set out in the original arm's length offer to purchase from the third party. This type of right of first refusal is often referred to as a "hard right" since the selling shareholder must have received a firm offer from the purchaser before the right of first refusal can be triggered.

Some rights of first refusal permit a shareholder to offer to sell its shares to the other existing shareholders at a price that the selling shareholder believes it would be able to sell its shares to a third party. If the other shareholders do not agree to purchase the offered shares, the selling shareholder then has a period of time following the expiry of the internal offer to find a buyer for the shares at the same price and terms offered to the other shareholders. This type of right of first refusal is generally referred to as a "soft right" since it does not require the selling shareholder to have a firm offer in hand before he or she triggers the right of first refusal.

A right of first refusal can be a significant restriction on the ability of any shareholder to dispose of his or her shares to a third party. In fact, it is very difficult to dispose of shares subject to a right of first refusal without actively and directly involving the shareholders who benefit from the right of first refusal in the sale process. Seldom are third parties willing to make an offer and then wait on the sidelines to allow rights of first refusal to run their course.

3.4.4 Piggy-backs

In a corporation where there are minority shareholders, a "piggy-back" clause can provide a meaningful mechanism for the protection of these minority shareholders.

A piggy-back clause can be used both in lieu of and in conjunction with a right of first refusal. The piggy-back provisions may make the right of first refusal redundant.

A piggy-back clause requires a selling shareholder to obtain a *bona fide* offer in writing from a third party to acquire at a fixed price per share not only the shares of the selling shareholder but also the shares of all minority shareholders. The piggy-back clause then gives those minority shareholders the option to sell their shares together with the selling shareholder at the same price per share and on the same terms as the selling shareholder. In most cases where a piggy-back clause is used in a shareholder agreement, it is intended to provide minority shareholder protection and to apply to a majority shareholder selling his or her shares. In other cases, a piggy-back clause may apply to all shareholders such that any selling shareholder must first obtain a third-party offer that would allow all other shareholders to sell their shareholdings at the same price per share and on the same terms as the selling shareholder. Piggy-back rights are sometimes referred to as co-sale rights.

3.4.5 Drag-alongs

The corollary to a piggy-back right is a drag-along. A drag-along right requires that in the event an offer is made for all or substantially all of the shares or assets of

a corporation and such offer is supported by the owners of a specified number or percentage of shares (typically, at least a majority of the shares), all shareholders are required to vote in favour of and, if applicable, tender their shares to the offer. A properly drafted drag-along provision in a shareholder agreement effectively provides that minority shareholders (who are party to the agreement) must support a transaction approved by the majority shareholders.

3.4.6 Disability/death/insolvency of a shareholder

A USA often provides that in the event of a shareholder's disability, death, or insolvency, the remaining shareholders and/or, in many cases, the corporation shall be obligated to purchase (or at least have the option to purchase), and the personal representative of the deceased shareholder or the disabled/insolvent shareholder shall be obligated to sell, the shares of the disabled, deceased, or insolvent shareholder.

Two important issues to be considered in any mandatory transfer of shares in the event of disability, death, or insolvency are the source of the moneys required to complete the purchase and the establishment of the value of the shares to be acquired.

Under some agreements, disability and life insurance is obtained on each shareholder to fund all or part of the share purchase on the disability or death of that shareholder.

To establish a value for the shares, the term "fair market value" is frequently applied. This is a term that leaves room for future debate on what that value is, and it is frequently easier to facilitate a mandatory transfer if either the actual value of the shares or the method of valuing the shares is clearly set out, identifying with precision how share value will be established.

3.5 Family Law Act

Many shareholders are concerned that matrimonial conflict may destabilize the shareholdings of a corporation.

In some cases, care is taken at the time a USA is prepared to ensure that the spouse of each participating shareholder produces a waiver of any claims to the shares of the shareholder or a waiver of any right to information respecting the corporation, together with a certificate of independent legal advice. It is, however, frequently not possible to obtain such documentation.

An alternative would be to require the sale of the shares of any shareholder in the event an application or proceeding is brought by or against that shareholder under the *Family Law Act* (*FLA*).

In such an event, the shareholder involved would be required to provide satisfactory evidence to the other shareholders within a fixed period (e.g., 90 days) that the claims being asserted in the proceedings shall not affect, encumber, or interfere with that shareholder's shareholdings.

Should the remaining shareholders not be satisfied with the evidence provided or should the shareholder fail to disclose his or her involvement in an application under the *FLA* that may affect that shareholder's shares, the corporation or the remaining shareholders have the right to purchase those shares, *pro rata*, for a value set in the same manner as it would be set in the event of the death of a shareholder or other triggering event.

Chapter 22
Share capital

1. Legal nature of a share

The ownership interests in a business corporation are represented by "shares." A share has been legally categorized as a chose in action, personal property, and personal estate. It is an equity security and a fractional part of the capital of a corporation. As a fractional part of the capital, a share confers upon the holder rights to a proportionate share of the assets of the corporation, whether by way of dividend or upon a distribution of assets on the winding-up of the corporation.

The corporation's assets are the property of the corporation, and the shares of the corporation are the property of the shareholders. A share certificate is evidence that the person in whose name the certificate is registered is a shareholder. A share may carry such rights as the right to dividends, the right to vote, and the right on dissolution of the corporation to participate in the distribution of assets. Certain incidental rights arising from ownership of shares are to

- receive a share certificate in respect of the shares held;
- receive notices of meetings of shareholders (usually applicable in the case of voting shares only);
- receive financial statements;
- inspect minutes of meetings of shareholders and certain documents and registers required to be maintained pursuant to the various statutes; and
- apply to court for a winding-up (i.e., a dissolution) of the corporation and other relief.

Shares are transferable by the shareholder although that right may be restricted by law or by contract.

2. Authorized capital

Share capital is divided into "authorized capital" and "issued capital." Ontario's *Business Corporations Act* (*OBCA*) and its regulations require the articles of incorporation of each Ontario business corporation to set out the classes, any maximum number of shares that the corporation is authorized to issue, and if there is more than one class of shares, the conditions attaching to each class. Authorized capital is the amount of each class of capital that a corporation, by its articles, is authorized to issue (i.e., a corporation's authorized capital could be an unlimited number of Common Shares, 1,000,000 Class A Preference Shares, and an unlimited number of Class B Preference Shares).

3. Issued capital

"Issued capital" is that part of the authorized capital that has been issued to the shareholders. The *OBCA* requires that shares be fully paid for in cash or cash equivalent (not a promissory note) before they can be issued. The "unissued capital" of a corporation is the unissued balance of the authorized capital.

4. The capital clause

4.1 Classes of shares

4.1.1 One class of shares

If the corporation will have only one class of shares, the *OBCA* provides that such shares are equal in all respects and must carry certain rights that will automatically apply to all of the issued shares of such class. Subsection 22(3) provides that the rights attaching to that one class of shares shall include

- the right to vote at all meetings of shareholders; and
- the right to receive the remaining property of the corporation upon dissolution.

Because the above rights apply automatically, it is not necessary to provide for such rights in the articles. This one class of shares may be given any name, although shares of this class are usually designated "common" shares.

4.1.2 More than one class of shares

If the corporation is to have more than one class of shares, s. 22(4)(a) of the *OBCA* requires that the specific rights, privileges, restrictions, and conditions attaching to the shares of each class must be set out in the articles. The s. 22(3) rights set out above must be attached to at least one class of shares or allocated among the various classes of shares (s. 22(4)(b)). One or more of the classes will usually be called "special" or "preference" shares.

4.2 Number of shares

The articles of an *OBCA* corporation may, but need not, contain a restriction on the maximum number of shares of any class that the corporation is authorized to issue. Accordingly, the corporation may be authorized to issue "an unlimited number" of shares of a specific class or a specified number of such shares.

Often incorporators will wish to create an unlimited number of shares when establishing a class to afford the

greatest flexibility in the future in issuing shares. If the articles provide for a maximum number of shares of any particular class, articles of amendment will be required if the corporation subsequently desires to issue a greater number of shares of that class. Conversely, there may be instances where a maximum number of shares of a particular class is desired, such as where tax planning is involved, where conversion rights exist, or where there are other similar arrangements designed to restrict future issuances of a particular class of shares.

5. Stated capital account

Each *OBCA* corporation is required to maintain a separate stated capital account (an accounting record of amounts received for the issuance of shares and of adjustments to those amounts) for each class and series of shares that it issues (*OBCA*, s. 24(1)). In simplified terms, the amount received by the corporation for the issue of each share is the amount that goes into the stated capital account for shares of that class or series. When shares are issued in consideration of property or past services, rather than for money, the directors are required to determine

- the amount of money the corporation would have received if it had issued the shares for money; and
- either the value of the property or past services, or that the property or past service has a value not less than the amount the corporation would have received if it had issued the shares for money.

If the directors determine the value of the property or past services, then this amount is added to the stated capital account. However, if the directors merely determine that the value was not less than the amount of money the corporation would have received if it had issued the shares for money, then the amount of money the corporation would have received is the amount to be added to stated capital.

Specific rules for additions to and reductions from the stated capital account are found in ss. 24(3)–(11) of the *OBCA*.

6. Paid-up capital (PUC)

6.1 General

Paid-up capital (PUC) is an important income tax concept in the federal *Income Tax Act* (*ITA*). PUC is an amount that a private corporation may return to its shareholders free of income tax. That is, PUC generally represents the after-tax amount of money contributed by a shareholder on the original investment in shares of a corporation.

Understanding and being able to compute (and track) PUC is important in determining the income tax implications of various corporate distributions (and reorganizations) to or involving shareholders, such as a redemption or repurchase of shares, corporate dissolution, or reorganization of share capital.

For example, on redemption of a share or a purchase of a share for cancellation, the amount paid by a corporation to a shareholder in excess of the PUC of the share(s) is treated as a deemed dividend (*ITA*, s. 84(3)) and is taxable as such to the shareholder.

PUC is similar to stated capital (which is a corporate law concept), but whereas stated capital is determined for a class or series of shares, PUC can be determined for a class of shares, for one particular share, or for all the issued shares of a corporation. PUC is often calculated for a particular share, and in such a case, the PUC of a share is the PUC for the particular class of shares divided by the number of issued shares in the class (*ITA*, s. 89(1)).

While the PUC of a class of shares is generally equal to the stated capital of that class, several sections of the *ITA* specify that the PUC of a share or class of shares is to be adjusted in certain circumstances.

Example

Aco is a newly incorporated corporation and issues 10 common shares to X for $1 each. The stated capital is the amount of consideration received by the corporation for issuing the shares, and this is equal to $10 for Aco's class of common shares. Since the *ITA* specifies that PUC is computed by starting from the stated capital of the shares, and the stated capital for the common shares is $10, then the PUC of the class of common shares is also $10. The PUC of each common share is therefore $1 ($10 divided by the 10 issued common shares). Assume that two years later, Aco issues a further 10 common shares to Y for $2 each. Now the total stated capital of the class is $30 (calculated as the original $10 Aco received from X plus the $20 Aco now receives from Y). Similarly, the PUC of the class of common shares is also $30. As well, since there are now 20 common shares issued and outstanding (10 to X and 10 to Y), the PUC for each common share owned by X and Y is $1.50 (i.e., the PUC of $30 divided by the 20 common shares).

On the other hand, assume instead in this same example that two years later Aco issues a further 10 common shares to Y for $0.50 each. Now the total stated capital of the class is $15 (calculated as the original $10 Aco received from X plus the $5 Aco now receives from Y). Similarly, the PUC of the class of common shares is also $15. As well, since there are now 20 common shares issued and outstanding (10 to X and 10 to Y), the PUC for

each common share owned by X and Y is $0.75 (i.e., the PUC of $15 divided by the 20 common shares).

6.2 Keeping PUC low

When a share in the capital stock of a corporation is issued, the stated capital account maintained by the corporation for that class is generally increased by the amount of the consideration received by the corporation for issuing the share. However, s. 24(3) of the *OBCA* and s. 26(3) of the corresponding federal law, the *Canada Business Corporations Act* (*CBCA*), permit that in certain non-arm's length circumstances or transactions, the directors of a corporation may add to the stated capital account of a class of shares, an amount less than the consideration received by the corporation for issuing the shares. There are usually income tax reasons for the directors of a corporation keeping (or holding down) the stated capital account for a class of shares to a lower amount. For example, if shares of a corporation are redeemed and the PUC of the shares being redeemed is lower than the redemption amount being paid by the corporation, the excess of the redemption amount paid over the PUC of the shares is treated and taxed as a deemed dividend (and not as a capital gain) to the shareholder. For almost all taxpayers in 2011 (except those taxpayers in the highest marginal tax bracket in the following provinces and territories: British Columbia, Saskatchewan, Manitoba, Ontario, Quebec, Nova Scotia, Prince Edward Island, and Nunavut), eligible dividends are currently taxed at rates that are lower than capital gains.

6.3 Differences between stated capital account and PUC

It is possible that the stated capital and PUC of a class of shares will be identical. However, it should be noted that in certain circumstances or as a result of certain transactions or corporate reorganizations, the tax rules result in changes to the computation of PUC such that PUC for a class of shares will be different from the stated capital of the same class of shares.

For example, this often occurs where property (i.e., assets) is transferred by a taxpayer to a corporation under the provisions of s. 85(1) of the *ITA*. In this case, one has to be careful of the tax rule in s. 85(2.1) of the *ITA*, which states that the PUC of the shares issued by the corporation as consideration (i.e., payment) for the transferred assets generally cannot exceed the aggregate elected amount of the transferred assets (to the corporation) less any non-share consideration received by the transferor. Since the elected amount for assets is carefully chosen to ensure a deferral of tax on the transfer to the corporation, this amount is often less than the fair market value of the assets. Since the directors of the corporation add to the stated capital account of the class of shares issued (in exchange for the assets) the fair market value of the assets received less any non-share consideration paid by the corporation, the stated capital of the class of shares issued may often be greater than the elected amount (and therefore differ from the PUC for the class of shares).

Example

X is an individual taxpayer who owns shares of corporation Aco, and X wishes to transfer his or her shares to another corporation, Xco. X and Xco do not deal at arm's length under the *ITA*, and after X transfers his or her shares of Aco to Xco, the two corporations (Aco and Xco) are "connected" within the meaning of s. 186(4) of the *ITA*. In return for transferring his or her shares to Xco, Xco pays X by issuing shares of Xco to X. In these circumstances, the tax rules in s. 84.1 of the *ITA* apply to reduce the PUC of the shares of Xco issued to X to equal the greater of the PUC of the transferred shares (i.e., X's shares of Aco) or X's actual adjusted cost base (ACB) in his or her shares of Aco.

Accordingly, as a matter of good corporate law "housekeeping or practice," in this type of transaction (i.e., where the PUC of the issued shares is or will be affected by one of these provisions in the *ITA*), it may be helpful for the directors to add to the stated capital for the class of shares a lesser amount equal to the reduced or limited PUC, as permitted under corporate law statutes. In a non-arm's length transaction, this practice is permitted by s. 24(3) of the *OBCA* and s. 26(3) of the *CBCA*. This practice is also permitted in an arm's length transaction involving an exchange of property, provided that the corporation and all holders of shares in the class or series so issued consent to the exchange (*OBCA*, s. 24(3)(a)(iii); *CBCA,* s. 26(3)(a)(iii)). As a result of the directors taking this action, there will be fewer circumstances in which the amount of the stated capital and PUC of a class of shares are different. It is also important for corporate law practitioners to be aware that when determining the PUC of a share, they should not simply rely on a corporation's financial statements (i.e., the equity section on the corporation's balance sheet), which generally only reflects the stated capital of the issued shares (and therefore is not necessarily the PUC of the shares).

6.4 Difference between PUC and ACB

The PUC of a share (or class of shares) and a shareholder's ACB in his or her shares are important in order to determine the income tax implications on a redemption (or repurchase) of the share(s). PUC

represents the average issue price (i.e., the amount paid to the corporation) for a particular class of shares. Tax practitioners often describe PUC as being "internal" with the corporation. On the other hand, a shareholder's ACB in his or her shares is the amount of money (or the purchase price) paid by the shareholder to acquire the share(s). Likewise, tax practitioners often describe ACB as being "external" to the corporation and applying at the shareholder level.

Example

Aco, a newly incorporated corporation, issues two common shares to X for $1 each. X subsequently sells one of his or her common shares to Y for $5. The PUC of the class of common shares remains at $2, which is the amount of money the corporation received initially on issuing the common shares (i.e., PUC is internal to the corporation). The PUC of each common share owned by X and Y is $1 each. X's ACB in the one common share he or she still owns is $1 (the amount he or she originally paid for the common share.) However, Y's ACB in the one common share he or she bought from X is $5—the amount he or she paid to X for the common share.

6.5 Problem on issuing shares for property

Aside from corporate law issues, there are income tax consequences if the directors of a corporation add to the stated capital account for the class of shares being issued an amount that is greater than the value of consideration received by the corporation. The tax rule in s. 84(1) of the *ITA* will deem the excess amount added to the stated capital account for the class of shares to be a dividend to the shareholder. This problem can arise when property is transferred to a corporation in exchange for the issuance of shares.

Example

X, an individual taxpayer, wishes to transfer land to a corporation. X's ACB in the land is $100, and the land is estimated by X to be worth or have a fair market value of $150. In exchange for the land, the corporation will issue some common shares to X. The directors of the corporation determine that $150 is the value of the consideration (i.e., land) it received for issuing the common shares. The $150 amount is added to the stated capital and PUC of the common shares. Later, it is determined that the land received by the corporation is only worth $130. Consequently, the increase in the PUC of the common shares in excess of the value of the land is $20 (i.e., $150 minus $130), and this $20 excess amount is deemed to be and taxed to X the shareholder as a dividend. The lesson in this case is for the directors and transferor to be careful whenever property (with an uncertain value) is transferred to a corporation in exchange for the corporation issuing shares. The directors should not add to the stated capital account of the shares being issued an amount that is greater than the actual fair market value of the property being transferred. Prudent practice would suggest the parties (transferor and corporation) include a price adjustment clause in their transfer agreement.

7. Rights, conditions, and restrictions on shares

Some of the more usual rights, privileges, restrictions, and conditions attaching to shares in a corporation that has more than one class of shares are discussed below.

7.1 Preferential dividends

Special or preference shares frequently carry the right to a "preferential" dividend entitling the holder of such shares to the payment of a specified dividend before any dividend is paid upon a junior class of shares (such as the common shares). The preferential dividend can be a fixed percentage (based upon the amount paid up per share) or a fixed amount usually expressed as a monetary amount, which in either case, must be set out in the articles.

The special shares may provide for a further participation in the earnings of the corporation over and above the specified preferential dividend.

7.2 Cumulative or non-cumulative dividends

A dividend may also be "cumulative," in which case the dividend, if not paid in any particular year, accumulates and must be paid in a future year. Although cumulative dividends are not paid until specifically declared by the board of directors, such dividends continue to accumulate and must be paid for all periods in arrears before dividends are paid on junior shares. Alternatively, the dividend may be "non-cumulative," in which case the right to receive dividends in each year expires at the end of the corporation's fiscal year if not declared and the shareholder loses forever the right to a dividend for such year. In the absence of any specific language in the special share conditions, the dividend is presumed to be cumulative where a preference is conferred and nothing more said.

Since shareholders are not creditors of the corporation, they may not demand payment of a dividend until specifically declared by the directors, whether or not the dividend is cumulative; once declared, the dividend becomes a debt owing by the corporation.

7.3 Return of capital

The holders of special or preference shares may be entitled to preference as to the repayment of their capital

(i.e., the amount paid for the share when it was originally issued) in the event of the dissolution or winding-up of the corporation. A preference as to the repayment of capital must be specifically set forth in the terms and conditions attaching to the special shares. Typically, when creating a true "preference" special share, the special shareholder will be given a preference as to the return of his or her capital and any unpaid dividends, and thereafter all rights to participate in additional funds of the corporation will disappear. The matter of any declared but unpaid dividends or even undeclared dividends in the event of a cumulative dividend should be addressed in the share conditions as well.

When a share is redeemed or repurchased by the corporation, the PUC for the share is the amount that can generally be returned to a shareholder without income tax. In the (rare) event that the PUC of a share is greater than the shareholder's ACB for the share, the return of the PUC may result in a capital gain to the shareholder. The amount of the capital gain would be equal to the amount by which the PUC exceeds the shareholder's ACB.

Example

In year 1, X subscribes for and pays $100 for one common share in Aco, a new corporation. It is year 2, and Aco has not done very well financially. In year 2, Y subscribes for and pays $10 for one common share in Aco, such that there are now 2 issued and outstanding common shares of Aco (one to X and one to Y). The stated capital of the class of common shares is now $110 in total (i.e., the $100 the corporation initially received from X and $10 later received from Y), and the PUC is also $110 for the class of common shares or $55 for each common share (i.e., $110 of PUC divided by the 2 common shares). It is now year 5, Aco has been more successful financially in its operations and decides to repurchase (redeem) Y's common share for $125. The income tax consequences to Y from this share redemption are

- a deemed dividend of $70 (redemption proceeds of $125 less PUC of $55); and
- a capital gain of $45.

The capital gain is calculated as the redemption proceeds of $125 minus (reduced by) the $70 deemed dividend already taxed to Y, in excess of Y's ACB of $10 (the amount Y initially paid for his or her one common share).

If in year 5, Aco had instead redeemed X's common share for $125, the income tax consequences to X would be

- a deemed dividend of $70 (redemption proceeds of $125 less PUC of $55); and
- a capital loss of $45.

The capital loss to X is calculated as the redemption proceeds of $125 minus (reduced by) the $70 deemed dividend already taxed to X, in excess of X's ACB of $100 (the amount X initially paid for his or her one common share).

It should be clearer now that stated capital and PUC is important to shareholders and can give rise to very different tax consequences to shareholders who

- subscribe for the same class of shares at different times; and
- pay a different subscription price for the shares.

7.4 Conversion

7.4.1 Convertible shares

A corporation's articles may provide that the shares of one authorized class is convertible into shares of another authorized class. Such a conversion is typically based on an established ratio set out in the share provisions; for example, four preference shares can be converted into one common share.

In granting such a conversion privilege, the conditions of the special share class should also provide for the protection of the privilege in the event that the number of issued common shares is increased or subdivided. This protection, referred to as an "anti-dilution" provision, automatically adjusts the conversion ratio upon the occurrence of such events.

A share conversion, i.e., one share into a share of another class or all the shares of one class into shares of another class, may take place on a tax-deferred basis provided certain requirements of the *ITA* are satisfied. A tax-deferred share conversion might be available under the provisions in ss. 51, 85, 85.1, or 86 of the *ITA*. While some of these tax-deferred provisions of the *ITA* may apply automatically, other sections may require an election to be filed by taxpayers.

7.4.2 Other convertible securities

The authority for a corporation to issue convertible securities (e.g., warrants, options, or rights) other than shares is found in s. 27 of the *OBCA*. If the articles of the corporation limit the number of shares of a particular class that is authorized, it is necessary to "reserve" sufficient shares to fulfill any conversions of such convertible securities (*OBCA*, s. 27(3)).

7.5 Purchase or redemption of shares

The drafters of the share conditions have to determine the circumstances, if any, under which the corporation will be entitled to require shareholders to sell their shares

to the corporation at a price pre-determined and established in the share conditions and specified in the articles (a redemption) and the circumstances, if any, under which shareholders will be entitled to require the corporation to purchase their shares at a price pre-determined and established in the share conditions and specified in the articles (a retraction). Although these events are commonly referred to as "redemption" and "retraction," respectively, s. 32 of the *OBCA* uses only "redemption" to encompass both concepts. Aside from the pre-determined nature of a redemption and retraction as set out in the share terms, the shareholder and the corporation may always arrive at an agreement as to the price at which the corporation would be prepared to purchase (subject to certain restrictions) and the shareholder would be prepared to sell the shares (a purchase) (*OBCA*, ss. 30–31).

From the point of view of the corporation, the advantage of being able to redeem shares is that the corporation may, subject to the specific terms of the share conditions, redeem the shares outstanding and repay the capital to the shareholders, thus removing any dividend obligation, the participation of such shareholders in the future growth of the corporation, and their voting rights. Where a share is redeemable, it resembles a debt security in that it may be "paid off" by the corporation at certain times and under certain circumstances.

7.6 Purchase or redemption of shares — income tax consequences

A corporation's redemption of a share or the purchase of a share for cancellation could result in the shareholder receiving a deemed dividend and also realizing either a capital gain or loss. The amount of the deemed dividend is equal to the amount paid by the corporation on the redemption or purchase in excess of the PUC of the share. This result should be compared to the tax consequences to the shareholder from a sale or transfer of a share to a third party. In that case, a capital gain or loss will be realized by the selling shareholder equal to the amount by which the proceeds of disposition (i.e., sale price) exceed or are exceeded by the aggregate of the selling shareholder's

- ACB of his or her shares; and
- costs (expenses) of disposing of the shares.

Example

ABC Co. redeems its one Class A Share and pays $50 to the shareholder on redemption. The paid-up capital and the shareholder's ACB of the Class A Share is $1.

The shareholder of this Class A Share will be deemed to receive a dividend of $49, calculated as follows:

Redemption proceeds	50
Less: paid-up capital	1
Deemed dividend	$49

A redemption of a share is also treated as a sale or disposition of property by the shareholder for income tax purposes. The shareholder will realize either a capital gain or loss equal to the amount by which the proceeds of disposition exceed or are exceeded by the shareholder's ACB of the share. "Proceeds of disposition" is defined in s. 54 of the *ITA*. To prevent double taxation, the rules in the *ITA* provide for an adjustment (i.e., decrease or reduction) to the proceeds of disposition equal to the amount of the deemed dividend (which is already taxable to the shareholder and on which the shareholder should not be taxed again). This prevents the amount of the deemed dividend from being taxed again in the form of a capital gain to the shareholder.

In this same example, the Class A shareholder will realize neither a capital gain nor a capital loss, calculated as follows:

Redemption proceeds	$50
Less: Deemed dividend	49
Adjusted proceeds	$1
Less: ACB	1
Capital gain/loss	NIL

If, in this same example, you were told the shareholder's ACB for the Class A was $10, then in this situation the Class A shareholder would realize a capital loss of $9, determined as follows:

Redemption proceeds	$50
Less: Deemed dividend	49
Adjusted proceeds	$1
Less: ACB	10
Capital loss	$9

The ability of taxpayers to use capital losses is more restricted under the *ITA*. The *ITA* provides that taxpayers can only deduct (i.e., use or apply) capital losses against capital gains. As a result, there may be a timing issue (and a mismatch) in the income tax treatment of a share redemption, since the deemed dividend will be included in current income and therefore subject to income tax now and yet any capital loss can only be applied or used against capital gains (if and when realized) by the taxpayer.

7.7 Sinking fund

Special or preference share conditions may provide for the establishment of a sinking fund, whereby the

corporation agrees to set aside a specific amount each year to redeem or purchase a certain number of special shares.

7.8 Voting

Often, special or preference shares are restricted, limited, or totally prohibited from having the right to vote in the election of directors (and for other purposes except as the *OBCA* provides otherwise). Sometimes a voting right will be granted to such shareholders during a period in which preferred dividends are in arrears or the special shareholders may be given the right to elect a specified number of the directors.

Although voting rights may be specifically limited in the case of special shareholders, the *OBCA* entitles even holders of non-voting shares to vote in respect of the following matters (ss. 170(1) and (3)): certain amendments of the articles and the variance of any right or condition attaching to their specific class of shares. In addition, where any amalgamation or a sale of assets would have the same effect as an amendment referred to in s. 170(1), the affected shares may vote. Except in limited circumstances that must be provided for in the articles (with respect to the statutory votes in ss. 170(1)(a)–(b) and (e) of the *OBCA*), the share conditions cannot restrict these statutory voting rights.

7.9 Pre-emptive rights

A "pre-emptive" right can be granted to existing shareholders to protect their existing proportionate holdings by having the option to take up a *pro rata* portion of any new issue of shares (*OBCA*, s. 26).

8. Changing rights of shareholders

The addition, change, or removal of any maximum number of shares that the corporation is authorized to issue, the creation of new classes of shares, the increase or reduction of capital, and other changes in the capital structure of a corporation must be effected by articles of amendment pursuant to ss. 168(1)(d)–(k) of the *OBCA*. Certain special authorizations by the holders of each class of shares pursuant to s. 170 may be required where there is more than one class of shares. Under certain types of corporate changes, shareholders may have dissent rights that allow them to require the corporation to buy back their shares (*OBCA*, s. 185).

9. Selection of shares and their terms

In structuring the share capital of a corporation, the first question to ask is whether there actually is a need for more than one class of shares. The corporation can be incorporated with only one class of shares, which may be designated "common," "Class A," etc. The question of another class or classes of shares may be deferred until such time as they may be required, at which time articles of amendment may be filed that set out the specific share conditions that can be customized to satisfy the then applicable requirements.

Of the various factors to be provided in the articles when establishing the rights, privileges, restrictions, and conditions attaching to shares, the following major share conditions should be considered if more than one class of shares is to be created:

- cumulative, non-cumulative, or partially cumulative dividends and specific dividend rates;
- preference as to payment of dividends;
- preference as to repayment of capital upon dissolution;
- participation in the distribution of the corporation's assets upon dissolution other than with respect to return of capital;
- right to elect all or part of the board of directors;
- right to convert into shares of another class;
- redemption of shares at the option of the corporation or retraction of shares at the option of the shareholder;
- purchase of shares by the corporation for cancellation; and
- conditions, restrictions, limitations, or prohibitions on the right to vote at shareholders' meetings.

The various kinds and the extent of preferences, rights, and conditions that may be attached to shares are virtually limitless and depend upon the specific requirements of each case. It should be emphasized that when drafting provisions for special or preference shares, lawyers should restrict their provisions to specifically take account of the intent of the client so as to accomplish the goal of creating a special share in the first place.

Often upon becoming a special shareholder, a person may obtain certain preferences but may, as a result, also relinquish some of the normal rights of a shareholder, such as voting and distribution of the property of the corporation upon the winding-up of that corporation.

A special shareholder is not a creditor of the corporation, and therefore it may be to the advantage of the corporation to finance by way of special shares rather than by borrowing. The articles of incorporation specifically govern a special shareholder's rights.

While the corporation may initially obtain its operating funds from the share capital provided by shareholders, it is here that the incorporator or owner of the corporation balances the issues of control and participation in the

profits of the corporation. A special or preference share is used in situations where the investor wishes to be in a position somewhere between that of a full equity shareholder (such as the common shareholder) and that of a creditor (who becomes entitled to repayment of the debt before repayment of any capital to any shareholder of any class). A special or preference share is a security that has some of the characteristics of equity capital and some of the characteristics of debt. Depending upon the rights attached to the shares, a special or preference shareholder may be in a preferred and safer position than the common shareholder, but not as safe as a holder of debt instruments. The "upside" of being a special or preference shareholder is often found in the share conditions that allow the holder to participate in the profitability of the corporation by way of dividends, which then qualify for the dividend gross-up and tax credit mechanism under the *ITA*. Other provisions that a special or preference shareholder can negotiate to allow him or her to share in the future growth of the corporation include the right to participate in the distribution of assets on liquidation, dissolution, or winding-up and the right to convert into common shares.

For the corporation, depending on the array of preferences negotiated with investors, the special or preference share may be one way to obtain equity capital without diluting either the common shareholders' control or their participation in the growth of the corporation.

10. Classes and series of shares

Under some circumstances, it may be advantageous to create more than one class of shares, each with its own rights and conditions. In other circumstances, it may be desirable to have a class of shares that permits the issuance of several series of shares within that same class, thus permitting the corporation to have "class" conditions (being those rights and conditions that attach to the class as a whole) as well as "series" conditions (being those rights and conditions, usually related to price and dividend rate, affecting the separate series issue).

The use of series shares is advantageous when the corporation will be issuing the same class of shares over an extended period of time.

Example

A class of 1,000,000 Preference Shares issuable in series is created with certain class rights and conditions; 250,000 of the Preference Shares are designated as Series A, and these shares have attached to them the class rights and conditions and a specific dividend rate. At a later point, by directors' resolution, 250,000 additional Preference Shares are designated as Series B, which while having the same class rights and conditions as Series A, are given a different specific dividend rate according to market conditions.

Series shares are created in the articles and may be provided for either at the time the class of shares is created (with the designation, rights, privileges, restrictions, and conditions of the series shares being created at the same time as the class) or by giving the directors authority in the articles to subsequently fix such conditions. If the corporation adopts series shares, then articles of amendment must be filed as each series is given its own conditions (*OBCA*, ss. 25(1) and (4)–(5)). In creating series shares, each series share within the same class must rank equally with respect to priority on dividends and return of capital in the event of the liquidation, dissolution, or winding-up of the corporation, pursuant to s. 25(3).

11. Share capitalization — advantages and disadvantages

The following is a brief summary of the advantages and disadvantages to both the corporation and the investor when funding a corporation by the issuance of share capital.

11.1 Advantages of share capital to corporation

- There is no obligation on the corporation to repay. Money is locked in as permanent capital until dissolution or distribution of assets, unless any of the following is true:
  - A retraction privilege exists.
  - A dissent right arises.
  - A court makes an order under the oppression remedy.
- There is no commitment to pay dividends. Typically, failure to pay non-cumulative dividends on special shares only means dividends cannot be paid on common shares that year. If the dividends are cumulative and preferential, then all dividends in arrears on special shares must be paid before dividends can be paid to common shareholders.

11.2 Disadvantages of share capital to corporation

- Unlike interest paid on debts, dividends are not deductible by the corporation in computing its income for tax purposes.
- Preferences may need to be very attractive (for example, high dividends) before shares are saleable.
- There may be dilution of ownership and control.

11.3 Advantages of share capital to shareholders

- As owner of a corporation, a shareholder is entitled to share in the profits. If the share is fully participating, there is no limitation on the amount of profit the shareholder can receive by way of dividends if the corporation prospers. Participation by a preference shareholder is usually limited to a specified amount, but share conditions could permit as much participation as enjoyed by common shareholders or the option to convert the preferred share into a participating common share.
- Even if dividends are not paid, profits kept in the corporation may increase the value of the shares if the shares fully or partially participate in return of capital.
- Capital gains treatment is possible if the share value increases. Only one-half of a capital gain is included in income. (Tax benefits are lost if the shareholder is in the business of trading in shares because the whole gain may then be subject to tax—as on account of income and not as a capital gain).
- Preference shares usually have priority for payment of dividends (but are usually restricted in the amount of the dividend).
- Preference shares are often redeemable or repurchasable so that capital can be returned to the shareholder.
- There are certain provisions in the *ITA* that mitigate the effect of double taxation (i.e., the dividend gross-up and tax credit mechanism) when income is earned through a corporation and later distributed to the shareholders (the owners) as dividends.
- Generally speaking, dividends can be received tax-free (because of the inter-corporate dividend deduction) by a corporation resident in Canada from either (i) a taxable Canadian corporation, or (ii) another corporation resident in Canada. This is true where the dividends are paid from either
  - the after-tax business earnings of a corporation (free from Part I income tax under the *ITA*);or
  - the after-tax investment income (earnings) of a corporation—provided the recipient shareholder corporation owns shares representing more than 10% of the votes and value of the corporation paying the dividends (free from Part IV income tax under the *ITA*).
- If the share is a voting share, the shareholder has some say in the management of the company (because the shareholder may vote in the election of directors).
- Certain fundamental changes in the corporation require shareholder approval, including, in some instances, the approval of shareholders not otherwise entitled to vote.
- Shareholders have extensive and specific remedies available to them under the *OBCA* (such as the oppression remedy).

11.4 Disadvantages of share capital to shareholders

- There is no commitment by the corporation that dividends will be paid even if the corporation makes a profit.
- There is no security for the investment.
- There is no priority over creditors. On default by the corporation in meeting its obligations, all creditors rank ahead of all shareholders.
- The shareholder may be locked-in. The shareholder may not be able to transfer his or her shares if there are restrictions on transfer and may not be able to force the corporation to redeem or purchase the shares.

12. Acquisition of corporation's own shares

12.1 Introduction

Subject to certain solvency tests discussed below and the articles of the corporation, *OBCA* corporations may "purchase or otherwise acquire" any of their issued shares (*OBCA*, s. 30(1)).

A purchase would be at the price negotiated, as contrasted with a redemption or retraction, which takes place according to the specific terms established by the share conditions and which is governed by s. 32 of the *OBCA*.

12.2 Purchase of shares by private contract

When a corporation purchases or otherwise acquires previously issued shares, other than in accordance with the share conditions (for example, by private contract with both the corporation and the shareholder agreeing on the terms of the purchase), such a purchase is governed by s. 30 of the *OBCA*. Subsection 30(2) of the *OBCA* prohibits such a purchase where the corporation cannot meet the solvency test, i.e., where there are reasonable grounds for believing either of the following:

- The corporation is, or after such purchase would be, unable to pay its liabilities as they become due.
- After the payment, the realizable value of the corporation's assets would be less than the aggregate of its
  - liabilities; and
  - stated capital of all classes of shares.

Notwithstanding such prohibitions, s. 31 provides for limited exceptions, such as the settlement or compromising of a debt or claim asserted by or against the corporation, the elimination of fractional shares, the

fulfillment of certain agreements to purchase shares, the satisfaction of the dissent rights provisions of the *OBCA*, and the compliance by the corporation with certain court orders. In some of these instances, the solvency test has been altered to make it slightly less onerous to make such a purchase (*OBCA*, s. 31(3)(b)).

12.3 Purchase or redemption of shares in accordance with conditions specified in articles

Section 32 of the *OBCA* provides that a corporation may purchase or redeem previously issued shares in accordance with the share conditions attaching to such shares as specified in the articles. The applicable solvency test is set forth in s. 32(2) of the *OBCA* and is the "easier" one.

12.4 Tax consequences

The income tax consequences to a shareholder whose shares are (re)purchased by the corporation are identical to the income tax consequences for the redemption or retraction of shares by a corporation.

13. Share certificates

A share certificate is *prima facie* evidence of the title of the shareholder to the shares represented by it, and every shareholder is entitled to a share certificate in respect of the shares held by that shareholder except where the directors of the corporation (unless prohibited by the articles) provide that all shares shall be uncertificated (*OBCA*, s. 54). The execution and content of share certificates are governed by ss. 55–56 of the *OBCA*. Only public corporations are likely to adopt uncertificated securities.

Chapter 23
Corporate changes

1. Corporate characteristics

1.1 Establishing corporate characteristics

The characteristics of a corporation are determined by the provisions of the corporation law by which it is governed and the terms of its articles of incorporation.

1.2 Changing corporate characteristics — process

The general rule (as set out in s. 168 of Ontario's *Business Corporations Act* (*OBCA*)) is that the provisions of the articles of incorporation can be amended only by means of a "special resolution," which is defined in s. 1(1) as a resolution either passed at a meeting of shareholders of the corporation by a majority of not less than two-thirds of the votes cast or consented to in writing by each shareholder of the corporation entitled to vote at such a meeting. A proposal to amend the articles may be made by the directors or by any shareholder who is entitled to vote at an annual meeting of shareholders (*OBCA*, s. 169(1)). Therefore, it is not necessary for there to be a directors' resolution approving the proposed amendment when the amendment is suggested by a shareholder.

The notice calling a meeting of shareholders to consider an amendment to the articles must set out the proposed amendment in a manner that will enable the shareholders to understand the proposal and to exercise an intelligent judgment as to whether to vote for or against it.

If the amendment gives rise to a dissent right, the notice must also state that a dissenting shareholder is entitled, pursuant to s. 169(2) of the *OBCA*, to be paid the fair value of his or her shares in accordance with s. 185. If the corporation is an "offering corporation," management must solicit proxies and issue a management proxy circular pursuant to ss. 111–112.

If there are only a few shareholders, it may be possible to have all the shareholders entitled to vote sign a resolution in writing, which pursuant to s. 104, would satisfy all the requirements relating to meetings of shareholders.

In the case of a proposed amendment to a corporation's capital structure, where the shares of a particular class or series will be affected by the amendment in a manner set out in s. 170 of the *OBCA*, the holders of such shares are entitled (with certain exceptions) to vote separately on the proposed amendment whether or not shares of such a class or series would otherwise carry the right to vote. In such circumstances, the proposal must be approved separately by a special resolution of the shareholders of each class or series entitled to vote. Shareholders of a class or series who have a right to vote separately also have a dissent right pursuant to s. 185(2) of the *OBCA*. Any shareholder may also dissent if the amendment to the articles is to add, change, or remove any provisions restricting or constraining the issue or transfer of that shareholder's shares, or to add, change, or remove any restriction upon the business the corporation may carry on or the powers it may exercise pursuant to s. 185(1). In these cases, if the proposed amendment to the articles is approved and a shareholder dissents in accordance with the procedure in s. 185, the corporation may be required to purchase the shareholder's shares for their fair value.

After a special resolution amending the articles of a corporation has been passed, the articles of amendment must be sent to the Director in duplicate. The Director will then issue a certificate of amendment to the corporation endorsed on the articles of amendment.

Subsection 168(3) of the *OBCA* provides that the directors may, if authorized by the shareholders in a special resolution amending the articles, revoke the resolution before it is acted upon without further approval of the shareholders. This authority enables the directors to see how many shareholders dissent in circumstances where a dissent right exists. If more shares are tendered to the corporation by dissenting shareholders for purchase by it than the directors wish the corporation to buy, the directors have the option of revoking the amendment of the articles and so terminating the dissent right pursuant to s. 185(14).

There are a few exceptions to the general rule that a corporation's articles may only be amended by a special resolution. Although the names of the first directors and the address and place of the registered office are included in articles of incorporation under the *OBCA*, a change in the directors or in the address of the registered office within the municipality or geographic township where the registered office is located or a change in the municipality or geographic township in which its registered office is located to another place in Ontario does not require an amendment to the articles (*OBCA*, ss. 14(3)–(4)). Instead, notice of such changes is to be

filed under Ontario's *Corporations Information Act* (*CIA*).

A corporation may be incorporated with a number name or with a non-number name. The directors alone may amend the articles to change the number name of a corporation to a non-number name pursuant to s. 168(4) of the *OBCA*.

Where the articles authorize a corporation to have a class of shares that may be issued in series, the articles may also authorize the directors to fix the number of shares in a series and their rights, privileges, restrictions, and conditions.

Finally, the general rules applicable to the amendment of the articles may be altered if the articles themselves provide for some greater number of votes to amend some provision in the articles than would otherwise apply. For example, the articles might contain a provision that a restriction as to the business a corporation may carry on may not be altered without the approval of all the shareholders.

1.3 Certain corporate changes

1.3.1 Change of corporate name

If a corporation wishes to change a name that is not a number name, the shareholders must pass a special resolution. However, under s. 171(3) of the *OBCA*, no corporation is permitted to change its name if the corporation is unable to pay its liabilities as they become due or the realizable value of the corporation's assets is less than the aggregate of its liabilities.

1.3.2 Reduction in stated capital

(a) Corporate considerations

A corporation is required pursuant to s. 24(1) of the *OBCA* to maintain a separate "stated capital" account in its accounting records for each class and series of shares it issues. The stated capital account for each class and series of shares generally records the full amount of any consideration received by the corporation for such shares (*OBCA*, s. 24(2)).

It is permissible to reduce the stated capital of a corporation without amending the articles, but a special resolution of shareholders is required, and the appropriate solvency test must be satisfied under s. 34 of the *OBCA*. If the holders of a class or series of shares of a corporation are affected differently from the manner in which the holders of any other class or series of shares would be affected, the former are also entitled to vote separately on the proposal to reduce the stated capital pursuant to s. 34(2).

If stated capital is to be reduced by means of an amendment to the articles, the solvency test in s. 34(4) of the *OBCA* applies (*OBCA*, s. 171(2)).

(b) Income tax considerations

Under the federal *Income Tax Act* (*ITA*) any reduction to stated capital will have income tax consequences. Stated capital is important for income tax purposes, since under s. 84(4) of the *ITA*, it is the starting point for computing "paid-up capital" (PUC). Tax practitioners often refer to PUC as "your friend," since PUC represents an amount that a private corporation can return to its shareholders free of income tax.

Generally speaking, the PUC for a class of shares will be equal to the corporation's stated capital for the class of shares. However, in certain circumstances, the PUC for a class of shares may be different from the stated capital of that class (i.e., as a consequence of certain non-arm's length transfers of property to a corporation and the application of special tax rules in the *ITA* that dictate adjustments to PUC). This can have further and significant tax consequences to shareholders in later share reorganizations.

While corporate law speaks of the stated capital of a class or series of shares, PUC can be determined for a class of shares, for one particular share, or for all the issued shares of a corporation. Since s. 89(1) of the *ITA* defines PUC "in respect of a share of any class of the capital stock" as the amount equal to the PUC of the class of shares divided by the number of issued shares of that class outstanding, PUC is often calculated for a particular share or on a per share basis.

(i) Private corporations

Subsection 84(4) of the *ITA* provides that when a corporation reduces its PUC on any class of shares (other than by redemption or repurchase, which has tax consequences under a separate rule), the corporation is deemed to have paid a dividend to the shareholders to the extent the amount actually paid (on the PUC reduction) exceeds the PUC of the class of shares. If this PUC reduction involves a Canadian corporation, this deemed dividend will be subject to the dividend gross-up and dividend tax credit mechanism.

The tax rules also deem all shareholders of the class to receive this dividend (and on a *pro rata* basis) even if no actual distribution of funds is made to the shareholders. A PUC reduction also has consequences for capital gains purposes. Subparagraph 53(2)(a)(ii) of the *ITA* provides that the adjusted cost base (ACB or tax cost) of shares is to be reduced by the amount received by the shareholder as a tax-free return of capital. This reduction or "tax

grind" to a shareholder's ACB in shares reflects the fact that funds have been removed or withdrawn from the corporation. It should be pointed out that in the event a shareholder's ACB becomes negative as a result of an adjustment (i.e., in circumstances where the PUC of the share(s) is greater than the shareholder's ACB in the shares), a capital gain will be realized.

Example

ACo is a private corporation with 100 issued and outstanding common shares with a total PUC of $100. ACo reduces the total PUC of the common shares from $100 to $50 by the appropriate corporate resolution. However, instead of paying just $50 to its common shareholders, ACo pays $90.

In this situation, the *ITA* deems ACo to have paid a dividend of $40 (the $90 payment minus the $50 PUC reduction). If Shareholder X owns 50% of the common shares of ACo, X will be deemed to have received a dividend of $20 (50% of $40). In addition, X's ACB of his/her common shares will be reduced by a total of $25 (50% of the $50 tax free return of capital or PUC).

In the event X's ACB of his or her common shares was less than $25 before the corporation reduced the PUC of its common shares, X would be deemed to have realized a capital gain equal to the amount by which $25 exceeds X's ACB in his or her shares before the PUC reduction.

If ACo paid only the amount of the PUC reduction to its common shareholders, there would have been no deemed dividend to the shareholders. Likewise, if ACo had limited the PUC reduction to X's ACB in his or her common shares, X would not have realized a capital gain.

(ii) Public corporations

A PUC reduction by a public corporation results in different income tax consequences to shareholders. In the case of a public corporation, the deemed dividend is equal to the total amount paid by the public corporation to the shareholders, not just the amount in excess of the PUC reduction. In our example above, if ACo had been a public corporation, the amount of the deemed dividend to the shareholders would have been $90. In addition, since there is no tax-free return of PUC to the shareholders, there is also no reduction to the shareholders' ACB in their shares.

1.3.3 Redemption, cancellation, and purchase of shares

(a) Corporate considerations

Under ss. 30–31 of the *OBCA*, a corporation may purchase or otherwise acquire its shares unless the corporation's articles provide otherwise. A corporation may, pursuant to s. 32, redeem any shares that are issued by it as redeemable shares at the redemption price stated in the articles or at a redemption price calculated according to a formula stated in the articles. It is common to find share provisions in a corporation's articles that state that a class or series of shares may be redeemed at the option of the corporation at prescribed prices and times. If a corporation exercises its right to redeem a class or series of shares, the shareholder must send his or her redeemed shares to the corporation in exchange for receiving payment of the redemption price. In contrast, if a corporation seeks to purchase some of its shares, a shareholder has the option of refusing to sell, and the takeover bid and issuer bid rules under the *OBCA* and the Ontario *Securities Act* may be applicable.

Under ss. 30(2), 31(3), and 32(2) of the *OBCA*, a corporation is not authorized to redeem or purchase any of its shares if, as a result of making the required payment, there are reasonable grounds for believing that the relevant solvency test in the statute would not be satisfied. The redemption, purchase, or other acquisition by a corporation of its shares reduces the stated capital of the corporation for the class or series of shares being purchased, redeemed, or otherwise acquired pursuant to s. 35(1). The reduction is on a *pro rata* basis for the whole class or series affected. Unless the articles provide otherwise, no resolution of shareholders is required for a corporation to redeem, purchase, or otherwise acquire its shares; a directors' resolution authorizing such an action is sufficient.

(b) Income tax considerations

In the following income tax discussion, any reference to the redemption of shares (or share redemption) includes a purchase of shares for cancellation.

In circumstances where a corporation redeems shares, the rules in the *ITA* may deem the corporation to have paid a dividend to its shareholders. Under s. 84(3) of the *ITA*, the amount of this deemed dividend is equal to the amount (if any) by which the price paid by the corporation on the redemption of shares exceeds the PUC of such shares. From a tax policy and conceptual point of view this deemed dividend may best be viewed as a distribution of the corporation's after-tax surplus (or profits). By definition, payment of such after-tax surplus or profits to a shareholder takes on the character of dividend income and is therefore taxed as a dividend to the shareholder whose shares are redeemed.

However, the deemed dividend does not represent the proceeds of disposition (sale price) to the shareholder of the redeemed share, and determining the income tax

consequences to the shareholder from this share disposition is a separate step.

A redemption of a share is also treated as a sale or disposition of property by the shareholder for income tax purposes. The shareholder whose shares are redeemed will realize either a capital gain or loss equal to the amount by which the proceeds of disposition exceed or are exceeded by the shareholder's ACB of the share(s). To prevent double taxation, the rules in the *ITA* provide for an adjustment (i.e., decrease or reduction) to the proceeds of disposition equal to the amount of the deemed dividend (which is already taxable to the shareholder and on which the shareholder should not be taxed again). This prevents the amount of the deemed dividend from being taxed again in the form of a capital gain to the shareholder. Where the shareholder's ACB in his or her shares exceeds the PUC of the shares redeemed, the result will be a capital loss.

Example

X is an individual taxpayer who owns Class A redeemable preference shares of BCo. Each Class A share has a PUC of $1. X's ACB for each Class A share is $10. BCo decides to redeem its Class A shares for $50 each. Under the *ITA* rules, BCo is deemed to have paid to X, and X is deemed to have received, a dividend of $49 in respect of each Class A share redeemed by the corporation. The amount of the deemed dividend is calculated as follows:

Redemption price	$50
Less: paid-up capital	1
Deemed dividend	$ 49

In this same example, X will also realize a capital loss from the corporation's redemption of each Class A share, calculated as follows:

Redemption proceeds	$50
Less: Deemed dividend	49
Adjusted proceeds	$1
Less: ACB	10
Capital **loss**	$9

Again, for purposes of calculating X's capital gain or loss, the proceeds received by X are reduced by the amount of the deemed dividend and therefore equal $1 (the actual redemption proceeds of $50 minus the deemed dividend of $49). X therefore realizes a capital loss of $9 in respect of each Class A share (the revised proceeds of $1 minus X's ACB of each Class A share of $10). Depending on X's circumstances, this capital loss may only be useful (applied against) in reducing capital gains from other transactions. It should also be noted that other sections of the *ITA* (i.e., the stop-loss rules) might operate to reduce for tax purposes the capital loss realized on the disposition of shares by all or a part of the amount of any tax-free capital dividends received by a shareholder on his or her shares.

1.3.4 Increase in stated capital

(a) Corporate considerations

A corporation can increase its total stated capital by issuing a stock dividend. In other words, the corporation issues new treasury shares in payment of a dividend. The amount of the dividend so paid is added to the stated capital account for the class of shares issued as the stock dividend (*OBCA*, s. 38(2)).

A corporation may also increase its stated capital by capitalizing its surplus. Subsection 24(6) of the *OBCA* requires approval of such a step by special resolution if the amount to be added to the stated capital account of a class or series of shares was not received by the corporation as consideration for the issue of shares or was received as consideration for the issue of shares but does not form part of the stated capital attributable to such shares and the corporation has outstanding shares of more than one class or series.

(b) Tax considerations

Under s. 248(1) of the *ITA*, a corporation's payment of a stock dividend to its shareholders is treated for income tax purposes the same as the (corporation's) payment of an ordinary cash dividend. The amount of the stock dividend that is included in a shareholder's income is equal to the amount of the stated capital attributable to the stock. The amount of the stock dividend also becomes the shareholder's ACB of the stock received (*ITA*, s. 52(3)).

Generally speaking, when a corporation increases the stated capital of a class of shares or capitalizes contributed surplus (i.e., converts surplus to capital stock in the corporation), the rules in the *ITA* deem the corporation to have paid a dividend on the issued shares of the class in which the stated capital (and also the PUC) is increased. It should be noted that the *ITA* also contains certain exceptions to this general rule. For example, no dividend is deemed to have been paid by the corporation where the stated capital (and the PUC) of another class of issued shares in the corporation is reduced by an equivalent amount. All the shareholders of that class of shares (in which the stated capital is increased) are deemed to have received a *pro rata* share of the deemed dividend. Income tax is triggered at the time the stated capital (and consequently the PUC) is increased because PUC represents the amount of money that a corporation

may later return to the shareholders tax-free (except where the amount of the PUC returned to a shareholder exceeds his or her ACB in the shares, in which case the shareholder will realize a capital gain). Again, to ensure there is no double taxation to a shareholder (i.e., on a later sale of his or her shares), the *ITA* provides that the amount of the deemed dividend be added to the shareholder's ACB in his or her shares (*ITA*, s. 53(1)(b)).

1.3.5 Increase in authorized capital

Unless the authorized capital of a corporation is limited by the articles, no amendment of the articles is required to permit a corporation to issue more shares of an existing class or series of shares. If the articles do limit the authorized capital and the corporation wishes to issue more shares than are permitted, an amendment to the articles will be necessary (s. 168(1)(d)). The articles may also have to be amended to create a new class of shares pursuant to s. 168(1)(e) of the *OBCA*.

1.3.6 Change in number of directors

A change in the number of directors or in the minimum or maximum number will require an amendment to the articles pursuant to s. 168(1)(m) of the *OBCA*.

2. By-laws

The by-laws of a corporation are general regulations that constitute the rules that establish the manner in which the business and affairs of a corporation are conducted. Normally, a set of by-laws deals with matters such as the execution of documents on behalf of the corporation, the corporation's financial year-end, the procedure to be used in connection with meetings of directors and shareholders, the provision for committees of directors, the duties of the officers of the corporation, and various other matters. It is also common to integrate into the by-laws certain common operational rules even though they are contained in the *OBCA* or the *Canada Business Corporations Act* (*CBCA*). As a result, a shareholder, director, or officer of a corporation can find in one place the rules that regulate ordinary corporate activities.

Unless the articles, the by-laws, or a unanimous shareholder agreement (USA) provide otherwise, the directors may make, amend, or repeal any by-laws that regulate the business or affairs of a corporation (*OBCA*, s. 116). A by-law or an amendment or repeal of a by-law is effective as soon as a directors' resolution is passed at a meeting or signed by all the directors. Once the directors make, amend, or repeal a by-law, they must submit it to the shareholders at the next meeting of shareholders, who may confirm, reject, or amend it. If a by-law or an amendment or repeal of a by-law is rejected by the shareholders or if the directors do not submit the by-law, amendment, or repeal to the shareholders, it ceases to be effective on the date of rejection or on the date of the meeting of shareholders to which it should have been submitted. In such a case, no subsequent resolution of the directors to make, amend, or repeal a by-law having substantially the same purpose or effect is effective until it is confirmed or confirmed as amended by the shareholders.

Any shareholder entitled to vote at a meeting of shareholders may propose a by-law or an amendment to or a repeal of a by-law. If the by-law, amendment, or repeal is passed at a meeting of shareholders, it is effective from the date of such adoption. No action by the directors is required.

An ordinary resolution of shareholders is required to approve or confirm a by-law or an amendment or repeal of a by-law. If a greater majority is considered desirable, provisions that would normally go into the by-laws can be placed in the articles, in which case a special resolution of shareholders will be required. If a special resolution is not considered to provide sufficient consent, the articles may specify what greater number of votes is required to alter such a provision in the articles. If it is not desirable to put the provision in the articles to avoid public knowledge of its terms, a USA may specify that a greater number of votes of directors or shareholders is required to change some or all of the provisions of the by-laws. Neither a USA nor the by-laws of a corporation is a public document.

3. Asset purchases from shareholders

It is not uncommon for a person to transfer or sell assets or property to a corporation. For example, after carrying on business as a sole proprietor for a period of time, the proprietor may wish to transfer or sell the business to a corporation for both tax and non-tax reasons. These reasons may include

- deferring current personal taxation on investment income;
- passing on the future growth or appreciation in the value of an asset to a spouse or children; or
- passing on the ownership interest in a business to the next generation.

These objectives can be achieved by having the individual transfer the investment or appreciating asset(s) or property to a corporation in exchange for fixed-value preferred shares of the corporation. In these circumstances, the current value of the asset(s) or property transferred to the corporation is "frozen" (to the transferor) in the form of the fixed-value preferred shares of the corporation. Any future growth or appreciation in the transferred assets or property will now accrue

(indirectly) to the owners of the corporation's common shares, which could include a spouse, children, trust, or other related parties. There are various requirements set out in the *ITA* that must be satisfied to ensure the transfer occurs without triggering current taxation to the transferor (i.e., on a tax-deferred basis).

Under the provisions of s. 85 of the *ITA*, the transfer of assets or property to a corporation may take place on a tax-deferred or a "rollover" basis (that is, without any immediate tax liability being triggered to the transferor of the assets or property). At the same time the recipient (transferee corporation) assumes or steps into the transferor's cost in the assets or property transferred (hence the "rollover" of cost in the assets or property to the transferee corporation).

One of the most important requirements of carrying out a tax-deferred transfer of property under s. 85 of the *ITA* is the filing (with the Canada Revenue Agency (CRA)) of a joint election by the transferor and recipient (transferee corporation) of the property. Under this election, the transferor (vendor) and the recipient jointly elect to receive the tax-deferred treatment associated with the transfer of the property and disclose particular information related to the transfer of the property and consideration received in exchange from the corporation. Other requirements for a s. 85(1) rollover include the following:

- There must be eligible parties to the transfer (eligible transferor and transferee corporation).
- Only certain assets qualify or are eligible for a s. 85(1) transfer.
- Certain consideration must be received by the transferor from the transferee corporation.

The s. 85 rollover provisions (as well as other rollover provisions in the *ITA*) permit a taxpayer to transfer and reorganize their ownership of assets with another taxpayer (i.e., a corporation in a s. 85 rollover) without triggering immediate income tax consequences. Consequently, a rollover does not avoid income tax but instead defers recognition of this income tax to a later date. Where a taxpayer otherwise transfers property or assets to a corporation (without a s. 85 election) with which the taxpayer does not deal at arm's length, the rules in s. 69 of the *ITA* deem the taxpayer to have disposed of the transferred assets or property at fair market value and hence realize any income (i.e., on inventory), recaptured capital cost allowance (CCA) on depreciable capital property, or accrued capital gains on capital property.

3.1 Who may use the s. 85 rollover

A s. 85 rollover is available to taxpayers that are an eligible transferor (i.e., seller) and an eligible transferee (i.e., the buyer or recipient of the assets or property). With respect to an eligible transferor, the good news is that any "taxpayer" qualifies. This includes persons, corporations, and trusts, whether or not resident in Canada for income tax purposes. To be an eligible transferee, the transferee must be a "taxable Canadian corporation," and this term is defined under the *ITA* as either

- a corporation incorporated in Canada; or
- a corporation resident in Canada (uninterrupted since June 18, 1971) that is not exempt from income tax.

Since a partnership is not a taxpayer under the *ITA*, it is not an eligible transferor for a s. 85(1) rollover of property to a corporation. However, a partnership may transfer property to a corporation on a rollover basis (i.e., tax deferred) under s. 85(2) of the *ITA*.

3.2 Which assets qualify

Only certain assets are eligible property for a s. 85(1) transfer. Eligible property is described in s. 85(1.1) of the *ITA* and includes the following:

- any capital property (includes both depreciable and non-depreciable capital property, but notably excludes any real property owned by a non-resident person unless this real property is used in a business carried on by the non-resident in Canada);
- Canadian and foreign resource properties;
- inventory (except real property that is inventory, an interest in real property, or an option in respect of real property);
- eligible capital property (i.e., goodwill and other intangible property); and
- real property, an interest in real property, or an option in respect of real property owned by a non-resident that is used in a business carried on by the non-resident in Canada.

3.3 The required share consideration

The tax rules in s. 85(1) require that the taxpayer transferring assets or property to the corporation must receive in exchange at least one fraction of a share in the capital stock of the purchasing corporation as consideration for the transfer. Any class of share will qualify or satisfy this requirement. For example, the transferor may receive a common, preference, or special share.

Non-share consideration (or what tax practitioners commonly refer to as "boot" consideration) may also be

received by the transferor. Examples of non-share consideration include cash, a promissory note(s), the assumption of liabilities (i.e., a mortgage), or any other type of property.

There is a limit on the amount of non-share consideration (or "boot") that a transferor may receive and still achieve a full tax-deferred rollover under s. 85(1). The tax rule states that if the amount of the non-share consideration exceeds the "tax cost" of a transferred asset, the transferor will trigger income tax (because the "elected amount" will be increased).

3.4 Claiming the rollover

As noted above, in order to achieve a s. 85(1) tax-deferred rollover, the transferor (vendor) and the transferee (recipient) corporation must jointly execute and file the prescribed election form (Form T2057, "Election on Disposition of Property by a Taxpayer to a Taxable Canadian Corporation") with the CRA and within the prescribed time (see "Timing," below). This election form contains detailed tax information about the parties and their transfer agreement, the assets transferred and consideration received from the corporation in exchange, and also a specified "elected amount" for each asset transferred. Under the operational rules in s. 85(1), the choice of the elected amount is all-important to achieving the tax-deferred rollover. The elected amount is important for income tax purposes because it becomes

- (is deemed) the vendor's proceeds of disposition for the assets transferred;
- (is deemed) the purchasing corporation's cost of the assets transferred; and
- the transferor's (vendor's) cost amount in the consideration (i.e., both share and non-share) received from the transferee corporation.

Generally speaking, if the parties to a s. 85(1) transfer of assets wish to fully achieve a tax-deferred rollover (i.e., give rise to neither income, recapture, nor capital gain to the vendor), they would select or choose an "elected amount" equal to the vendor's cost amount (for income tax purposes) in the transferred asset(s). The cost amount (for tax purposes) for various types of assets is shown in Figure 1, below.

Figure 1

Asset Type	Asset Example	"Cost" under the *ITA* ("Tax Cost")
Non-depreciable capital property	land, shares, partnership interest	Adjusted cost base ("ACB")
Depreciable capital property	machinery, equipment, building(s)	Undepreciated capital cost ("UCC")
Eligible capital property	goodwill, incorporation costs	4/3 Cumulative eligible cost ("CEC")
Other	inventory	Cost

One issue that must be carefully considered is when a transferor (vendor) of assets has no cumulative eligible capital. This situation can arise when the transferor did not previously pay for any goodwill, but rather generated or created goodwill by carrying on and developing a business enterprise and then transferred the ongoing business to a corporation. In such circumstances, if the ongoing business had any goodwill, the goodwill would be included with the other assets being transferred in the s. 85(1) election. If the goodwill is omitted from the s. 85(1) election, the transferor would still be deemed to have disposed of the goodwill at its fair market value. As a result, the transferor would realize a capital gain and be liable for the tax arising. Consequently, in such circumstances the parties should nonetheless choose a nominal amount for goodwill equal to $1, because the CRA does not recognize "nil" (or $0) as a valid elected amount for income tax purposes under s. 85(1). Where the transferor and transferee corporation select the appropriate cost amount(s) for the type of assets described in Figure 1, the tax-deferred rollover from transferor to transferee corporation under s. 85(1) will be achieved. The transferor will not trigger tax on the transfer of the assets, since assets are deemed to be disposed of at cost. The transferee corporation acquires the same asset(s) at this cost amount, and therefore the cost is "rolled over" (i.e., becomes the cost of the asset(s)) to the transferee corporation.

By using a s. 85(1) transfer of assets, the transferor and transferee may choose an elected amount that is different than cost for particular purposes. This is reviewed in more detail below.

3.5 Limits on the elected amount

There are tax rules in s. 85 that restrict (i.e., impose upper and lower limits on) the elected amount the transferor and transferee corporation may choose for the transferred asset(s). The limitations on the elected amount are designed to ensure the transferor and transferee corporation do not achieve other income tax

benefits other than the deferral of income tax on the transfer of assets.

3.5.1 Upper limit

The transferor and transferee corporation may not choose an elected amount that is greater (i.e., the upper limit) than the transferred asset's fair market value at the time of transfer. The tax rules will reduce a higher elected amount to the level of the transferred assets' fair market value. There may also be other tax consequences arising from the consideration the transferor receives.

Example

Assume a transferred asset has a fair market value of $100 and the transferor and transferee corporation choose an elected amount of $150. First, the elected amount would be reduced to $100. Secondly, there may be adverse tax consequences to the transferor if the value of the consideration received from the transferee corporation was $150. In this case, the difference of $50 ($150 value of consideration received minus $100 fair market value of asset) would be treated as a taxable benefit. In addition, it is likely that the transferee corporation will be denied a deduction for this $50 taxable benefit since the excess consideration was not paid to earn income. As a result, there is double taxation on the $50—a taxable benefit to the transferor and a denied deduction to the transferee corporation for the same amount.

3.5.2 Lower limit

(a) Lesser of fair market value or cost amount

The transferor and transferee corporation may not choose an elected amount that is less (i.e., the lower limit) than the lesser of

- the asset's fair market value at the time of transfer; and
- the transferor's "cost amount" for the asset (see Figure 1, above).

The tax rules will increase a lower elected amount to the lower limit for the transferred asset(s).

(b) Non-share consideration

The tax rules in s. 85 also impose an additional limit on the elected amount chosen by the transferor and transferee corporation related to the value of any non-share consideration received. The transferor and transferee corporation may not choose an elected amount that is less than the value of any non-share consideration the transferor (vendor) receives in exchange for the transferred asset.

Example

Assume the parties attempt to choose an elected amount that is less than the value of the non-share consideration received by the transferor. In this case, the elected amount would be increased to the value of the non-share consideration. For tax practitioners, this rule tells us that in order for the transferor (vendor) to fully defer recognizing income tax on the transfer of an asset, the amount of the non-share consideration received by the transferor must be limited to the transferor's tax cost in the transferred asset. By limiting the amount of non-share consideration received to an asset's tax cost, an elected amount equal to the tax cost of the asset will not be increased by this rule, and the tax-deferred transfer of the asset will be achieved.

Example

A transferor wishes to transfer a piece of equipment to a corporation on a fully tax-deferred basis under s. 85(1). The transferor paid $100 for the equipment, and it still has a current fair market value of $100. However the UCC of this equipment is $50. In order for the transferor to achieve the rollover (i.e., not trigger income tax on the transfer of the equipment), the transferor must not receive any more than $50 worth of non-share consideration from the transferee corporation. Assume that the transferor takes back or receives an $80 promissory note (non-share consideration) from the transferee corporation. The tax rules provide that the elected amount cannot be less than $80 (the value of the non-share consideration). Consequently, the elected amount on this transfer of equipment will be $80, and the transferor will realize $30 of recaptured depreciation and report this as income (calculated as $80 (sale price) minus $50 (UCC)).

3.6 The vendor's cost base of the shares and non-share consideration received

As described above, the elected amount is important for income tax purposes for several reasons. One reason is that the elected amount becomes the transferor's (vendor's) cost amount in the consideration (i.e., both share and non-share) received from the transferee corporation. This will also be important in determining the tax consequences to the transferor from a later disposition of the shares and/or any non-share consideration received from the transferee corporation in a s. 85(1) rollover. There is an ordering rule in s. 85 that tells a transferor how to allocate the elected amount among the types of consideration received (from the transferee corporation) as follows:

- **non-share consideration:** the transferor's tax cost (ACB) is the fair market value of non-share consideration;
- **special shares:** the transferor's tax cost (ACB) is the lesser of
  - the special shares' fair market value, and
  - the elected amount minus the value of the non-share consideration; and
- **common shares:** the transferor's tax cost (ACB) is the elected amount minus the sum of the transferor's tax cost for any non-share consideration and any special shares, as determined above.

3.7 Related problems

There are additional tax rules in the *ITA* (i.e., in s. 85 and elsewhere) designed to ensure taxpayers (transferor and transferee corporations) do not abuse the tax advantages from a tax-deferred s. 85(1) rollover. These rules may impose other income tax consequences on a transferor (i.e., deem a taxable benefit or a dividend to be received) notwithstanding a valid s. 85(1) transfer agreement and a properly filed election with the CRA. Tax practitioners must keep these additional tax rules in mind when planning and implementing a s. 85(1) rollover transaction.

3.7.1 Value of consideration: shareholder benefit

If a transferor and transferee corporation do not deal at arm's length, a taxable benefit may be assessed to the transferor if the fair market value of the consideration received (in exchange) by the transferor from the transferee corporation is greater than the fair market value of the asset transferred.

3.7.2 Value of consideration received: benefit conferred on non-arm's length person

If a transferor of assets and another shareholder (i.e., a spouse or other related party) in the transferee corporation do not deal at arm's length, the fair market value of the consideration issued by the transferee corporation should not be an amount that is less than the value of the asset transferred. In such circumstances, the income tax rules will result in a tax liability to the transferor for the shortfall (which is treated as a benefit the transferor is attempting to confer on the other shareholder) in the consideration received from the transferee corporation.

Accordingly, special care should be taken by tax practitioners and taxpayers in any non-arm's length transfers of assets to a corporation. One mechanism for dealing with such concerns is to ensure the transfer agreement includes a price adjustment clause. A price adjustment clause (PAC). A PAC may also be included in the share provisions (or attributes) of the shares to be issued by the transferee corporation. In the event the CRA later determines that the fair market value of the consideration the transferor receives is not equal to the fair market value of the transferred asset, the parties to the agreement can exercise the PAC. This way the fair market value of the consideration received will be increased or decreased as is necessary to ensure the fair market value of the consideration received equals that of the transferred asset. The CRA has stated that it will recognize a PAC (i.e., not assess other income tax payable) where the transferor and transferee corporation

- proceeded reasonably to try and determine the fair market value (i.e., obtained an independent appraisal) for the asset transferred; and
- notified the CRA (i.e., in a letter filed with the parties' respective tax returns for the year of transfer) of the existence of a PAC.

It should also be pointed out that the CRA would treat the parties answering "yes" to the question (concerning a PAC) on CRA Form T2057 (i.e., the s. 85(1) election form) as acceptable notification.

3.7.3 Paid-up capital

Under the rules in s. 85(2.1) of the *ITA*, there is an upper limit imposed on the amount of the PUC of the share consideration issued by the transferee corporation. The upper limit is specified as the elected amount of the transferred asset minus the fair market value of any non-share consideration issued to the transferor. In the event the directors of the transferee corporation add an amount in excess of this upper limit to the stated capital account of the shares (and thereby also to the PUC of the same class of shares) being issued to the transferor, s. 85(2.1) will automatically reduce the PUC of the issued shares to the upper limit.

3.7.4 Double taxation

There is another important aspect to s. 85(1) transfers of assets that has to be considered. Whenever assets are transferred under this provision, there is a possibility of double taxation. This follows from the tax-deferred rollover and the elected amount. Since the elected amount becomes

- the transferor's cost for the consideration received; and
- the transferee corporation's cost for the asset(s) transferred,

both the transferor and transferee corporation may realize the same income or capital gains at a later date.

Example

If the transferor disposes of the consideration received on the transfer, any deferred income or capital gains will be triggered and realized. If the transferee corporation disposes of the transferred asset(s), the deferred income or capital gain on the transferred assets will also be triggered and realized.

It should now be clearer that the transferor and transferee corporation each have the potential to realize and pay tax on the same amount of income and capital gain (and therefore be doubly taxed). Generally speaking, this possibility for double taxation may be less of a concern to the parties where the following are true:

- The benefits of the s. 85(1) tax-deferred rollover outweigh the potential disadvantage of double taxation.
- Neither the transferor nor transferee corporation anticipate a sale or other disposition to a third party for some time.

However, this potential disadvantage should be considered and reviewed before finalizing a s. 85(1) rollover transaction.

3.7.5 Timing

The due date for filing the prescribed form (Form T2057) for a s. 85(1) transfer is on or before the day that is the earliest of the days on or before which any of the transferor and the transferee corporation is required to file its respective income tax return for the taxation year in which the transfer of asset(s) occurs (*ITA*, s. 85(6)).

One of the parties files the (jointly) signed election form in duplicate, and the other party files a copy.

Example

Mr. X (an individual taxpayer) transfers assets to a corporation, ACo, in exchange for the issuance of common shares of ACo under s. 85(1). Mr. X and ACo also have to file a joint election under s. 85(6) of the *ITA*. ACo has its fiscal year-end on June 30, 2011, and the transfer of assets by Mr. X takes place on July 2, 2011.

Since Mr. X is an individual taxpayer, he is required to file a tax return for his taxation year on or before April 30, 2012 (or June 15, 2012, if Mr. X carried on a business during 2011). Since ACo is a corporation and it is required to file its tax return within six months of the end of its tax year, ACo is required to file a tax return on December 31, 2012, in respect of the taxation year ended June 30, 2012. Therefore, the due date for filing the s. 85(1) joint election form is on or before Mr. X's due date for filing a return, either April 30, 2012, or June 15, 2012 (because Mr. X has to file his tax return for the year in which the transfer of assets takes place before ACo has to file its tax return—December 31, 2012).

It is possible to file a joint s. 85(1) election form late. However, the latest filing deadline is three years after its due date and is subject to a late-filing penalty. The late-filing penalty is the lesser of

- a certain dollar amount per month; and
- a percentage of the gain deferred on the transfer of the asset(s).

After the three-year period (i.e., three years after the filing deadline), the parties may still try to file a joint election, but this can only be done with the consent of the Minister of National Revenue (MNR). It must be just and equitable to allow the late-filed election, i.e., the parties must show that they did everything possible to file the joint election within the allowed time period, but due to circumstances beyond their control, that was not possible. If that consent is obtained, the joint election will be treated as validly filed, but remains subject to a late filing penalty.

Tax practitioners and taxpayers should ensure the joint election form is complete and accurate. There is no provision under the *ITA* for the parties to this joint election to file an amended election form. The CRA does allow the filing of an amended election form where it is in the opinion of the MNR just and equitable to do so. Typically this would be permitted where the parties wish to correct typographical errors in the completion of the first filed form. Where an amended election form is allowed, it is treated as a late-filed election and is subject to a late-filing penalty.

4. Share purchases from shareholders

As with the case of assets or property, it is not uncommon for a person to transfer or sell shares of a corporation to

- the same corporation (i.e., the corporation may buy shares from its shareholders); or
- another corporation (i.e., a shareholder may incorporate a holding company).

Such transactions may be undertaken

- as part of an estate freeze;
- as part of a transaction designed to creditor-protect an operating company; or
- by an individual shareholder wishing to realize a capital gain in order to utilize the $750,000 capital gains exemption available in respect of qualified shares of a small business corporation (i.e., crystallize the capital gains exemption).

Such transactions may be carried out by the shareholder using s. 85(1) of the *ITA* in order to defer income tax on

the transfer of such shares to the same or another corporation.

The rules with respect to asset purchases from shareholders also apply to share purchases by a corporation from shareholders. When an individual shareholder is selling (transferring) shares in a Canadian corporation, further thought must be given to minimize the possible application of s. 84.1 of the *ITA* to the selling shareholder.

The operative provisions of s. 84.1 state that if the transferor of shares and the transferee corporation do not deal at arm's length and the transferee corporation issues to the transferor an excess amount of non-share consideration, then the transferor of shares will be deemed to receive a taxable dividend. At the same time, the PUC of any shares issued by the transferee corporation will be reduced.

While these deemed dividend rules (in non-arm's length transactions) are complicated and will not be discussed in significant detail, a transferor can minimize their application by ensuring that the amount of

- any non-share consideration; and
- the stated capital of the class of shares issued in exchange for the transferred shares

is not in excess of the PUC of the transferred shares.

The directors of the transferee corporation may restrict the addition to the stated capital account of the share consideration being issued in non-arm's length situations (*OBCA*, s. 24(3)).

The rules in s. 251 of the *ITA* deal with arm's length relationships. Taxpayers who are related are deemed not to deal at arm's length for income tax purposes. Relationships of individuals are determined by reference to blood, marriage, common-law partnership, and adoption (*ITA*, ss. 251(1)(a) and (6)); relationships between an individual and a corporation or relationships involving two corporations are determined by "control" (*ITA*, s. 251(2)). It is also a question of fact whether unrelated persons will be treated for income tax purposes as not dealing at arm's length. Consequently, the tax rules may result in taxpayers being treated as receiving a deemed dividend in several scenarios.

Scenario 1

Aaron and Bob are brothers. They are the sole shareholders of ABCo, and now Aaron wishes to retire and sell his shares of ABCo to Bob. Aaron plans on claiming the $750,000 capital gains exemption in order to avoid paying tax on any capital gains he realizes from the sale of his shares. Unfortunately, Bob does not have sufficient funds to pay Aaron the purchase price. Bob's holding company, BobCo, does have the necessary funds, so BobCo purchases Aaron's shares of ABCo for cash.

Tax Consequences: Aaron will not realize a capital gain on selling his shares of ABCo to BobCo but rather realizes a taxable dividend equal to the amount by which the cash paid to him by BobCo exceeds the PUC of Aaron's shares of ABCo. Aaron cannot claim the $750,000 capital gains exemption because he did not realize a capital gain but rather has dividend income from this sale of shares to BobCo.

Scenario 2

John is the sole shareholder of an operating company JCo. John wishes to retire and sell his shares of JCo to his granddaughter, Cheryl. Cheryl incorporates a new company to acquire the shares of JCo from John, and Cheryl's company will pay John for his shares with a promissory note equal to the fair market value of John's shares in JCo.

Tax Consequences: John does not realize a capital gain but rather a taxable dividend on the sale of his shares of JCo to Cheryl's company. The amount of the dividend to John is equal to the amount by which the principal amount of the promissory note exceeds the PUC of John's shares in JCo.

It should now be clear that if an individual taxpayer transfers shares to another corporation in a non-arm's length transaction, the possibility of s. 84.1 applying to any transfer of the shares should be carefully reviewed.

5. Continuance

Continuance is a mechanism that is provided in some corporation statutes, including the *OBCA*, to permit a corporation that is governed by the provisions of one corporation's statute to leave that jurisdiction (exporting jurisdiction) and be continued under and governed by the corporation laws of another jurisdiction (importing jurisdiction). For the continuance to occur, the exporting jurisdiction must allow the corporation to leave, and the importing jurisdiction must be willing to accept the corporation.

There are no income tax issues that arise on a corporation continuing itself in another jurisdiction, provided the importing and exporting jurisdictions are in Canada (i.e., continuing among the provinces or territories and federally). There are more significant income tax considerations where a corporation is exported from a jurisdiction in Canada to a jurisdiction outside Canada.

5.1 Import continuance from another jurisdiction

The *OBCA* allows a corporation to be continued under it if authorized to do so by the laws of the exporting jurisdiction.

In order to continue a corporation from an exporting jurisdiction under the *OBCA*, application must be made pursuant to s. 180(1) by completing articles of continuance. These articles contain similar information to that required in articles of incorporation plus the name of the exporting jurisdiction; the date of incorporation, amalgamation, or continuance of the corporation in that jurisdiction; and a statement that the continuation of the corporation under the laws of Ontario has been properly authorized under the laws of the jurisdiction that the corporation is leaving. Accordingly, before the articles of continuance can be submitted, the corporation must have taken the steps necessary under the laws of the exporting jurisdiction to authorize it to apply for continuance in Ontario. In preparing the articles of continuance, the corporation must also make any changes to its existing charter documents that are necessary so that the articles of continuance will conform to the laws of Ontario. At the same time the corporation may also make such other amendments as would be permitted under the *OBCA*, provided at least the same shareholder approval has been obtained for these latter amendments as would have been required under the *OBCA* (s. 180(3)). However, any share of a corporation issued before the corporation is continued under the *OBCA* is deemed to have been issued in compliance with the *OBCA* pursuant to s. 180(8).

Once these steps have been completed, the articles of continuance are submitted in duplicate to the Director together with

- a copy of the incorporating document of the body corporate with all amendments certified by an authorized officer of the incorporating jurisdiction;
- a letter of satisfaction, certificate of discontinuance, or other document issued by the proper officer of the incorporating jurisdiction indicating the corporation is authorized to apply for articles of continuance under the *OBCA*;
- except in the case of a corporation incorporated or continued under the laws of Alberta, British Columbia, Saskatchewan, Manitoba, or Canada, a legal opinion to the effect that the laws of the jurisdiction to which the corporation is subject authorize the corporation to apply for articles of continuance; and
- the appropriate fee.

If the corporation's name is to be changed on the continuance, a name search report with any appropriate consents should also be filed, unless the new name is to be a number name. Following receipt of the certificate of continuance, appropriate filings should also be made under s. 2 of the *CIA*, and the necessary material should be prepared to register or license the corporation in any other provinces where the corporation will carry on business.

5.2 Export

In order to be continued in the importing jurisdiction it is first necessary to obtain permission for the corporation to leave the exporting jurisdiction. Under s. 181(3) the *OBCA*, an application for continuance must be authorized by a special resolution of shareholders. Such a resolution normally

- authorizes the corporation to apply for a certificate of continuance under the laws of the importing jurisdiction;
- authorizes the corporation to apply to the Director under the *OBCA* to authorize the continuance in another jurisdiction;
- amends the corporation's charter to make all changes necessary to conform to the laws of the importing jurisdiction; and
- authorizes the corporation's directors and officers to take all necessary action to implement the special resolution.

The special resolution may also authorize the directors to abandon the application without further approval by the shareholders pursuant to s. 181(5) of the *OBCA*. This may be a useful addition if the reasons for undertaking the continuance change, if difficulties are encountered in the importing jurisdiction, or if an unexpectedly large number of shares are offered to the corporation by shareholders under the dissent right.

If the special resolution is passed approving the continuance, dissenting shareholder rights automatically arise. The notice of the meeting of shareholders to consider the continuance must include or be accompanied by a statement that a dissenting shareholder is entitled to be paid the fair value of his shares, but failure to make that statement does not invalidate the authorization for the continuance.

An application to the Director under the *OBCA* for authorization to continue a corporation in another jurisdiction is made in Form 7, "Application for Authorization to Continue in Another Jurisdiction." To complete this application, it is necessary for the corporation to be up to date in its filings under the *CIA*. It is also necessary to obtain and file the following documents with the application:

- consent letter from the Ontario Ministry of Revenue, which will only be issued if the corporation's tax filings are up to date and the corporation owes no taxes under the *Corporations Tax Act*;
- where the corporation is an offering corporation, consent letter from the Ontario Securities Commission (OSC), which will be granted unless the OSC believes that any action it may be considering regarding the corporation will be prejudiced by the proposed continuance;
- except in the case of a continuance under the laws of Alberta, British Columbia, Saskatchewan, Manitoba, or Canada, a legal opinion to the effect that the laws of the importing jurisdiction meet the requirements in s. 181(9) of the *OBCA*, that is, they provide that
  - (a) the corporation's property continues to be the property of the body corporate;
  - (b) the body corporate continues to be liable for the corporation's obligations;
  - (c) an existing cause of action, claim, or liability to prosecution is unaffected;
  - (d) a civil, criminal, or administrative action or proceeding pending by or against the corporation may be continued; and
  - (e) a conviction against the corporation or a ruling, order, or judgment in favour of or against the corporation may be enforced; and
- the applicable fee.

If the Director approves the application, he or she will make an endorsement on it to that effect. The endorsed application can then be submitted to the importing jurisdiction. This should be done promptly, since the Director's authorization of the continuance expires six months after the endorsement, unless within the six-month period, the corporation is continued under the laws of the importing jurisdiction (*OBCA*, s. 181(6)). Once the corporation has received an instrument of continuance from the importing jurisdiction, it should file a copy with the Director under s. 181(7) of the *OBCA* within 60 days of the date of issuance. The *OBCA* ceases to apply to the corporation on the date the corporation is continued under the laws of the importing jurisdiction (s. 181(8)).

6. Amalgamations

6.1 Corporate aspects

6.1.1 General

An amalgamation results in a union of the amalgamating corporations, which continue after the amalgamation as one corporation (*OBCA*, s. 174). The continuing corporation has the rights, is subject to the liabilities, and owns the property of the amalgamating corporations. The amalgamated corporation is not a new legal entity, but a continuation of the amalgamating corporations. This situation is often analogized to the combination of two streams that join and continue along as a larger river.

All of the corporations to be amalgamated must be governed by the same corporation law. If this is not so, it will be necessary first to continue one or more of the amalgamating corporations so that they are all governed by the same corporate statute when amalgamation proceedings commence.

An amalgamated corporation is entitled to take the name of one of the amalgamating corporations. If the amalgamated corporation is to have a name that is not a number name and is different from the name of any of the amalgamating corporations, a name search report and any necessary consents must be obtained.

Except in the case of a "short form amalgamation," considered below, to effect an amalgamation, it is necessary for the amalgamating corporations to enter into an amalgamation agreement, which sets out the terms and means of effecting the amalgamation. Under the *OBCA*, the amalgamation agreement must contain the provisions required to be included in articles of incorporation. It also must state the basis on which the holders of shares in the amalgamating corporations will receive money or securities in the amalgamated corporations or in some other corporation, including the amount of money to be paid in lieu of the issue of fractional shares. It must also indicate whether the by-laws of the amalgamated corporation are to be those of one of the amalgamating corporations and the address where a copy of the proposed by-laws may be examined. The amalgamation agreement must also include such other details as may be necessary to perfect the amalgamation and to provide for the subsequent management and operation of the amalgamated corporation pursuant to s. 175(1) of the *OBCA*. In a simple amalgamation agreement, no such additional details may need to be prescribed. Where shares of one amalgamating corporation are held by or on behalf of another of the amalgamating corporations, the amalgamation agreement must provide for the cancellation of these shares when the amalgamation is effective. Pursuant to s. 175(2) of the *OBCA*, such shares cannot be converted into shares of the amalgamated corporation. The amalgamation agreement may also provide that at any time before the certificate of amalgamation is granted, the amalgamation agreement may be terminated by the directors of an amalgamating corporation notwithstanding prior shareholder approval (s. 176(5)).

In some cases, where an amalgamation is between previously unaffiliated corporations, warranties and representations regarding their assets and affairs will be given either in the amalgamation agreement or in a separate agreement by each amalgamating corporation regarding its assets and affairs.

The amalgamation agreement must state the basis on which the holders of shares in each amalgamating corporation will receive money or securities for their shares. The book value of the assets and liabilities shown in the financial statements of each amalgamating corporation may not reflect their fair market value. Therefore, valuations will often need to be carried out if the shareholders of each amalgamating corporation cannot otherwise agree as to the respective values of shares of each amalgamating corporation. In such instances, it will be necessary to agree on the appropriate method for valuing each amalgamating corporation and its shares. Sometimes the valuations cannot be completed by the date of the amalgamation, and that date cannot be deferred for tax or commercial reasons. In such cases, it may be necessary to have the shareholders agree that the money or securities that each shareholder will receive on the amalgamation does not necessarily reflect the true value of their interests. After appropriate valuations have been received, securities will be transferred or issued or money will be paid in order to put each shareholder into the same financial position he or she was in prior to the amalgamation.

When the amalgamation agreement is settled, it should be approved on behalf of each amalgamating corporation by its respective board of directors. Then it must be submitted to the shareholders of each amalgamating corporation for approval by a special resolution pursuant to ss. 176(1) and (4) of the *OBCA*.

Holders of voting shares are entitled to vote on the amalgamation. In addition, the holders of each class or series of shares of an amalgamating corporation may vote separately as a class or series, whether or not they are otherwise entitled to vote, if the amalgamation agreement contains a provision that, if contained in a proposed amendment to the articles, would entitle such holders to vote separately as a class or series under s. 170 (s. 176(3)). As a result, under the *OBCA* there may be holders of non-voting shares who may not vote on the amalgamation. Under the *CBCA*, all shares are entitled to vote on an amalgamation (s. 183(3)). There may also be one or more separate class or series votes, if required.

An amalgamation pursuant to an amalgamation agreement gives rise to rights of dissent. The holder of shares or series entitled to vote on the resolution respecting an amalgamation may dissent if the resolution is approved pursuant to s. 185(1)(c) of the *OBCA*. Holders of shares who are not entitled to vote may not dissent.

6.1.2 Short form amalgamations

The *OBCA* permits "short form amalgamations" to proceed without an amalgamation agreement and without shareholder approval. Pursuant to s. 177 of the *OBCA*, a short form amalgamation may be a "vertical amalgamation" between a parent or holding corporation and one or more of its wholly owned subsidiaries or a "horizontal amalgamation" between two or more wholly owned subsidiary corporations of the same parent or holding corporation. Short form amalgamations require approval only by a resolution of the directors of each of the amalgamating corporations. The resolutions must specifically contain certain provisions. In the case of a short form vertical amalgamation, the resolutions must provide all of the following:

- The shares of each amalgamating subsidiary corporation shall be cancelled without any repayment of capital.
- The by-laws of the amalgamated corporation shall be the same as the by-laws of the amalgamating holding corporation.
- Except as may be prescribed in the resolution, the articles of amalgamation shall be the same as the articles of the amalgamating holding corporation.
- No securities shall be issued and no assets shall be distributed by the amalgamated corporation in connection with the amalgamation.

In the case of a short form horizontal amalgamation, the resolutions must provide all of the following:

- The shares of all but one of the amalgamating subsidiary corporations shall be cancelled without any repayment of capital.
- The by-laws of the amalgamated corporation shall be the same as the by-laws of the amalgamating subsidiary corporation whose shares are not cancelled.
- Except as may be prescribed in the resolution, the articles of amalgamation shall be the same as the articles of the amalgamating subsidiary corporation whose shares are not cancelled.
- The stated capital of the shares of the amalgamating subsidiary corporation whose shares are cancelled shall be added to the stated capital of the amalgamating subsidiary corporation whose shares are not cancelled.

6.1.3 Post-approval of amalgamation

Once the requisite approval of an amalgamation has been obtained, articles of amalgamation must be filed with the Director pursuant to s. 178(1) of the *OBCA*, accompanied by a copy of the amalgamation agreement, if there is one,

and the applicable fee. If the amalgamation is a short form amalgamation under the *OBCA*, the articles must be accompanied by copy of the directors' resolutions.

The articles of amalgamation must also be accompanied by a statement of a director or officer of each amalgamating corporation, providing that the corporation is solvent and either that there are reasonable grounds for believing that no creditor will be prejudiced by the amalgamation or that adequate notice has been given to creditors and no creditor objects to the amalgamation except on grounds that are frivolous or vexatious (*OBCA*, s. 178(2)). It will be easier to make the statement that no creditor will be prejudiced by the amalgamation than to notify creditors. A creditor's interest is to be paid the amounts owing to it. The statement that no creditor will be prejudiced by the amalgamation may be made if it is reasonable to believe that a creditor will be paid by the amalgamated corporation on the same terms and conditions to which it is entitled as a creditor of an amalgamating corporation. To obtain reasonable grounds for this belief, the director or officer should examine the financial statements for the amalgamating corporations, any *pro forma* financial statement for the amalgamated corporation, and any valuations that have been made of the assets and liabilities of any amalgamating corporation.

Upon receipt of the requisite information, the Director will issue a certificate of amalgamation pursuant to s. 178(4) of the *OBCA*. Once the certificate of amalgamation is obtained, various post-amalgamation proceedings are necessary, including the adoption of new by-laws, if necessary, and the passage of directors' resolutions to appoint officers; approve banking arrangements, forms of share certificates, and the form of corporate seal; and authorize any provincial registrations or licensing applications required in jurisdictions where the amalgamated corporation will carry on business. The certificate of amalgamation should be registered in any land registry offices where any amalgamating corporation has a registered interest in land. It is necessary to advise the authorities who administer the Canada Pension Plan, Employment Insurance, Workers' Compensation, Harmonized Sales Tax (HST), and the like. It is also important to give notice of the amalgamation to suppliers, customers, insurance agents, and municipalities where the amalgamated corporation owns property if the name of the amalgamated corporation changes. It is also important to notify the bank before amalgamation in case any loan agreement requires bank consent. If any amalgamating corporation has issued debt securities under a trust deed or other debt instrument, it will be necessary to comply with the successor company provisions of such documents, which normally require the amalgamated corporation to execute an instrument evidencing the succession of the amalgamated corporation to the obligations of the amalgamating corporation.

6.2 Income tax aspects

6.2.1 Deemed year-end

The *ITA* treats (with some limited exceptions) an amalgamated corporation (AmalCo) as a new legal entity (distinct from its predecessor corporation(s)), and as such, AmalCo's first taxation year begins the day of amalgamation. The *ITA* also treats the taxation year of each predecessor corporation as ending on the day immediately before amalgamation. Therefore tax returns must be prepared and filed for the tax year of each predecessor corporation ending at that time.

The date of the amalgamation will be treated by the CRA as the date shown on the certificate of amalgamation (unless a different effective date for the amalgamation is specified in the certificate). Similarly, the CRA views the particular time of amalgamation as being the earliest moment on the date of amalgamation—unless a specific time is shown on the certificate.

6.2.2 Tax deferral

Unless the rollover rules in the *ITA* apply, there are particular tax consequences that arise on an amalgamation of corporations. For example, the shareholders of each predecessor corporation are treated for tax purposes as having disposed of their shares of those corporations for sale proceeds equal to the fair market value of the new shares received from AmalCo. In addition, certain tax losses of the predecessor corporations may be lost (expire) on an amalgamation.

On the other hand, since Canadian corporate law treats AmalCo as a continuation of each predecessor corporation, there is no disposition of the assets or liabilities of any predecessor corporation on an amalgamation. Therefore, no tax disposition consequences will arise under the provisions of the *ITA*, the *Land Transfer Tax Act* (see the Land Transfer Tax Bulletin, LTT3-2000), or Part IX of the federal *Excise Tax Act* in respect of the HST (generally applicable after June 30, 2010, but subject to certain other transitional rules). The HST, which applies at a combined rate of 13% in Ontario, replaces the former separately imposed and administered Goods & Services Tax (GST) and Ontario Retail Sales Tax (RST), which generally applied to transfers of tangible personal property (TPP). Therefore, the tax base to which the new HST applies in Ontario (i.e., to goods and services) is broader than the former RST.

Under s. 87 of the *ITA,* a rollover is available where there is an amalgamation of two or more taxable Canadian corporations.

In order for the amalgamation provisions of the *ITA* (i.e., rollover) to apply, there must be a merger (i.e., amalgamation) of two or more taxable Canadian corporations to form one corporate entity, other than resulting from one corporation acquiring the property of another corporation as a result of a purchase or a winding-up. As well, the following requirements must be satisfied on the amalgamation:

- All of the property and liabilities of the predecessor corporations become the property and liabilities of AmalCo (excluding amounts receivable from or payable between predecessor corporations and any shares held by a predecessor corporation in another predecessor corporation).
- All of the shareholders (except any predecessor corporation holding shares in another) of the predecessor corporations prior to the merger must receive shares of AmalCo.

The rollover provisions of the *ITA* also apply to certain short form amalgamations and those amalgamations in which the shareholders of the predecessor corporations receive shares of a parent corporation of AmalCo (instead of shares of AmalCo). A tax-deferred rollover is also available to a Canadian shareholder of a foreign corporation that merges with another foreign corporation (in either the same or a different foreign jurisdiction).

It should be noted that a rollover is only available to taxpayers with respect to shares they hold as capital property. In addition, any shares held by one predecessor corporation in another predecessor corporation (which are eliminated in any event on the amalgamation) do not qualify for the rollover.

Under the amalgamation rollover provisions in s. 87 of the *ITA*, shareholders of each predecessor corporation (other than shareholders who are other predecessor corporations) are deemed to have disposed of their shares (the Former Shares) in the predecessor corporations for proceeds equal to their ACB in those shares. The shareholders are then deemed to have acquired new shares of AmalCo (the New Shares) at a cost equal to their ACB in the Former Shares. Consequently, there is no deemed dividend, capital gain, or capital loss realized by the shareholders. If the shareholders own shares of several classes or series in the predecessor corporations, then the shareholders' ACB of the Former Shares is pro-rated among the New Shares of AmalCo (based upon the fair market value of the New Shares received).

Example 1 — ACB of shares

Shareholder A owns one common share (with an ACB of $1) and 99 preference shares (with a total ACB of $99) in a predecessor corporation. On the amalgamation, A receives 50 common shares (with a fair market value of $100) and 50 preference shares (with a fair market value of $100) in AmalCo. Because the shares of the predecessor corporation (Former Shares) had an aggregate ACB to A of $100, this will be the aggregate ACB to A of the shares (New Shares) of AmalCo he receives. The total fair market value of all the new AmalCo shares is $200, of which $100 (or ½) represents the fair market value of the 50 common shares of AmalCo. Consequently ½ of A's total ACB of the Former Shares (or $50) is allocated to the 50 common shares of AmalCo. The remaining ½ of A's original ACB of $100 (or $50) is then allocated to A's ACB in the new 50 preference shares of AmalCo.

Generally speaking, the PUC of the shares of AmalCo (New Shares) issued on the amalgamation will equal the aggregate PUC of the Former Shares in the predecessor corporations. It should be noted that the PUC of the shares in a predecessor corporation that are owned by another predecessor corporation is excluded from the PUC of New Shares of AmalCo (again, because such shares are eliminated on the amalgamation).

Example 2 — PUC of shares

The PUC of shares of Corporation A is $50, and the PUC of the shares of Corporation B is $100. If Corporation A and B do not own any shares in each other, the amalgamation of Corporations A and B to form Corporation AB will result in the PUC of the shares of Corporation AB being equal to $150. On the other hand, assume Corporation A is a wholly-owned subsidiary of Corporation B. On the amalgamation of Corporations A and B, the PUC of Corporation AB will be only $100. The PUC of Corporation A has disappeared or been eliminated on the amalgamation.

A rollover also applies to the non-capital losses (i.e., net operating losses) and net capital losses of the predecessor corporations. Generally speaking, these predecessor corporation's losses can be carried forward and used by AmalCo within the carryover periods applicable to such losses. However, losses realized by AmalCo after the date of the amalgamation (post-amalgamation losses) may not be carried back and applied or deducted from the income of a predecessor corporation (and in a pre-amalgamation taxation year), unless the amalgamation was between a parent corporation and one or more wholly owned subsidiary corporations.

Notwithstanding the tax rollover rules in s. 87 of the *ITA*, the ability of AmalCo to carry forward losses of a predecessor corporation and apply them against income of AmalCo is subject to (i.e., limited by) the acquisition of control rules found in s. 111 of the *ITA*.

Consideration should also be given to the effective date of any amalgamation. Since an amalgamation triggers a year-end (for each predecessor corporation), this alone may reduce the amount of business losses available for the carryover by (rollover to) AmalCo. The effect of this rule may be seen in the following example.

Example

Two predecessor corporations, each with a fiscal year-end of December 31, amalgamate on July 1, 2011. After amalgamation, AmalCo also chooses to have a December 31 year-end like the predecessor corporations. In this case, two separate fiscal years will expire during the 2011 calendar year. The first fiscal year that expires is for each predecessor corporation, and this is the period from January 1 to June 30, 2011 (and even though this is a short year for each, it counts as a full taxation year under the rules in the *ITA*). The second year that expires is for AmalCo, and this is for the period from July 1 to December 31, 2011 (i.e., the first fiscal and tax year of AmalCo). If the fiscal period from January 1 to June 30, 2011, was the 20th taxation year after the predecessor corporations suffered a non-capital loss, then such loss will expire on June 30, 2011. In order to avoid this result from the expiry of the predecessor corporations' losses, the amalgamation should have occurred on January 1, 2011. The result would then be that the non-capital loss(es) (of the predecessor corporations) would still be available for use by AmalCo until December 31, 2011. It should be noted that the non-capital loss carryforward periods have been increased recently, i.e., a seven-year carryforward period exists for losses incurred in taxation years ending before March 23, 2004; a 10-year carryforward period exists for losses incurred in taxation years ending between March 23, 2004, and December 31, 2005; and a 20-year carryforward period exists for losses incurred in taxation years ending after December 31, 2005.

There are several other rollover provisions in the *ITA* with respect to amalgamations, such as the tax accounts of the predecessor corporations (i.e., for depreciable and non-depreciable assets).

Upon amalgamation, AmalCo is treated as having acquired depreciable property from a predecessor corporation at the cost amount (i.e., UCC) of that property to the predecessor corporation. AmalCo will also be treated for income tax purposes as having claimed the same CCA on a class of assets that was previously (was already) claimed by the predecessor corporation. Therefore, when AmalCo subsequently sells a depreciable asset, AmalCo will realize the same income tax consequences as would have been incurred by the predecessor corporation if the amalgamation did not occur. Similarly, AmalCo will be treated the same way with respect to eligible capital property (i.e., goodwill) of a predecessor corporation.

On a vertical amalgamation, AmalCo has the ability under the tax rules to increase its tax cost of certain capital property acquired on the amalgamation from a predecessor corporation. The increase in the tax cost of certain property on an amalgamation may offer future planning opportunities to AmalCo. This rule on amalgamation is similar to the "bump" available on the wind-up of a subsidiary corporation into a parent corporation. A detailed discussion of these rules follows below in "Wind-up of a wholly owned (90% or more) subsidiary into parent."

7. Arrangements and reorganizations

7.1 Corporate aspects

An "arrangement" is defined broadly in s. 182(1) of the *OBCA* to include

- reorganization of the share capital of a corporation;
- change in the articles of a corporation;
- amalgamation;
- a transfer of all the property of a corporation to another body corporate;
- exchange of securities of a corporation for money, property, or other securities of that corporation or of another body corporate as long as it is not a take-over bid under the *Securities Act*;
- liquidation or dissolution of a corporation; or
- any other reorganization or scheme which, at law, is an arrangement.

An arrangement requires court approval before it is effective, and subject to any court order, it must be approved by a special resolution of the shareholders. An arrangement must also be approved pursuant to ss. 182(3)–(5) of the *OBCA* by a special resolution of holders of any class or series of shares that, had the arrangement been contained in a proposal to amend the articles, would have been entitled to vote separately as a class or series under s. 170.

The *OBCA* does not provide an automatic dissent right to shareholders in connection with an arrangement. However, the court has discretion pursuant to s. 182(5)(c) to make an order permitting a shareholder to dissent if the arrangement is approved.

Provisions for arrangements also exist in the federal *Companies' Creditors Arrangement Act* (*CCAA*) and the *Bankruptcy and Insolvency Act* (*BIA*). The arrangements sanctioned under these federal Acts are arrangements made when a corporation is bankrupt or insolvent. Under these statutes, for example, existing creditors may be asked to delay the date on which they are to be repaid, accept a different rate of interest, accept payment of interest in shares of the corporation instead of in money, or postpone the priority of the repayment of their indebtedness to enable the corporation to raise new money by the issue of a new class of securities ranking ahead of existing securities and other indebtedness. If the proposed arrangement is sanctioned by the appropriate majority of creditors specified in the legislation and by a court, the arrangement becomes binding on all creditors. The terms of an arrangement between a corporation and its creditors may also require changes in the corporation's articles. A change in the articles in such circumstances is called a "reorganization" and is accomplished by the issue of articles of reorganization under s. 186 of the *OBCA*. The *OBCA* authorizes a court to issue articles of reorganization in connection with a court order made under the *BIA* or the *CCAA* approving a proposal. Pursuant to s. 186(6) of the *OBCA*, no shareholders have dissent rights in connection with an amendment of articles under a reorganization.

Under s. 248 of the *OBCA*, articles of reorganization may be issued in connection with a court order made to correct a situation found by a court to be oppressive or unfair.

7.2 Income tax aspects

The *OBCA* defines an "arrangement" very broadly. As a result, the income tax consequences of an arrangement will vary depending on the manner in which the arrangement occurs. If an arrangement is in fact an amalgamation, then the tax rules in the *ITA* dealing with an amalgamation may apply.

Where an arrangement is carried out as a reorganization of the share capital of a corporation, the provisions in s. 86 of the *ITA* may provide for rollover treatment. Section 86 of the *ITA* applies when there is an actual reorganization of the share capital of a corporation but not necessarily to conversions of convertible properties (i.e., debt) into shares. However, there are other rollover provisions in the *ITA* that may apply to convertible property transactions (i.e., s. 51 of the *ITA*).

Under the provisions of s. 86 (rollover) of the *ITA*, a shareholder must dispose of all the shares (Former Shares) of any particular class in a corporation that are capital property to the shareholder. The consideration (or property) that may be received by the shareholder from the corporation in return for the Former Shares must include other shares (New Shares) of the same corporation. The property receivable from the corporation may also include other property or non-share consideration (i.e., other than the New Shares).

Where the requirements of s. 86 are satisfied, the cost to the shareholder of any non-share consideration received will be deemed to be the fair market value of any such non-share consideration. The shareholder's cost of any New Shares of a particular class is deemed to be the amount by which the shareholder's aggregate ACB of the Former Shares exceeds the fair market value of the non-share consideration. As in an amalgamation, when more than one class of New Shares is involved (i.e., issued), the shareholder's ACB is pro-rated between the different classes of shares based on the fair market values of the New Shares received. The shareholder is also deemed to have received proceeds of disposition for the Former Shares equal to the (deemed) cost of all New Shares and non-share consideration received from the corporation.

Example 1 — ACB of shares

A shareholder owns Former Shares with an ACB of $100 and a fair market value of $200. A reorganization of capital in the corporation occurs in which the Former Shares are surrendered in exchange for the issuance of New Shares of a single class having a fair market value of $200. The shareholder does not receive any non-share consideration. The deemed cost of the New Shares to the shareholder is $100, and the deemed proceeds of disposition of the Former Shares will also be $100.

On the other hand, if the shareholder received Class A shares with a fair market value of $150 and Class B shares with a fair market value of $50, one-quarter of the cost of the Former Shares ($25) would be allocated to the Class B shares (i.e., since the fair market value of the Class B shares is $50, or one-quarter of the total fair market value of $200).

Example 2 — ACB of shares and non-share consideration

A shareholder owns Former Shares with an ACB of $100 and a fair market value of $300. The shareholder receives

- New Shares of a single class received in exchange from the corporation that have a fair market value of $250; and
- non-share consideration that has a fair market value of $50.

The cost of the New Shares is deemed to be $50 (the $100 ACB of the Former Shares minus the $50 fair

market value of the non-share consideration). As a result, a subsequent disposition of the New Shares will result in a capital gain to the shareholder (i.e., the deferred gain of $200 on the Former Shares is now inherent on the New Shares (ACB of $50 and fair market value of $250). The shareholder's proceeds of disposition for the Former Shares are still deemed to be $100 (the $50 cost of the New Shares plus the $50 (cost) fair market value of the non-share consideration). Consequently a rollover still occurs for the shareholder.

It should be noted that a full (i.e., tax-deferred) rollover will not occur where the fair market value of the Former Shares is greater than the fair market value of the consideration received in exchange from the corporation (i.e., is greater than the fair market value of the non-share consideration and the New Shares), and it is reasonable to view the excess as a benefit that the shareholder (disposing of the Former Shares) desired to have conferred on a related person (i.e., a spouse or other related party who is also a shareholder). In such circumstances, the shareholder's proceeds of disposition for Former Shares are deemed to be the lesser of the following amounts:

- the fair market value of any non-share consideration received plus the excess (i.e., value of Former Shares over the fair market value of all the consideration received in exchange); and
- the fair market value of the Former Shares.

As a result, the shareholder is denied any capital loss that might otherwise have been realized on the exchange. The cost of any New Shares of a class received from the corporation will equal the shareholder's ACB of the Former Shares minus the aggregate of

- the fair market value of the New Shares; and
- the excess amount.

Where there are more than one class of shares involved, the shareholder's cost (ACB) will be pro-rated among the classes based on fair market values of the classes of New Shares.

8. Going private transactions

A "going private transaction" is defined in *OBCA*, s. 190(1) as an amalgamation, arrangement, consolidation, or other transaction carried out under the *OBCA* that would cause the interest of a holder of a participating security to be terminated without the consent of the holder and without the substitution therefore of an interest of equivalent value in another participating security. A "participating security" is a security issued by a corporation other than a security that is limited in the extent of its participation in earnings. Common shares, for example, are participating securities.

One common example of a going private transaction is called an "amalgamation squeeze-out." In this situation, a controlling shareholder who owns a majority of the shares of a corporation (Corporation A) seeks to become the sole shareholder of Corporation A by "squeezing out" all the minority shareholders through an amalgamation. The controlling shareholder incorporates a corporation (Corporation B) and transfers to it all of the controlling shareholders' shares in Corporation A. The controlling shareholder then uses its voting power to cause Corporation A and Corporation B to amalgamate. The amalgamation agreement will provide that the controlling shareholder receives common shares in the amalgamated corporation, but the other shareholders receive cash or redeemable preference shares of the amalgamated corporation that are then redeemed for cash.

A second type of going private transaction is a share consolidation that is carried out by means of an arrangement. The authorized capital of the corporation is consolidated at a high enough ratio, such as one new share for every 5,000 shares held, so that following the consolidation only the controlling shareholder or controlling shareholders are left with more than one share. The former minority shareholders who would hold only fractional shares receive cash instead.

The income tax implications arising from a going private transaction will vary depending on the manner in which the transaction is structured. In an amalgamation squeeze-out, the provisions of the *ITA* dealing with amalgamations (described above) will apply on the amalgamation part of the transaction. Depending on the particular circumstances of the transaction, the amalgamation may qualify for tax rollover treatment. The tax consequences arising on a later redemption or repurchase of the shares of AmalCo are discussed above under "Redemption, cancellation, and purchase of shares."

In any case which qualifies as a going private transaction, a corporation that proposes to carry out such a going private transaction must do four things. First, pursuant to s. 190(2) of the *OBCA*, it must obtain an independent valuation of the securities affected, and if the consideration to be received for those securities is not to be cash, in whole or in part, the valuer must state whether the value of each security is equal to or greater than the consideration to be given for it.

Second, pursuant to s. 190(4), the going private transaction must be approved by a prescribed vote of the

holders of each class of affected securities, in addition to any other required security holder approval. If the consideration to be received is payable in whole or in part other than in cash or is payable in cash but the consideration is less than the valuation, the transaction must be approved by a special resolution. In other cases, the transaction must be approved by an ordinary resolution.

Third, in determining whether the transaction has been approved by the requisite majority, the votes of security holders with an interest in the transaction are not to be counted. In short, it is up to a majority, and in some instances a majority of more than two-thirds, of persons independent of the controlling shareholders to determine whether the going private transaction may occur.

Fourth, pursuant to s. 190(3), the corporation must send a management information circular to the holders of the affected securities not less than 40 days prior to the date of a meeting called to consider the transaction. The information circular must contain, in addition to any other required information, a summary of the valuation and a statement that a copy may be inspected at the registered office of the corporation or that a security holder may obtain a copy of the valuation upon request. The information circular must also describe what approval is required to be obtained, a statement of the class or classes of affected securities, the number of securities of each class, and a statement of the number of such securities that are not to be taken into account in the vote. There must also be a certificate signed by a senior officer or a director of the corporation certifying that the officer or director and, to his or her knowledge, the corporation are unaware of any material fact relevant to the valuation that was not disclosed to the valuer.

Finally, a holder of an affected security may dissent from a going private transaction. Also, the rights provided in s. 190 are in addition to any other rights of a holder of an affected security. This means, for example, that a holder of affected securities continues to have the right to make an application under s. 248 of the *OBCA* on the basis that a transaction is oppressive or unfairly prejudicial.

The *CBCA* contains no provision that is exactly equivalent to s. 190 of the *OBCA*. However, the OSC has rules on going private transactions that will be applicable to *CBCA* corporations with security holders in Ontario. The *CBCA* also regulates squeeze-out transactions by effectively preventing majority shareholders from voting on them (*CBCA*, s. 194).

9. Termination of a corporation's existence

A corporation will cease to exist if it is voluntarily dissolved, if it is wound up, or if its certificate of incorporation is cancelled by the Director. The principal distinction between dissolution and winding-up is the identity of the person or persons who carry out the steps required to terminate a corporation's existence. A dissolution is handled by the existing management of the corporation. A winding-up is managed by another person appointed solely for that purpose.

When a corporation is insolvent or bankrupt, it may only be wound up under the provisions of the federal *Winding-up and Restructuring Act* or the *BIA*, not under the provisions of a provincial law or under the provisions of the *CBCA*.

Both the *OBCA* and the *CBCA* provide for three methods by which a corporation's existence may be terminated when a corporation is neither bankrupt nor insolvent.

9.1 Voluntary dissolution

Voluntary dissolution is the most commonly employed method for dissolving a corporation when it has ceased to fulfill a useful purpose for its shareholders. Sometimes the corporation is never actively used after the certificate of incorporation is obtained, and the incorporators then decide to terminate the corporation's existence. The *OBCA* requirements for a voluntary dissolution are set out in ss. 237–239. A voluntary dissolution must be authorized by a special resolution passed at a meeting of the shareholders called for that purpose or, in the case of a corporation that is not an offering corporation, by such other proportion of votes cast as the articles provide, but this other proportion may not be less than 50% of the votes of all the shareholders entitled to vote at the meeting. Shareholder approval may also be granted by the consent in writing of all shareholders entitled to vote at a meeting on the issue of dissolution. If the corporation has not commenced business and has not issued any shares, the incorporators or their personal representatives may authorize the dissolution of the corporation within two years after the date set out in its certificate of incorporation.

The corporation must pay off or settle its debts, obligations, and liabilities prior to dissolution. If any of its creditors cannot be found, the corporation may make a payment to the Public Trustee equal to the amount due to the creditor. If any debts, obligations, or liabilities are not paid off, the unpaid creditors must consent to the dissolution.

Prior to filing articles of dissolution, the corporation should also distribute to its shareholders, according to their rights and interests, any property remaining after the discharge of its debts, obligations, and liabilities. These rights and interests are determined by reviewing the provisions in the share conditions of the corporation.

For example, before the common shareholders receive any part of the assets available for distribution, preferred shareholders will normally receive any cumulative unpaid dividends and the capital paid into the corporation when the preferred shares were issued. Such transfers are often accomplished by the dissolving corporation entering into one or more contracts that convey its assets to its shareholders. If a shareholder or his or her whereabouts are unknown, the corporation may, by agreement with the Public Trustee, deliver or convey that shareholder's share of the property of the corporation to the Public Trustee, who holds the property in trust for the shareholder.

The articles of dissolution (Form 10) must also be accompanied by a consent letter to the dissolution of the corporation from the Ontario Ministry of Revenue. The corporation must file all outstanding Ontario corporations' tax returns (for tax years prior to 2009) and all outstanding federal corporate tax returns (with the CRA for tax years after 2008, since the CRA is administering Ontario tax compliance for 2009 and subsequent tax years). Procedurally, for 2009 and subsequent tax years, the answer "Yes" should be checked for the question on the corporate tax return, "Is this the final return up to dissolution?" In addition, the taxpayer should write a letter to the Ontario Ministry of Revenue (i) quoting the corporation's federal and provincial tax numbers, (ii) indicating that the final corporate tax return (T2) has been filed, and (iii) requesting the Minister's "consent letter" to the dissolution. The corporation must also pay any taxes that are due in order to receive the consent. This consent of the Ontario Ministry of Revenue takes the form of a letter and is to be filed together with articles of dissolution and payment of the requisite filing fee within 60 days of date of consent letter.

The consent of the CRA to the dissolution should also be obtained, even though it is not required in order to obtain a certificate of dissolution under the *OBCA*. Failure to obtain an appropriate certificate from the CRA may result in the directors and officers of the corporation being held personally liable for the payment of amounts owing by the corporation under the *ITA* to the extent of the value of property distributed by the corporation by virtue of the dissolution.

In order to bring the dissolution into effect, articles of dissolution in the form prescribed and containing the information required in s. 238(1) or (2) of the *OBCA* should be filed in duplicate with the Director. Upon receipt of the articles, the Director will, pursuant to s. 239(1), endorse a certificate that constitutes the certificate of dissolution. The corporation is dissolved upon the date of the certificate of dissolution. Once the articles of dissolution are returned, a final corporate tax return should be filed with the CRA (for the time period from the last corporate return to the date of dissolution). CRA Form RC145 (requesting the CRA to close the business numbers of the corporation) should also be filed with this final corporate tax return along with a copy of the articles of dissolution.

Existing legal proceedings may be continued against a dissolved corporation, and new ones may be commenced pursuant to s. 242 of the *OBCA*. In connection with such actions, each shareholder to whom any property of a dissolving corporation was distributed is liable to the extent of the amount received by the shareholder on the distribution pursuant to s. 243(1).

9.2 Winding-up

9.2.1 Voluntary

Under the *OBCA*, the shareholders may by special resolution require a corporation to be wound up voluntarily. The winding-up is termed "voluntary" because it is initiated by the shareholders. The procedures to be followed are contained in ss. 193–205 of the *OBCA*. The principal difference between a voluntary dissolution and a voluntary winding-up is that in the case of a voluntary winding-up, the liquidation of the corporation's debts and the distribution of any assets to its shareholders are handled by a liquidator.

When the shareholders authorize a voluntary winding-up, they are also required to appoint one or more persons as a liquidator, who may be directors, officers, or employees of the corporation. Notice of the resolution authorizing the winding-up must be filed with the Director in a prescribed form within 10 days after the resolution is passed and must be published in the *Ontario Gazette* within 20 days (*OBCA*, s. 193(4)). Once the resolution is passed, pursuant to s. 198, the corporation must cease to carry on its business and undertaking except as it may be beneficial for the winding-up of the corporation. After the resolution is passed any subsequent transfer of shares is void unless the transfer is sanctioned by the liquidator. The board of directors also ceases to function, and the liquidator takes control of the assets of the corporation, disposing of them and paying off the corporation's debts or other liabilities. The liquidator may also make compromises or other arrangements with creditors and with contributories, who are persons liable to contribute property to the corporation. Such compromises or arrangements must be approved by the shareholders. After the commencement of a voluntary winding-up, no further proceedings may be commenced against the corporation and no

proceedings to attach or otherwise levy execution against its assets may be brought without leave of a court pursuant to s. 199 of the *OBCA*.

When the liquidator has completed disposing of the corporation's assets and settling its liabilities, a final meeting of shareholders must be called at which the liquidator gives an account of the winding-up to the shareholders. The liquidator then files a prescribed form with the Director within 10 days of the meeting and publishes a notice in the *Ontario Gazette* that the meeting was held. Three months after the date that the notice is filed with the Director, the corporation is dissolved, unless the dissolution is deferred or accelerated by a court order obtained at the request of the liquidator or any other interested person pursuant to s. 205 of the *OBCA*.

A voluntary winding-up has advantages over a voluntary dissolution when it is desirable to remove control of the liquidation from some or all of the directors and officers of the corporation, attempt to limit further actions against the corporation or further execution against its assets, insert the liquidator as a more neutral party than the existing management, or try to reach accommodations with creditors.

9.2.2 By court

A court may order that a corporation be wound up, in which case the winding-up is compulsory. It occurs whether or not the shareholders want the corporation to be wound up. The procedure governing a compulsory winding-up by court order is set forth in ss. 207–218 of the *OBCA*. An application for a corporation to be wound up by court order may be brought before a court by a shareholder, a liquidator engaged in a voluntary winding-up of the corporation, a contributory (a term defined in s. 191), or any creditor with a claim of $2,500 or more pursuant to s. 208(1).

A court may order that a corporation be wound up on any ground contained in s. 207 of the *OBCA*.

The procedure for winding up by court order is much the same as in the case of a voluntary winding-up, except that all proceedings in the winding-up are subject to the order and direction of the court and the court orders the dissolution of the corporation when the corporation's business and affairs have been fully wound up.

It may be advisable for shareholders to seek a court-ordered winding-up rather than a voluntary winding-up if litigation is expected to occur with respect to the winding-up. In such circumstances, a court will be involved in any case. A liquidator in a voluntary winding-up may wish to request a winding-up by court order if an action is brought or anticipated against the liquidator. The liquidator can then request that the court approve its actions, which should insulate the liquidator from liability.

The *CBCA* offers no equivalent to the *OBCA* arrangements for a voluntary winding-up administered by a liquidator. However, it is possible for any interested person, including the corporation's shareholders, to request that a voluntary liquidation and dissolution under the *CBCA* be carried out under the supervision of a court.

9.3 Dissolution by Director

Under the *OBCA*, the corporation's certificate of incorporation or other certificate may be cancelled by the Director (s. 240) if the corporation fails to appoint directors in accordance with s. 115(2), more than 75% of directors are not resident Canadians, the corporation is convicted of an offence under the federal *Criminal Code* or any other federal statute or an offence as defined in Ontario's *Provincial Offences Act*, it is in the public interest to cancel its certificate, or there has been oppressive conduct. Failure by a corporation to file corporate tax returns under Ontario's *Corporations Tax Act*, to file financial statements with the OSC as required under the *Securities Act*, or to comply with a filing requirement under the *CIA* may also result in cancellation of a corporation's certificate after appropriate notice has been given to the corporation, pursuant to ss. 240–241. A decision of the Director to dissolve a corporation is subject to appeal.

Property of a corporation that has not been disposed of at the date of its dissolution is forfeited to and vests in the Crown pursuant to s. 244(1) of the *OBCA*.

9.4 Income tax aspects

The winding-up or dissolution of a corporation results in two levels of dispositions for tax purposes. First, at the corporate level, the corporation disposes of its assets to its shareholders, resulting in an acquisition of the corporation's assets by the shareholders. Secondly, at the shareholder level, shareholders dispose of their shares in the corporation.

The resulting income tax consequences to the dissolving corporation and the shareholders will vary depending on whether the dissolving corporation is a taxable Canadian corporation and a wholly owned (90% or more) subsidiary of another taxable Canadian corporation. In that case, there is a tax-free rollover of the dissolving corporation's assets to the parent corporation. Where this prerequisite does not exist, tax consequences arise for the corporation and its shareholders.

There is no definition in the *ITA* of a winding-up of a corporation. Although some may be concerned that the *ITA*'s winding-up rollover provisions may not apply where a corporation terminates its existence by means of a "dissolution," the CRA takes the position that a "dissolution" under the *OBCA* and *CBCA* comes within the *ITA* rules dealing with wind-ups.

The wind-up rules in the *ITA* include the phrases "immediately before the winding-up" and "on the winding-up." In the view of the CRA, the phrase "immediately before the winding-up" refers to the point in time immediately before implementing the winding-up procedures (i.e., the shareholder's resolution authorizing the winding-up). It is reasonable to anticipate the view of the CRA of the phrase "on the winding-up" would mean the time period during which the actual winding-up transactions/transfers take place.

9.4.1 General winding-up of a Canadian corporation

If the rollover provisions on a wind-up under s. 88(1) do not apply, then the tax rules in ss. 88(2), 69(5), and 84(3) will apply and determine the tax consequences to the taxpayers (shareholders and corporation) who are parties to a winding-up or dissolution of a Canadian corporation.

(a) Corporation

When a corporation is wound up, it is considered to dispose and distribute all of its assets (at fair market value immediately before the winding-up) to its shareholders. This disposition of assets by the corporation will result in income (i.e., from inventory or recaptured CCA from capital property) as well as capital gains or losses being realized by the corporation.

Because of this income or capital gain (and the resultant tax liability to the corporation), provision should be made for the payment of this tax. Once the corporation has distributed its assets, there is no longer any property available to pay this liability.

(b) Shareholders

Following from the corporation's disposition of assets at fair market value, a shareholder is deemed to acquire each asset at a cost equal to its fair market value immediately before the wind-up. This is the starting point to calculate the tax cost of the distributed assets to the shareholders.

On a wind-up, the shareholders also dispose of their shares in the corporation. To a large extent this is similar to the redemption or repurchase of shares because the corporation is deemed to have paid a dividend to the shareholders. The amount of this dividend is equal to the amount by which the fair market value of the cash or other assets distributed by the corporation to the shareholders exceeds the amount by which the PUC of the shares is reduced by the distribution (in most circumstances the PUC of the shares is reduced to nil). Shareholders are deemed to receive this dividend on a *pro rata* basis.

For purposes of calculating a shareholder's proceeds of disposition for shares, only the part of the redemption proceeds not treated as a dividend is taken into account. In practical terms, this means that the actual proceeds of disposition are reduced by the amount of the deemed dividend (i.e., to ensure the shareholder is not taxed on this amount again). Where a shareholder's ACB in the shares is greater than the PUC of the shares, this reduction to the proceeds of disposition (for the amount of the deemed dividend) will result in the shareholder realizing a capital loss. On the other hand, where a shareholder's ACB in the shares is less than the PUC of the shares, the shareholder will realize a capital gain.

Example

A is an individual shareholder of shares in a corporation with PUC of $100 and an ACB in the shares of $200. The corporation is wound up, and the shareholder receives cash and other property from the corporation with a fair market value of $250. In this case, the shareholder will be deemed to received a dividend from the corporation of $150 ($250 minus the PUC of the shares of $100), and such excesses distributed by a corporation to its shareholders represent a distribution of corporate surplus (or after-tax profits—the equivalent of a dividend for tax policy purposes). Looking next at the shareholder's disposition of the shares (i.e., capital property), the actual amount that would otherwise be considered the proceeds of disposition ($250) is reduced by the deemed dividend ($150). Consequently the shareholder's adjusted or notional proceeds of disposition are now $100. Since the shareholder has an ACB in the shares of $200, the shareholder realizes a $100 capital loss on the disposition of his or her shares when the corporation is wound up.

Where a corporation is wound up and debts that are owed to the corporation are not fully paid (i.e., debtors do not fully repay the corporation), the shortfall from settled debts reduces certain tax accounts (i.e., loss carryovers and the UCC of depreciable assets) of the debtor. This is because the debtor has gained by settling debts it owes for a lesser amount. However, it should be noted that debtors might pay debts not just with cash, but also property. For example, assume a corporation is to be wound up, but there is money (a debt) owed by a shareholder to the corporation. In this case, the

shareholder can repay this debt to the corporation by offsetting (i.e., having the corporation reduce) the amount of assets or property distributed to the shareholder on the winding-up distribution. Similarly, a corporation's debt may be assigned to a shareholder to minimize any reduction in the tax accounts (and tax attributes of property) of the corporation.

9.4.2 Wind-up of a wholly owned (90% or more) subsidiary into parent

A rollover is available under s. 88(1) of the *ITA* where a taxable Canadian corporation (a subsidiary corporation) is being wound up and not less than 90% of the issued shares of each class of the capital stock of the subsidiary is owned by another taxable Canadian corporation (the parent corporation). Another requirement under s. 88(1) is that the shares of the subsidiary not owned by the parent immediately prior to the wind-up have to be owned by persons who deal at arm's length with the parent.

However, the rollover provisions in s. 88(1) only apply to property of the subsidiary distributed to the parent and only to those shares of the subsidiary owned by the parent. There is no rollover available under the *ITA* to the minority shareholders.

(a) Subsidiary

Since the subsidiary is deemed to dispose of its property to the parent on the wind-up for proceeds equal to the "cost amount" of the property to the subsidiary prior to the wind-up, the rollover provisions apply. (Note: The cost amounts of various types of assets are summarized in Figure 1 in "Claiming the rollover," above.)

As a result of the disposition of property by a subsidiary at the "cost amount," no income or capital gain or loss is realized, provided the cost amounts of the subsidiary's assets have not changed in the time period from "immediately before the winding-up" and the actual distribution.

Since the CRA's view is that the phrase "immediately before the winding-up" refers to that point in time before implementing the wind-up, it remains possible for a change to occur in cost amounts of assets to be distributed. As a concession and in order to minimize such timing problems for the subsidiary and parent, the CRA will consider that "immediately before a winding-up" for any asset disposition, means immediately before that particular disposition.

(b) Parent

The rules in s. 88(1) also provide that the shares of the subsidiary owned by the parent are deemed disposed of for proceeds equal to the greater of the following amounts:

- the parents' ACB in the shares of the subsidiary immediately before the winding-up; and
- the lesser of the following amounts:
  - the PUC of the shares of the subsidiary immediately before the winding-up; and
  - the cost amounts of all property held by the subsidiary immediately before the winding-up, plus the cash on hand of the subsidiary immediately before the winding-up, less all of the outstanding debts owing by the subsidiary immediately before the winding-up and the amount of certain tax reserves claimed and deducted in computing the income of the subsidiary for its taxation year during which its assets are distributed to the parent.

Applying this formula means the parent corporation's proceeds of disposition must be at least equal to its ACB in the shares of the subsidiary. Consequently, a parent cannot realize a capital loss on the subsidiary's winding-up. However, a parent may realize a capital gain if the parent purchased its shares (i.e., has an ACB in the shares of the subsidiary) for an amount that is less than the PUC of the subsidiary's shares.

Example

A parent owns shares in a subsidiary with an ACB of $800 and the PUC of these shares is $1,000. On a s. 88(1) wind-up, the subsidiary has no outstanding debts, no cash on hand and has deducted no reserves for tax purposes. The cost amount of the subsidiary's assets is equal to $1,500.

Therefore the parent's proceeds of disposition for its shares in the subsidiary is equal to the greater of

- its ACB in the subsidiary's shares (i.e., $800); and
- the lesser of
  - the PUC of the subsidiary's shares (i.e., $1,000); or
  - the cost amounts of the subsidiary's assets (i.e., $1,500).

The parent's proceeds of disposition are therefore $1,000, which results in the parent realizing a capital gain of $200 (proceeds of disposition of $1,000 minus its ACB in the shares of the subsidiary of $800).

Therefore, on a wind-up the parent usually acquires each asset distributed by the subsidiary for an amount equal to the proceeds of disposition of the property to the subsidiary (i.e., rollover of subsidiary's cost to parent). However, there is an exception to this general rule where the parent's ACB in the shares of the subsidiary exceeds the aggregate of the cost amounts to the subsidiary of

property distributed by the subsidiary to the parent (i.e., some of the parent's ACB in shares is lost in comparison to the cost in the assets received from the subsidiary).

In this situation, a parent may be able to increase (i.e., bump) its acquisition cost of certain non-depreciable capital property (i.e., land, shares) received from the subsidiary. This increase in an asset's cost by the parent is only available where the asset was owned by the subsidiary at the time the parent last acquired control of the subsidiary (without interruption until the asset was distributed to the parent). There is another limitation on the parent's increase or "bump" to the acquisition cost of any particular property; i.e., the parent's acquisition cost of the asset cannot exceed the fair market value of that asset at the time the parent last acquired control of the subsidiary. Likewise, there is an aggregate limitation to the parent's (increased) acquisition cost of all properties. The parent's aggregated acquisition cost may not exceed the fair market value of the properties at the time the parent last acquired control of the subsidiary.

The calculation of a parent's increase in the acquisition cost of assets received from the subsidiary on a wind-up is complicated. Simply stated, the parent's increase in the acquisition cost of assets is equal to the parent's ACB in the shares of the subsidiary minus the following amounts:

- the cost amount of all property held by the subsidiary immediately before the wind-up, plus cash on hand of the subsidiary immediately before the wind-up, minus all outstanding debts owing by the subsidiary immediately before the wind-up and the amount of certain reserves deducted in computing the income of the subsidiary for the taxation year during which its assets are distributed to the parent; and
- the total of certain tax-free dividends received by the parent on its shares in the subsidiary.

Example

A parent owns shares in a subsidiary with an ACB of $800 in the shares. At the time the parent acquired its shares of the subsidiary, the only asset the subsidiary owned was land with an ACB of $500 to the subsidiary. This land had a fair market value of $700 when the parent acquired the shares in the subsidiary. The land is still the only asset owned by the subsidiary. The subsidiary is now wound up into the parent. The subsidiary has no debts, has deducted no reserves, and has paid no tax-free dividends to its shareholders. How much can the parent increase its acquisition cost in the land? First, we know the parent's ACB in its shares is $800 and this is $300 greater than the subsidiary's cost amount ($500) for the land at that time. Secondly, the land had a fair market value of $700 at the time the parent acquired its shares of the subsidiary (and yet this fair market value for the land at that time is only $200 more ($700 minus $500) than the subsidiary's ACB in the land). As a result, the maximum increase by the parent to its acquisition cost in the land is $200.

Again, the explanation for the parent's increase in acquisition cost is because the parent has received land with an ACB that is less than parent's ACB in the shares of the subsidiary the parent is giving up on the wind-up. The increase in the parent's acquisition cost of the non-depreciable property is an allowable adjustment to alleviate an otherwise unfavourable consequence from winding up the subsidiary.

Generally speaking, the net capital and non-capital losses of a subsidiary flow through to the parent (i.e., are available for future use), provided there is no change of control (of the parent) and the relevant business continuation requirements (i.e., the same or similar business) are met. Since a parent may only deduct the subsidiary's losses beginning with the parent's taxation year that commences after the start of the wind-up, there may be a delay before the parent may use the losses.

9.5 Other taxes

Where land is transferred from a subsidiary on a wind-up, land transfer tax (LTT) will be payable by the shareholder receiving the land. The amount of LTT will be imposed on the fair market value of the land at the time the conveyance is tendered for registration by the shareholder.

Harmonized Sales Tax (HST) may also be payable to the extent that any goods and services are transferred to a shareholder on a wind-up. Where the parent corporation is also a registrant for HST, an input tax credit may be claimed by the parent corporation for any HST paid on receiving goods and services from the subsidiary on a wind-up.

10. Revival

Corporations are sometimes capable of being revived after their existence has ended.

The revival of a corporation, pursuant to s. 241(5) of the *OBCA*, is permitted by the Director on the application of any interested person within 20 years of the dissolution, if the corporation was dissolved for failing to file Ontario corporate tax returns, financial statements under the *Securities Act*, or information under the *CIA*. An application is made by filing articles of revival in Form 15 together with the prescribed fee. The articles of revival must also be accompanied by a consent letter to the revival from the Ontario Ministry of Revenue, a

statement by the Public Guardian and Trustee that he or she has no objection to the revival; a name search report and any consent required for the use of the name; and, if the corporation was dissolved due to its failure to file financial statements under the *Securities Act*, the consent of the OSC to the revival. A corporation that is revived shall, subject to any terms and conditions imposed by the Director, be deemed for all purposes to have never been dissolved.

Chapter 24

Securities law implications

1. Introduction

All of the provinces and territories have securities legislation in place. Securities legislation is broadly intended to regulate the provision of investment capital to business enterprises, whether through equity or debt, and the resale of securities issued in consideration for that investment capital. Securities legislation can be compared to consumer protection legislation in that it provides safeguards to protect the investing public with a view to promoting confidence in the capital market.

The *Securities Act* (*Act*) accomplishes this objective through

- the regulation of market participants, who are those persons or companies selling or marketing a security; and
- the regulation of the kind of information investors receive.

The securities or "capital" market consists of essentially two components: the primary market and the secondary market. The primary market for securities is represented by business entities that issue such securities. These entities represent all types of business organizations and include both large public companies and smaller, private and closely held companies. The secondary market comprises transactions involving the purchase and sale of previously issued securities. The most obvious example of a secondary market is a stock exchange, such as the Toronto Stock Exchange (TSX), where investors may buy and sell the securities of publicly traded companies that have previously been issued and that are accepted for trading on the exchange.

2. Securities law in Ontario

The principal source of securities legislation in Ontario is the *Act* and the regulations and rules made thereunder.

The Ontario Securities Commission (OSC) is charged with administering the *Act*. The OSC is provided with considerable authority under the *Act* and has broad discretion in the exercise of that authority. In its regulatory capacity, the OSC has historically issued "notices" and "policy statements," which prescribe the manner in which it intends to interpret the *Act* and its regulations, and "blanket rulings," which serve to regulate in a similar manner specific types of transactions or investment schemes. The OSC also has the power to adopt binding rules, the intent being that substantive matters will be addressed through the adoption of rules as opposed to statements of policy. Rules, once adopted, have the same force in law as the regulations. Certain rules are adopted by all or several jurisdictions nationally or among a number of provincial jurisdictions, and these are referred to as "national" or "multilateral instruments," respectively. The authority of the OSC to make rules has not in any way detracted from the continuing use of policy statements as a regulatory tool. The securities law practitioner must be familiar with not only the legislation (which, in certain cases, contain provisions that are no longer in effect due to rules) and rules, but also the policies and guidelines adopted by the OSC and other provincial securities regulatory authorities.

2.1 "Security"

It is critical to recognize that the *Act* has remarkable breadth of application. In order to determine whether a proposed investment transaction is subject to the legislation, one must consider whether the investment transaction involves a security within the meaning of the *Act*. The term "security" is given a broad definition in s. 1(1) of the *Act*. While there are 16 different enumerated branches of the definition, it is not exhaustive. It reads, "Security includes ...."

An expansive definition has been adopted to ensure that the *Act* will apply to all forms of traditional securities, such as shares, interests in partnerships, or debt instruments, as well as to new or innovative forms of securities. The definition includes, for example, any document "constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company."

The judicial treatment of the various enumerated heads in the definition of security has so far been to afford them a narrow construction with the exception of the concept of an investment contract contained within the definition. The "investment contract" concept has traditionally been used as the catch-all component within the definition. The leading case on that term established a test, which if satisfied, would be indicative of the existence of an investment contract:

- an investment of money;
- in a common enterprise;
- with an expectation of profit;

- solely from the efforts of others.

The Supreme Court of Canada in *Pacific Coast Coin Exchange of Canada Ltd. et al. v. Ontario Securities Commission* adopted that test. In this case, a promoter offered bags of silver coins for sale. The investor would agree to buy bags of silver coins by paying a portion of the price but would rarely take actual delivery of the coins. In most cases, it was contemplated that the full price for the coins would never be paid and the coins would be resold to the promoter, with the promoter or investor either suffering a loss or gaining a profit depending on the change in the market price or value of the coins at the time of resale. In deciding that the investment scheme constituted an investment contract, the Supreme Court of Canada pronounced that the *Act* represented remedial legislation, which should be broadly construed to enable the *Act* to respond to the "economic realities" of any particular investment scheme to which it is addressed.

An important concept of the *Act* is that the underlying policy of protecting investors is best accomplished by subjecting as many investment schemes as possible to the requirements of the *Act*. However, the *Act* itself recognizes that full compliance in certain situations would be burdensome and inefficient. To account for this, there are numerous exemptions from the requirements of the *Act* based on the nature of the security, the transaction, or the participants in the transaction.

2.2 Regulation of market participants

The *Act* attempts to protect the investing public by ensuring that only reputable persons are involved in the selling and marketing of securities. In s. 25, the *Act* provides that any individual who

- trades in securities; or
- acts as an adviser or underwriter

must be licensed (or registered) under the *Act*.

The expressions "trade," "adviser," and "underwriter" are defined in s. 1(1) of the *Act*.

The term "trade" is broadly defined and includes a disposition (or sale) for value of a security or an act in furtherance of such a disposition. The concept of a trade is important for an understanding of the registration requirements and also for the prospectus requirements.

The term "adviser" generally extends to persons who give investment advice as well as to those who enjoy a discretionary authority to invest as they see fit the funds of clients in specific securities. An "underwriter" refers to an individual or company that purchases or arranges for purchases of securities for the purpose of resale, either as principal or as agent.

A person or company who purports to either trade, advise, or underwrite must register in accordance with the *Act*, unless an exemption from this registration requirement is available. For example, a person who wishes to sell shares in a company to another person would, by doing so, be engaging in a "trade" and would either have to be registered to trade or make the trade under an exemption. Registrants must generally maintain a minimum level of capital, maintain a bond or insurance, participate in an investor compensation fund, provide certain ongoing financial reporting, and implement record-keeping procedures. In many cases, such person or company must also have obtained membership in an industry "self-regulatory organization" that assists in regulating the conduct of the business and affairs of its membership.

The goal of licensing securities market participants is to encourage honesty, competence, and financial responsibility. The enforcement of licensing requirements is intended to reduce instances of unfair dealing and safeguard against the risk of insolvency of market participants. Effective enforcement of licensing requirements is intended to promote confidence in the market and protect the investing public. Pursuant to s. 127(1) of the *Act*, where the OSC feels it is in the public interest to do so, the OSC is empowered to suspend, restrict, and impose terms and conditions on the registrant or reprimand the registrant.

As noted earlier, relief is granted to those individuals and business entities that are inappropriately included in the registration provisions in the Act. The exemptions from registration are generally enumerated in National Instrument 45-106, *Prospectus and Registration Exemptions* (NI 45-106), National Instrument 31-103, *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103), and OSC Rule 45-501, *Ontario Prospectus and Registration Exemptions*. There are also other rules that provide exemptions for particular situations. As a word of caution, all of the registration exemptions contained in ss. 34–35 of the *Act* are no longer in force because OSC Rule 45-501 has rendered them unavailable, and they are now in that rule, NI 45-106, or NI 31-103 either in their original or in an amended form.

Certain persons may act as advisers within the meaning of the *Act* but are exempt from the registration requirement. For example, Companion Policy 31-103CP outlines that, if trading or advising activity is incidental to a firm's primary business, such activity may not be considered to be a business purpose and would not

trigger a registration requirement. Professionals such as lawyers and accountants who may provide advice on securities in the normal course of their professional activities would not be considered to be advising on securities for business purposes. Any advice on securities would be incidental to their professional activities because they

- do not regularly advise on securities;
- are not compensated separately for advising on securities;
- do not solicit clients on the basis of their securities advice; and
- do not hold themselves out as being in the business of advising on securities.

By virtue of Companion Policy 31-103CP, registration is also not required for one-time trading or advising activities. For example, trading or advising that is carried out by an individual or firm acting as a trustee, executor, administrator, or other legal representative or that relates to the sale of a business would not require registration.

NI 45-106 provides many further exemptions from registration on the basis of the nature of the security. For example, one is exempt from registration if one intends to trade in a government bond or in a debenture of a chartered bank because such securities are acknowledged to be issued by entities already appropriately regulated and therefore separate registration would be superfluous (NI 45-106, s. 2.34).

Pursuant to s. 2.38(1) of NI 45-106, an exemption from the registration requirement of the *Act* is available in respect of securities issued by an issuer organized exclusively for educational, benevolent, fraternal, charitable, religious, or recreational purposes. This exemption may only be relied upon if the issuer is organized and operated on a not-for-profit basis. Further, in order to qualify as an exempt trade, a condition is imposed that no commission or remuneration may be paid in connection with the sale of the securities and no part of the net earnings of the issuer may benefit any security holder of the issuer.

Many of the principal exemptions from registration, including those available under NI 45-106, NI 31-103, and OSC Rule 45-501, are linked to corresponding exemptions from information disclosure or "prospectus" requirements imposed by the *Act*.

If a person is unable to characterize the type of security or purchaser of the security in such a way as to take advantage of a registration exemption and the person feels an exemption should otherwise be available, he or she may apply under s. 74 for a ruling from the OSC providing a discretionary exemption from the registration requirement. Under this provision, the OSC is empowered to exempt a trade, intended trade, security, person, or company from the registration requirements if to do so would not be prejudicial to the public interest.

2.3 Regulating the type of information investors receive

2.3.1 The prospectus

A fundamental premise of the regulation of securities markets is that the investing public, if provided with full, plain, and true material information concerning the investment, will be able to make its own investment decision. The *Act* therefore requires that some trades may only be completed if the purchaser of the security is first provided with sufficient information pertaining to the security.

An individual or business entity that intends to trade in a security, where such a trade would be a "distribution," must initially file with the OSC a preliminary prospectus and, subsequently, a final prospectus pursuant to s. 53 of the *Act*. A "distribution" is defined in s. 1(1) of the *Act* and generally arises in one of two types of trades:

(1) An issuer intends to issue previously unissued securities (i.e., the issuance of shares out of treasury).

(2) Any person who is a "control person" with respect to an issuer disposes of some or all of his or her securities of that issuer (a control person generally means a person who owns greater than 20% of the voting securities of the issuer).

One can develop a better understanding of the process of disclosure of material information by way of an example. A corporation, X Ltd., wants to raise a significant amount of capital from the public to expand operations by issuing shares in the corporation. X Ltd. proposes to issue and sell to the public new shares, which would be both a "trade" and a "distribution" of the securities. In order to comply with the *Act*, assuming no exemption under ss. 25 and 53 exists, X Ltd. must prepare and file with the OSC a preliminary prospectus and a final prospectus for this distribution.

The proposed issuance of new shares as a means of raising money for X Ltd. is only effective if there is a market for those shares. To facilitate the offering of shares, X Ltd. would engage an investment dealer (who would be registered under the *Act*) to act as an underwriter or selling agent in connection with the offering. The underwriter's function is to use its expertise in assembling information about X Ltd. and market conditions in order to determine the best attributes to attach to the shares (i.e., voting rights, dividend rights,

redemption features, etc.), attract investors, assess an appropriate price for the shares, and sell the shares through its network of stockbrokers to both institutional (e.g., banks, pension funds, etc.) and retail customers (e.g., average Canadian investors). The underwriter will either purchase the new issue at a discount and then arrange for its resale to the investing public (underwriting) or act as agent, on a best efforts basis, to sell securities and receive a commission based on what is sold (agency offering).

The distribution of securities requires the preparation of a preliminary and final prospectus. Only when these documents have been filed and receipts have been issued for them may the securities be sold to the public. A prospectus is a comprehensive disclosure document that is intended to provide "full, true and plain disclosure of all material facts relating to the securities issued" (*Act*, s. 56). The prospectus is generally a long and complex document that includes a wide variety of information, including information about the issuer, a description of its share capital, and in particular, the class of shares to be sold as well as its price. The prospectus must also contain historical, audited financial statements.

The preliminary prospectus contains in essence the same content as a prospectus, although the preliminary prospectus has a warning that indicates that it is a preliminary prospectus and that the information is not yet complete. The preliminary prospectus is submitted electronically to the OSC, and a receipt is issued. The OSC will review the document and issue a deficiency letter indicating the areas of the preliminary prospectus that need attention before the OSC will accept a final prospectus. Once the deficiencies are settled, the final prospectus will be filed, and the Director will issue a receipt.

The process of "going public" is time consuming and complex, and the participants (issuers, underwriters, etc.) would be reluctant to embark upon such an "adventure" without the earliest possible indication as to the prospects for success—i.e., how many shares can be sold and at what price. Securities laws address this practical issue by providing for the issuance of the preliminary prospectus. An issuer, or indeed anyone else, is not permitted to do any act in furtherance of a trade that is also a distribution, prior to obtaining from the OSC a receipt for a final prospectus. However, pursuant to s. 65(2), the legislation provides an opportunity to solicit expressions of interest from prospective purchasers through dissemination of the preliminary prospectus after a receipt for the preliminary prospectus has been issued by the OSC and before the final prospectus has been approved.

The interval between these two events is known as the "waiting period." During this waiting period, the regulators scrutinize the preliminary prospectus and propose revisions, and solicitations of expressions of interest are sought by the underwriter (which generally involves giving prospective buyers copies of the preliminary prospectus) to help the issuer and the underwriter measure investor interest and be prepared for a quick sale when the final prospectus is receipted and the shares can finally be sold. The *Act* acknowledges the need for a purchaser to have an adequate opportunity to review the final prospectus in requiring that the prospectus be delivered to the proposed purchaser before a legal obligation to purchase the securities may arise.

Throughout the prospectus preparation process, lawyers and other professionals will be involved in acting for both the issuer and the underwriter. The prospectus preparation process is influenced by the danger of civil liability imposed by the *Act* in connection with misrepresentations in a prospectus. Certain persons, other than the issuer, may be relieved of that liability if they made adequate inquiries to afford them a reasonable belief that there was no misrepresentation. The issuer and the underwriter are principally responsible for ensuring that the prospectus discloses all material facts and will, with the assistance of their lawyers, adopt procedures that provide a record of diligent search for and disclosure of material information. The process whereby the issuer and others assemble and disclose material information in the prospectus is known as the "due diligence" process.

The directors and certain officers of an issuer, on behalf of the issuer and themselves personally, will be required to sign a statutory certificate contained in the prospectus to the effect that the prospectus constitutes full, true, and plain disclosure of all material facts relating to the securities (*Act*, s. 58). A similar certificate based on knowledge and belief is executed by the underwriter (*Act*, s. 59).

2.3.2 Exemptions from the prospectus requirement

If the intended distribution is of a limited nature or involves an issuer that is newly formed or a small business, satisfying the prospectus requirement may not be practical. The *Act* recognizes that the disclosure of information as contemplated by the prospectus is unnecessary if the security is by nature a safe investment, if the particular investor is not in need of the protection of the legislation, or if the distribution is subject to some other regulatory regime.

There are two main types of exemptions from the prospectus requirement:

(1) those found in NI 45-106 or in OSC Rule 45-501; and

(2) those that apply to the resale of securities that initially were distributed without a prospectus in reliance on one of the prospectus exemptions referred to in (1).

(a) Section 72 exemptions

One should be cautious in reviewing s. 72 of the *Act*, since all of the prospectus exemptions contained in that section are no longer available as a consequence of s. 5.1(3) of OSC Rule 45-501. Instead, NI 45-106 in particular and, to a lesser extent, OSC Rule 45-501 contain a variety of both prospectus and registration exemptions that are, generally, the most important exemptions relevant to the financing of small- and medium-sized business enterprises.

(b) Exempt distribution — NI 45-106

NI 45-106 was originally introduced in September 2005 and served to drastically change a variety of the more common registration and prospectus exemptions in an attempt to make it easier for small businesses in Ontario to raise start-up and expansion capital.

This chapter will focus on only three of the exemptions: the "private issuer" exemption, the "accredited investor" exemption, and the "minimum amount investment" exemption.

(c) Private issuer exemption

Pursuant to s. 2.4 of NI 45-106, registration and prospectus exemptions are available for trades in securities of a private issuer to a person who purchases the security as principal and is

- a director, officer, employee, founder, or control person of the issuer;
- a spouse, parent, grandparent, brother, sister, child, or grandchild of a director, executive officer, founder, or control person of the issuer or a parent, grandparent, brother, sister, child, or grandchild of the spouse of a director, executive officer, founder, or control person of the issuer;
- a close personal friend of a director, executive officer, founder, or control person of the issuer (Companion Policy 45-106CP defines a "close personal friend" as an individual who knows the director, executive officer, founder, or control person well enough and has known them for a sufficient period of time to be in a position to assess their capabilities and trustworthiness);
- a close business associate of a director, executive officer, founder, or control person of the issuer (Companion Policy 45-106CP defines a "close business associate" as an individual who has had sufficient prior business dealings with the director, executive officer, founder, or control person to be in a position to assess their capabilities and trustworthiness);
- a spouse, parent, grandparent, brother, sister, child, or grandchild of the selling security holder;
- a security holder of the issuer;
- an accredited investor;
- a person who beneficially owns a majority of the voting securities;
- a trust or estate of which all of the beneficiaries or a majority of the trustees or executors are persons described above; or
- a person that is not the public.

The seller is not mandated to give the investor any informational or disclosure document with respect to the issuer's business affairs. However, to the extent the seller prepares a disclosure document for use by the investor, it may constitute an "offering memorandum," and the investor will receive a statutory right of action for misrepresentation.

A private issuer is defined in s. 2.4(1) of NI 45-106 as an issuer (other than a reporting issuer or an investment fund) who has distributed securities only to persons listed in s. 2.4(2) of NI 45-106 and whose

- securities (other than non-convertible debt securities) are subject to a restriction on transfer contained either in its constating documents or in one or more agreements made between the issuer and holders of its securities; and
- number of beneficial security holders, directly or indirectly, does not exceed 50, excluding persons who either are or were employees of the issuer or its affiliates, provided that each person is counted as one beneficial owner unless the person is created solely to purchase or hold securities of the issuer, in which case each beneficial owner or each beneficiary of the person, as the case may be, must be counted as a separate beneficial owner.

The private issuer exemption replaced, among others, former exemptions available in respect to "private companies" and "private issuers" whose securities were not sold to members of the public. A definition of a "private company" is still contained in the *Act* in s. 1(1) and contemplates a company that has adopted a prohibition on the offering of securities to members of the public, a restriction on share transfer, and a limit on the number of shareholders in the company. Practitioners should recognize that a large number of corporations in Ontario will have, in their constating documents, the restrictions contemplated in s. 1(1) for a "private company." The practical effect of such

restrictions, however, will serve to limit the availability of certain exemptions in Ontario since, in addition to the restrictions of the private issuer exemption, the constating documents of the issuer will, in accordance with the private company restrictions, prohibit sales to members of the public.

When considering the former private company restrictions, there are two tests commonly employed to determine whether a prospective investor is a "member of the public." The first is called the "common bonds" test and asks whether the investor has common bonds of interest or association with the issuer or its founders. Under this test, family members of the founders, former directors, current directors, officers, or employees of the issuer and to some degree long-time business associates may be considered non-public investors. The alternative "need to know" test exempts those who clearly have no need for the information disclosure and other protections that securities legislation would afford the normal investor. This test was often employed to allow for sales to founders and their immediate family, former directors, current directors, senior officers, employees, and sophisticated investors such as financial institutions and venture capital firms experienced in small business investment.

(d) Accredited investor exemption

The "accredited investor" exemption (NI 45-106, s. 2.3) permits issuers to raise any amount of investment, at any time, from any number of accredited investors who purchase the securities for their own account. Accredited investors are presumed to be capable of making an investment decision without the information in a prospectus or the assistance of a registered dealer. The list of accredited investors contained in s. 1.1 of NI 45-106 includes

- Canadian and foreign banks; credit unions; caisses populaires; loan, trust, and insurance companies; and their wholly owned subsidiaries;
- Canadian and foreign national, federal, state, provincial, territorial, or municipal governments and their agencies;
- Canadian and foreign registered advisors or dealers, other than limited market dealers, and Canadian current and former registered representatives;
- Canadian and foreign regulated pension funds;
- registered charities;
- individuals, either alone or with a spouse, having "financial assets" (generally cash or securities but not real estate or non-financial personal property) with net (after deducting associated liabilities) pre-tax realizable value over $1 million;
- individuals, either alone or with a spouse, having net assets of at least $5 million;
- individuals with net pre-tax income in each of the last two calendar years over $200,000 or $300,000 in conjunction with a spouse and a reasonable expectation of the same level in the current year;
- corporations, partnership, limited partnership, and other entities with net assets of at least $5 million; and
- companies and other entities owned by accredited investors.

(e) Minimum amount investor exemption

The "minimum amount investment" exemption (NI 45-106, s. 2.10) provides registration and prospectus exemptions for trades to a person who purchases the security as principal where the security has an acquisition cost to the purchaser of not less than $150,000 paid in cash at the time of the trade. This exemption does not apply to a trade in a security to a person if that person is created or used solely to purchase or hold securities in reliance on this exemption.

(f) Informational disclosure

As noted earlier, there is no mandated informational disclosure with respect to the issuer or its affairs required to be provided to an investor in connection with a trade made under the private issuer exemption, and the same applies for the accredited investor exemption and the minimum amount investment exemption. Frequently, issuers or selling security holders must for marketing purposes, prepare a disclosure document to attract or educate potential investors. The preparation of disclosure documents will attract certain obligations under the *Act*.

Subsection 1(1) of the *Act* defines an "offering memorandum" as a document purporting to describe the business and affairs of an issuer that has been prepared primarily for delivery to and review by prospective purchasers to assist the prospective purchaser to make an investment decision. The definition excludes any document setting out current information about an issuer for the benefit of a prospective purchaser familiar with the issuer through prior investment or business contacts, and in companion policy 45-501CP to Rule 45-501, the OSC has confirmed its long-standing position that "term sheets" (representing a skeletal outline of the features of an offering without dealing extensively with the business and affairs of the issuer) will not be considered to constitute an "offering memorandum."

While there is no prescribed format as to the disclosure to be contained in an offering memorandum, s. 5.2 of OSC Rule 45-501 requires that certain rights of action contained in s. 130.1 of the *Act* be described in the

offering memorandum. Section 130.1 of the *Act* imposes statutory civil liability for a misrepresentation contained in an offering memorandum, giving the purchaser a right of action for damages or for rescission against the issuer or selling security holder. These rights of action are subject to limitation periods contained in s. 138 of 180 days following the trade for rescission, and the earlier of 180 days following knowledge of the facts giving rise to the cause of action and three years from the date of the trade for an action in damages. Since a "misrepresentation" is defined in s. 1(1) of the *Act* to mean an untrue statement of a material fact or an omission of a material fact that is required to be stated or that is necessary to make a statement not misleading in light of the circumstances in which it was made, the disclosure appropriate for inclusion in an offering memorandum is by necessity comprehensive and required to be prepared with appropriate care for accuracy and completeness. Additionally, National Instrument 51-102, *Continuous Disclosure Obligations*, significantly restricts an issuer's ability to include future-oriented financial information (FOFI) in offering documents and imposes updating obligations when FOFI is provided. It should be carefully reviewed in such circumstances.

If an offering memorandum is used in connection with the private issuer or accredited investor exemption, it must be filed with the OSC within 10 days after the trade. No notice of the trade itself need be filed with the OSC in connection with a trade made under the private issuer exemption. Subject to certain limited exceptions, a notice on Form 45-106F1 of a trade made under the accredited investor exemption must be filed with the OSC within 10 days after the trade, accompanied by the applicable filing fee prescribed in OSC Rule 13-502, *Fees*. It is extremely important to file the notices as required.

(g) Employee exemptions

The prospectus exemption and corresponding registration exemption found in ss. 72(1)(n) and 35(1)19 of the *Act* have been replaced by s. 2.24 of NI 45-106, which governs trades to employees, executive officers, directors, and consultants of a business enterprise. The exemptions are based on the recognition that the issuer's employees and other service providers, by virtue of their association with the business, should be provided with the ability to invest in the business enterprise notwithstanding the fact that many may not have access to "prospectus-level" information or the ability to make an informed decision. The exemptions are frequently used for incentive arrangements with employees such as share purchase plans and employee stock option plans; however, those proposing to use s. 2.24 of NI 45-106 should review it carefully as many of its exemptions are subject to a variety of conditions.

(h) Resale restrictions

Where securities are acquired under a prospectus exemption, they may generally not be resold by the initial purchaser unless the issuer has become a "reporting issuer" under the *Act* and a requisite "hold period" has been satisfied or the purchaser can rely on another exemption to allow the resale of securities. The *Act* functions on a "closed system" basis, so that each resale of an originally prospectus-exempt security is deemed a distribution that requires the preparation and filing of a prospectus, unless certain requirements are met (NI 45-106).

One reason for exempting a primary distribution is the presumed sophistication of the purchaser. If, for example, X Ltd. desired to issue treasury shares to an accredited investor, the sale could be completed without X Ltd. preparing a prospectus by relying on the accredited investor exemption. If the investor subsequently desired to sell the shares in X Ltd., it is common sense that such a secondary sale should be subject to the same scrutiny as the original sale. The *Act* accomplishes this objective by deeming the resale of securities originally acquired under an exemption as constituting a "distribution."

Securities acquired under the private issuer exemption, accredited investor exemption, or minimum investment amount exemption may be resold under these or other available exemptions, provided in the case of the private issuer exemption, the issuer continues to maintain its status as a private issuer. Alternative exemptions may also be used; for example, an accredited investor who acquired shares in a private issuer under the accredited investor exemption could resell those securities to a non-accredited investor under the private issuer exemption provided the issuer at the time of resale remained a private issuer. Certain resale exemptions are unique to a particular rule. For example, s. 2.27 of NI 45-106, provides unique resale exemptions for personal transfers made between an employee and permitted transferees, such as spouses or trustees of tax-deferred plans such as RRSPs, and s. 2.26 of NI 45-106 provides for certain transfers among directors, officers, or current and former employees.

To the extent a prospectus exemption is not available, the resale will be a distribution for the purposes of the *Act*. In these cases, resales are generally required to be made by way of a prospectus unless the issuer has become a reporting issuer under the *Act* and a requisite "hold period" has elapsed. These hold periods are now found

primarily in NI 45-102, *Resale of Securities* (Resale Rule), which by virtue of s. 2.2 of the NI 45-102 has effectively replaced the former resale provisions found in ss. 72(4)–(7) of the *Act*. The current Resale Rule came into force on September 14, 2005. Generally, under the Resale Rule, resale restrictions will not exceed four months from the later of the date the purchaser acquired the securities pursuant to a prospectus exemption and the date the issuer became a reporting issuer. Special considerations apply to resales of securities made by controlling shareholders.

3. Publicly-held corporations

Companies whose securities were originally distributed by way of a prospectus are reporting issuers under the *Act*. These companies are generally known in the marketplace as "public companies." The *Act* requires that a "reporting issuer" comply with the requirements for continuous disclosure, which are found in the *Act* and its regulations, including a variety of rules. Through the system of continuous disclosure, investors in the secondary market are assumed to have access to sufficient information from which to make informed investment decisions. Accordingly, the securities of reporting issuers are generally freely tradeable and may be bought and sold without restriction.

The continuous disclosure regime primarily deals with the publication and distribution of financial information on an ongoing basis and the preparation of informational documents in conjunction with meetings of security-holders. In addition, the effect of NI 51-102 is to require a reporting issuer, where a "material change" occurs in the affairs of a reporting issuer, to immediately issue and file a press release authorized by a senior officer, disclosing the nature and substance of the change, and then file a "material change report." For the purposes of the *Act*, "materiality" is found to exist where the event would reasonably be expected to have a significant effect on the market price or value of the securities of the reporting issuer. However, in other contexts, an event may be material where disclosure of the event would reasonably be expected to have a significant influence on a reasonable investor's investment decision.

Chapter 25

Debt financing and secured transactions

1. Debt financing

1.1 General

At its simplest level, debt financing is a form of transaction in which one party (the lender/creditor) provides financing to another party (the borrower/debtor).

The obligation of the borrower to repay its indebtedness to the lender under the financing may be unsecured or may be secured by the assets of the borrower. In addition to or in lieu of security over the assets of the borrower, a guarantor, who may secure the obligations under the guarantee with security over the guarantor's assets, can guarantee repayment of the indebtedness of the borrower to the lender.

1.2 Commitment letters and loan/credit agreements

A loan transaction typically begins with the lender agreeing to provide financing to the borrower under certain terms and conditions. This agreement or offer to finance can come in various different forms, lengths, and complexity and under various different names, such as a commitment letter, offer to finance, a facility letter, a letter loan agreement, or a term sheet. These kinds of agreements (for the purposes of this chapter, the "commitment letter") will set out the principal terms and conditions under which the lender is prepared to advance credit to the borrower. Such terms and conditions will generally include

- the types of financial accommodation available to the borrower, such as direct loans, letters of credit, bank guarantees, and bankers' acceptances, and the rate of interest applicable to each type of accommodation;
- the type of credit or credit facilities, i.e., term or demand or a combination thereof, and whether the credit is fixed or revolving (where credit balances are permitted to revolve up and down);
- the maximum amount of the credit available under each type of credit facility made available to the borrower;
- repayment and prepayment terms, including the maturity date in the case of a term loan;
- fees that will be payable to the lender, such as commitment fees (usually payable on acceptance of the commitment letter by the borrower), stand-by fees, stamping fees, administration or work fees, monitoring fees, etc.;
- the conditions precedent to any advances (including any security the lender is requiring);
- representations and warranties of the borrower upon which the lender relies in advancing funds to the borrower;
- positive and negative covenants of the borrower to do or not to do certain actions during the term of the agreement; and
- in the case of a term loan, events of default and the lender's remedies upon the occurrence of any such event (such as accelerating the debt and enforcing its security).

The commitment letter is signed by the lender and usually contains a deadline date by which the borrower is required to sign back the commitment letter signifying the borrower's agreement to the terms and conditions set out. Once the lender and borrower have signed the commitment letter, a binding agreement exists.

In some cases, the commitment letter will be the only written agreement between the borrower and lender. In other cases, the commitment letter will expressly provide that the commitments contained therein are subject to "customary representations and warranties, covenants, and events of default" and/or more "definitive loan and security documentation" in form and substance satisfactory to the lender, with or without a reasonableness qualification. In such cases, the commitment letter will be replaced by a formal loan or credit agreement setting forth in a more detailed manner the terms and conditions set out in the commitment letter.

Once a loan agreement has been executed, it replaces the commitment letter and, together with the other loan and security documents that may be entered into pursuant to the loan agreement, will constitute the entire agreement between the parties as to the terms and conditions of the financing by the lender. This is typically confirmed by an "entire agreement" provision in the loan agreement, which provides that the loan agreement together with other loan and security documents constitute the entire agreement between the parties and supersede all prior agreements between the parties, including any prior commitment letters between the parties.

1.3 Structuring loan arrangements

Loan arrangements can take a variety of different forms depending on the business, legal, and other needs of the borrower and the lender. The following is an overview of the most common types of financial accommodation available to borrowers in Canada. (It is assumed that the lender is a Canadian chartered bank because some of the options are only available from Canadian chartered banks.)

1.3.1 Direct loans

The direct loan is one of the most common types of debt financing provided by banks. In structuring a direct loan, a number of factors must be considered. These include the following.

(a) Currency of the loan

Section 12 of the *Currency Act* provides that a judgment by a court in any province in Canada may be awarded in Canadian currency only. This restriction does not prohibit a loan to be drawn in a currency other than Canadian dollars. Section 121 of the *Courts of Justice Act* outlines the manner in which foreign currency obligations are to be converted into Canadian dollars for the purpose of enforcing judgments.

(b) Evidence of the loan

Some lenders may require the borrower to execute a separate promissory note for each advance made or a "grid note" on which the bank makes notations of successive advances, repayments, re-advances, etc. The requirement for promissory notes has largely become outdated and is not practical in the case of revolving loans. Instead, most loan agreements will provide that the accounts kept by the lender will constitute *prima facie* evidence of the indebtedness owed by the borrower to the lender from time to time, including in respect of interest and fees.

(c) Demand or term loan

A demand loan allows the lender to demand repayment of the loan at any time. A term loan is for a specified term (to the maturity date), but repayment of the loan may be required on the occurrence of specified events of default, when the lender is entitled to accelerate the outstanding indebtedness and demand earlier repayment in full.

(d) Repayment provisions

A loan agreement can require mandatory payments either on a periodic basis or upon the occurrence of certain events (i.e., if excess cash of the borrower exceeds a specified amount or if the borrower sells assets outside the ordinary course of business). The loan agreement can also provide for the right of the borrower to make voluntary prepayments of the loan obligations with or without terms and conditions attached (such as up to a maximum dollar amount per year).

(e) Promissory notes

Occasionally, instead of a loan or credit agreement, loans will be evidenced by promissory notes. A promissory note is a document signed by the debtor and addressed to the lender in which the debtor undertakes to pay the lender a certain amount of money, which may or may not include interest, to the lender on terms and conditions set out in the promissory note. Promissory notes typically fall into two categories: term notes and demand notes. Term notes provide for the debtor to pay the lender on a specified date or series of dates. Demand notes require the issuer of the promissory note (the debtor) to pay whenever the holder of the note makes a demand for repayment.

(f) Interest rate alternatives

(i) Canadian dollar loans

The following are the most common types of interest rate alternatives available for Canadian dollar loans:

- *Fixed Rate:* a fixed rate of interest for a specified term.
- *Floating or Variable Rate:* interest rate "floats" or varies, usually based on the bank's "prime rate," with or without a predetermined margin (e.g., prime plus 2%). A prime rate is the reference rate established by the bank from time to time as its "prime rate" for Canadian dollar loans.
- *Cost of Funds:* interest rate is based on a formula based upon an average of interest rates quoted from time to time by two or three recognized dealers in the money market.

(ii) U.S. dollar loans

Two common interest rate alternatives for U.S. dollar loans are as follows:

- *U.S. Base Rate:* this floating or variable interest rate is based on the reference rate of interest applicable to U.S. dollar loans made by Canadian banks from time to time; and
- *LIBOR:* this is the London Interbank Offered Rate, which is a rate of interest for U.S. dollars in the London Interbank Eurocurrency Market calculated on the basis of a 360-day year.

(iii) Annual rate requirement under Interest Act

Section 4 of the *Interest Act* provides that if any rate of interest is payable at a rate for any period less than a year, the loan agreement must contain an express

statement of the equivalent annual rate calculated on a 365-day year basis. Because the LIBOR rate is calculated on a 360-day year, the loan agreement should contain language explaining that for the purposes of calculating LIBOR under the loan agreement, the rate will be calculated on a 365-day basis.

1.3.2 Bankers' acceptances

This form of accommodation involves a bill of exchange drawn by the borrower, which the bank accepts for an acceptance or stamping fee. The acceptance fee will be based on the amount and term of the bank's acceptance. The bill of exchange is simply a promise by the customer to pay the face value of the bill on a specified future date, typically 30 to 180 days. The bank sells its acceptance at a discount in the commercial money market, and the sale proceeds are then provided to the borrower.

Under the *Bills of Exchange Act*, upon acceptance by the bank, the bank becomes primarily liable to pay the bill of exchange. Although the customer has a secondary liability to pay if the bank does not, the purchaser is really relying on the accepting bank's credit, not the borrower's credit.

On maturity of the acceptance, the bank pays the purchaser the face amount of the bill of exchange and then looks to the borrower for reimbursement pursuant to an indemnity or reimbursement agreement with the borrower.

From a business standpoint, a bankers' acceptance may be advantageous to a borrower. It allows the borrower to borrow in the money markets at a cheaper cost because the bank normally will have a stronger credit rating than the borrower.

1.3.3 Letters of credit

A letter of credit is in essence an undertaking by the issuing bank (the lender) to pay the beneficiary of the letter of credit a specified amount upon the terms and conditions specified in the letter of credit. Beneficiaries typically require letters of credit as a means of securing the borrower's payment obligations to the beneficiary. A letter of credit is a contract between the issuing bank and the beneficiary and is not affected by the insolvency of the borrower. Letters of credit are very commonly used in international trade transactions to provide certainty of payment involving foreign parties.

The issuing bank/lender typically will have an indemnity or reimbursement agreement with the borrower, and sometimes the borrower will provide security to the bank to which the bank will look if and when the letter of credit is called by the beneficiary. The issuing bank will typically charge a fee to the borrower for issuing a letter of credit based on its amount and term.

1.3.4 Bank guarantees

Under the *Bank Act*, chartered banks are permitted to guarantee the payment of fixed sums of money. Bank guarantees work very much like letters of credit except the holder or beneficiary of the guarantee cannot demand payment from the bank as guarantor unless there has been a default in payment of the guaranteed debt obligation.

Similar to banker's acceptances and letters of credit, the guaranteeing bank will usually charge a fee based on the amount and term of the bank guarantee, and there will be an indemnity or reimbursement agreement from the borrower that the bank will rely on to create the debt obligation from the borrower and sometimes security to secure that indemnity/reimbursement obligation.

2. Taking PPSA security

2.1 General

If the lender determines that security is needed to secure the borrower's obligations to the lender, a review of the borrower's assets will be required to determine what kind of security is appropriate in the circumstances. In determining the type of security required, several factors should be considered, including the type (real or personal; tangible or intangible; inventory, equipment, or accounts), value, and location of the corporation's assets. Different forms of security will also come with different costs and realization issues, and these should also be reviewed. Not all loans are secured. Some are simply unsecured, while others are guaranteed.

A security agreement creates a "security interest" in the property of a borrower as specified therein. Under the *Personal Property Security Act* (*PPSA*), a security interest is an interest in goods that secures payment or performance of an obligation. Certain lenders, such as "asset-based" lenders, will expressly tie the availability of advances to margins based upon the changing value of the borrower's collateral.

Whether drafting security for a lender or reviewing security for a borrower, the three most important components of a security agreement are as follows:

- There must be a clear grant of security.
- The collateral that is subject to the security grant must be sufficiently described.
- The rights and remedies available to the creditor in respect of the collateral must be clearly stated.

Although security agreements governed by Ontario law will, as a general matter, be enforceable and registrable

in other Canadian jurisdictions, with the exception of Quebec (a civil law jurisdiction), local counsel should be consulted at all times if any security to be obtained from the borrower is intended to cover assets located outside Ontario.

2.2 General security agreement

2.2.1 General

The most common type of security taken by bank lenders is the general security agreement (GSA). Under a GSA, the borrower will grant a security interest over all present and after-acquired property, assets, and undertaking of the borrower, of whatever kind and wherever located. Most often, the general security agreement will also list specific categories of property, such as accounts, equipment, inventory, intellectual property rights, and securities, although this is not strictly necessary if the description of all present and after-acquired property, assets, and undertaking is drafted broadly enough.

2.2.2 Real property interests

A GSA cannot create a valid legal charge over real property interests. In Ontario, a GSA that charges the real property of the borrower may create an equitable charge over any real property owned by the borrower, in priority to certain parties, including unsecured creditors of the borrower. An equitable charge is subordinate to holders of a specific charge/mortgage over the real property and *bona fide* purchasers of the real property without notice of the equitable interest.

In cases where the lender seeks both real and personal property security, the lender can obtain a GSA with a separate charge/mortgage of land for the specific real property, or a debenture containing fixed and floating charges over both real and personal property.

To the extent that a GSA includes an assignment of rents by the borrower who is a landlord, registration of the security interests against title to the applicable real property is required.

Although an assignment of rents is generally considered to be personal property security because it relates to security over payments of money, s. 36 of the *PPSA* gives priority to any person who has acquired an interest in the real property prior to notice of the assignment of rents being registered in the applicable land registry office. Therefore, in addition to a *PPSA* registration, an assignment of rents in the prescribed form should also be registered against title to the real property to obtain priority over holders of real property interests. Most assignments of rents by a borrower will also include an assignment of leases that are typically contained in a separate form of assignment of rents and leases agreement.

Clause 4(1)(e) of the *PPSA* provides that the *PPSA* does not apply to assignments of leases. Assignments of leases (by a landlord borrower) or leasehold charges (by a tenant borrower) must be registered against title to the real property. In order to register a leasehold charge, the lease itself must first be registered against title. Most lease agreements will provide that the lease cannot be registered against title nor a charge be granted over the leasehold interest without the landlord's consent.

2.2.3 Representations, warranties, and covenants

A GSA will typically contain representations and warranties of the borrower relating to the collateral such as the existence and location of and particulars relating to specific assets (such as intellectual property rights). A GSA will also typically contain covenants, both positive and negative, with respect to actions that the borrower can engage in that may have an impact on the lender's collateral.

One common representation and related negative covenant relates to the existence of other liens or encumbrances on the collateral. Typically, the borrower will be expected to represent and warrant that the collateral is free and clear of all liens and encumbrances of any kind. In some cases, the lender will allow for pre-existing encumbrances, often called "permitted encumbrances," to exist. Caution should be exercised to ensure that the lender is not inadvertently subordinating its security to these permitted encumbrances if they are not otherwise entitled to priority over the lender.

The related negative covenant is a covenant by the borrower to not further encumber any of the collateral other than in favour of the lender. The restriction would typically apply to both consensual grants of security and also to liens that are imposed by statute. This is often referred to as the "negative pledge." The negative pledge will sometimes have exceptions, the most common of which is for purchase-money security interests (PMSIs) over specific equipment or inventory acquired by the borrower.

Although lenders may take a GSA, they may also request supplemental security that covers specific assets already covered by the GSA. Supplemental security agreements do not give the lender any greater priority over these specific assets, but it may contain more specific representations and warranties, covenants, and rights related to the specific collateral that may in some circumstances be beneficial to the lender. Two of the most common types of supplemental security are general

assignments of accounts receivable and securities pledge agreements.

2.3 General assignment of accounts receivable

In addition to or instead of taking security over all of the assets of a borrower, a lender may choose to take security only over certain of the borrower's assets. This can occur for many reasons. Sometimes the nature of the borrower's business means that value is focused on specific kinds of assets. For example, in a predominantly service or intellectual property-based business, there could be little value in the tangible assets. In such cases, the most valuable asset, apart from its intellectual property, may be its accounts receivable from customers and other third parties. The standard general assignments of accounts receivable charges all present and after-acquired cash, debts, claims, receivables, moneys, and choses in action of the borrower, together with all books and records evidencing or relating to such assets.

Under the standard bank form general assignment of accounts receivable, the lender typically has the right to notify the borrower's account debtors of the assignment and to collect the accounts of the borrower at any time even if there has been no event of default. As a matter of practice, however, most lenders do not notify account debtors until there has been an event of default or some other event or occurrence that causes the lender to feel that it needs to protect the lender's collateral. In most cases, the borrower is permitted to deal with its receivables in the ordinary course of business until notification from the lender or default has occurred, after which time any receivables collected by the borrower are deemed to be held in trust for the lender.

2.4 Certificated securities and the direct holding system

If a borrower owns securities, these securities will be held either directly or indirectly. The borrower will hold securities directly where there is a direct relationship between the issuer of the securities and the borrower holding the securities. For example, a borrower may hold shares in its subsidiary. In these cases, the shares of the subsidiary are commonly certificated, i.e., there is a physical share certificate evidencing the borrower's ownership interest in the shares.

Where the borrower has any subsidiaries of value, a lender may require a pledge of shares of the subsidiaries or other securities, such as promissory notes held by the borrower, as security for the borrower's obligations to the lender. Typically, securities or share pledge agreements will charge the shares and also any dividends, interest payments, or other similar cash distributions derived from such shares. The lender will not have the right to vote the shares or receive any dividends or interest in respect of the pledged shares unless and until an event of default has occurred.

Possession of the share certificates relating to the pledged shares are delivered to the lender. These share certificates are either endorsed for transfer in blank (i.e., the transfer provision on the back of the share certificate is executed by the pledgor of the shares but the name of transferee is left blank) or are accompanied by a power of attorney executed by the pledgor in blank.

Prior to obtaining a pledge of shares, share transfer restrictions of the corporation whose shares are being pledged should be reviewed to determine whether consents (i.e., of the other shareholders) or other approvals (i.e., of the board of directors) are required in order for the lender to effectively transfer the shares. If so, the granting of the security may not be valid or the lender may only obtain an equitable right to receive dividends or distributions made in respect of the shares if and when declared or made. To avoid this issue, all required consents and approvals to the transfer should be obtained at the time the pledge is taken.

The most common types of secured lending transactions that lawyers in private practice deal with occur under the direct holding system.

2.5 Uncertificated securities and the indirect holding system

The indirect holding system for securities involves securities that are held by one or more intermediaries (i.e., clearing agencies such as the Canadian Depository for Securities Limited (CDS), a bank or trust company acting as a custodian, or a securities dealer). In the indirect holding system, although there may be an original certificate issued to CDS or the intermediary, the beneficial owner does not typically have a physical share certificate evidencing ownership of the securities. This "indirect holding" or "book-based" system allows the processing of large volumes of trades more cheaply and efficiently than can be obtained under a paper-based system.

The *Securities Transfer Act, 2006* (*STA*) together with related amendments to the *PPSA*, which were proclaimed in force on January 1, 2007, create a complex set of rules that govern the rights and obligations of issuers of securities, securities intermediaries, investors, and secured creditors. The *STA* and the related amendments to the *PPSA* introduce a new type of personal property called a "security entitlement" and replaces the concept of "deemed possession" of uncertificated securities with a

concept of "control." The *STA* and related *PPSA* amendments also set out the methods by which a secured creditor can exercise "control" over security entitlements to perfect its security interests.

Generally, for certificated securities, the steps that would be taken under the current law as set out above (i.e., the direct holding system of possession, endorsement, or transfer in the name of the secured creditor) are still effective to give a secured creditor the necessary "control." For uncertificated securities, control can be obtained by

(i) arranging for the securities intermediary to record the secured creditor as the entitlement holder;

(ii) obtaining a control agreement from the securities intermediary; or

(iii) someone else having control for the benefit of the secured creditor.

A control agreement is an agreement between the securities intermediary, the secured creditor, and the borrower, under which the securities intermediary agrees that it will comply with instructions from the secured creditor without any further consent of the borrower. A control agreement does not need to give exclusive control to the secured creditor. A borrower can retain rights to give instructions, and other secured parties can obtain (or may already have) a concurrent right to give instructions.

2.6 Debenture security

2.6.1 General

In certain circumstances, lenders will require security in the form of debentures. Debentures contain a corporation's promise to pay, together with a mortgage or charge over certain property of the corporation as security for that promise. The promise to pay is an amount larger than the principal amount of the loan to the borrower because the amount of the debenture will typically factor in such items as accrued interest, costs of realization, fees, etc. that usually form part of the indebtedness of the borrower to the lender under the loan agreement.

Like a GSA, a debenture can charge all present and after-acquired property of the borrower. However, debentures are distinguishable from GSAs in three principal ways. First, the debenture is usually pledged to the lender because the principal amount of the debenture is usually higher than the amount of the indebtedness that may be owed at any time to the lender. Second, the debenture can create a legal charge over real property and not just an equitable charge. Third, unless the property of the borrower is subject to a fixed charge under the debenture, the borrower is able to continue to deal with its assets without having to obtain the release or consent of the lender if it seeks to dispose of any of its assets subject to a floating charge.

2.6.2 The pledge agreement

Debentures are pledged to the bank as security for the borrower's obligations to the lender pursuant to a pledge agreement. The pledge agreement itself is a security agreement that sets out when the lender is entitled to enforce its security against the debenture and realize upon the benefits contained therein.

A debenture has to be pledged because the principal amount of the debenture usually exceeds the maximum principal amount of the loan. The rate of interest set out in the debenture usually also exceeds that governing the actual loan indebtedness. As a result of the pledge agreement, the bank is only entitled to claim repayment of the amount of the actual indebtedness of the borrower, up to the total amount of indebtedness secured by the debenture, with interest payable at the rate actually agreed to in the loan documents.

2.6.3 Fixed and floating charges

Debentures will usually contain a "fixed charge" on specified property and assets (usually land and/or equipment and machinery specifically described on a schedule to the debenture) and a "floating charge" on all other property and assets of the borrower. A floating charge "floats" over the assets of the borrower and does not specifically attach to any assets until the borrower defaults under the terms and conditions of the debenture and/or the loan agreement. Upon a default by the borrower, the floating charge "crystallizes" and becomes a fixed and specific charge on all property previously subject to a floating charge. Once the floating charge crystallizes and becomes a fixed charge, the borrower is restricted from disposing of its assets outside the normal course of business without the consent of the lender.

2.7 Other security agreements

In addition to or as an alternative to a GSA, general assignment of accounts receivable, share pledges, and debentures, lenders can also request specific security agreements granting security over certain other specific assets of the borrower. For example, lenders can take security in the general inventory or equipment of a borrower (through an inventory security agreement or equipment security agreement) or take security in specific inventory or equipment of a borrower.

3. Perfecting PPSA security

3.1 Attachment, financing statement, and possession

For security governed by the *PPSA*, the secured creditor must follow the appropriate steps to obtain a "perfected" security interest. Generally speaking, this means both of the following criteria have been met:

- Attachment pursuant to s. 11(2) of the *PPSA* has occurred.
- A financing statement has been filed in the appropriate form under the *PPSA* (s. 23) or the security interest is perfected by possession under s. 22 of the *PPSA*.

There are special rules for perfecting a security interest in investment property, as defined in the *PPSA* (see discussion below).

Pursuant to s. 11(2) of the *PPSA*, attachment occurs when all of the following have occurred:

- The secured party obtains a written security agreement that is signed by the debtor and contains a description of the collateral sufficient to enable it to be identified.
- Value has been given.
- The debtor has rights in the collateral.

Registration of a financing statement under the *PPSA* can be effected either before or at any time after the execution of the security agreement by the debtor. The financing statement will be assigned a reference file number and a registration number upon filing. The registration number will set out the date and order of registration.

The financing statement must show the correct name of the debtor as specified in s. 16 of the Minister's Order under the *PPSA* (Minister's Order) and classify the collateral in categories appropriate to the collateral charged under the security agreement.

In lieu of registration of a financing statement, it is also possible to perfect a security interest in many kinds of collateral by possession. For practical reasons, certificated securities are the most common type of collateral perfected by possession, as described in s. 2.4, above, and registration is much more common than possession for most personal property because it allows the debtor to continue to use its collateral.

3.2 Jurisdictional considerations

Before registering a financing statement, one must first determine the proper jurisdiction in which to register. As a general matter, one will need to register in the province in which the tangible assets are located. In Ontario, for example, the *PPSA* provides that the validity, perfection, and effect of perfection or non-perfection of a security interest in tangible personal property is governed by the jurisdiction in which the tangible personal property is located at the time the security interest attaches (*PPSA*, s. 5(1)). There are various exceptions to this general rule (such as for moveable goods that are normally used in more than one jurisdiction or goods that are equipment or inventory leased or held for lease by a debtor to others (*PPSA*, s. 7(1))), and care must be taken to confirm that the collateral in question is not subject to one of these exceptions.

For intangible assets, reference should be made to the conflicts of law provisions in the *PPSA* (ss. 7 and 8). In Ontario, the *PPSA* currently provides that the validity, perfection, and effect of perfection or non-perfection of a security interest in intangibles is governed by the jurisdiction in which the debtor is located at the time the security interest attaches (*PPSA*, s. 7.1). A debtor is deemed to be located at its place of business or, if there is more than one place of business, the debtor's chief executive office.

The *PPSA* does not define "chief executive office," so reference needs to be made to case law. Generally, one needs to look at factors such as where the books and records are located, from which office the invoices are issued, and where management of the debtor is located. In some cases, the designation is easy because all factors clearly point to one location. Other cases are not as clear because the factors point to two or more possible locations. In such circumstances, the general practice is to register in each of the jurisdictions where the debtor may be located based on the factors identified above.

It should be noted that the Ontario government has introduced amendments to the current conflict of law provisions dealing with intangibles (other than investment property). Although these provisions have received Royal Assent, they will not be proclaimed into force until the other provinces have enacted similar legislative amendments in order to provide consistency in the rules throughout most of Canada. When the new rules become effective, the applicable sections of the *PPSA* will be amended so that the location of a business debtor is no longer defined by reference to the debtor's place of business or chief executive office. Instead, the location of the debtor will be determined by much clearer deeming rules. For example, a provincially organized corporation will be deemed to be located in the province of its organization. For federally organized corporations, the debtor will be deemed to be located in the jurisdiction where its registered or head office is located as specified in its constating documents.

There are special rules for registering against certain types of collateral (such as motor vehicles and consumer goods), and it is critical that the *PPSA* be reviewed carefully to determine whether those special rules are applicable in the particular circumstances.

3.3 Registering a PPSA financing statement

3.3.1 General

The *PPSA* allows a secured lender to register notice of the security interests held by it over a debtor's assets. A properly registered registration under the *PPSA* will perfect the security interests created by security agreements to which the *PPSA* applies. The security interest must first "attach" before it can be perfected by registration. Attachment occurs at the time the security agreement is signed unless the parties have agreed to postpone the time for attachment (*PPSA*, s. 11(2)).

In Ontario, registration is effected by filing a financing statement against the legal name of the borrower under the *PPSA* and classifying the collateral charged under the security agreement as either "Accounts," "Equipment," "Inventory," "Other," and/or "Motor Vehicles." If the collateral is consumer goods, that also must be noted in the financing statement; "consumer goods" are goods used or acquired primarily for personal, family, or household purposes and are not typically taken as security in commercial transactions.

Registration of debentures can be effected by filing a financing statement under the *PPSA*. If the debenture secures real property, it will be necessary to register it on title to the real property, in accordance with the appropriate statutes governing its registration.

3.3.2 Debtor name

Very specific rules for completion of the debtor name in a financing statement are set out in ss. 16–17 of the Minister's Order. It is critical that these rules be reviewed and followed. Errors in completing the debtor names in a financing statement are one of the most common errors made in financing statements.

Generally, if the debtor is a corporation, the full legal name of the corporation as set out in its articles of incorporation or amalgamation, as applicable, should be set out in the financing statement. If the articles indicate that the corporation has an English form of name and a French form of name, then both forms of name also need to be set out in the financing statement (as additional debtor names). It is critical that the required corporate searches be conducted to confirm the proper name of the borrower to be set out in the financing statement.

Generally, for individual debtors, the first and last name, and middle initial must be completed, together with the date of birth. Registration against individual debtors can be a minefield because of the difficulties of verifying the individual debtor's name. This issue is exacerbated by the fact that some individuals can have several different legal versions of their name. Reference should be made to all available means of identification, such as a birth certificate, passport, citizenship card, social insurance card, and driver's license. If these evidence different legal versions of the individual's name, it is best to register against all versions to avoid any issues. The cost of registration is generally minimal.

Although errors in debtor names may be capable of being cured under s. 46(4) of the *PPSA*, not all errors are curable, so it is best to ensure from the outset that the financing statement is free from error.

3.3.3 Collateral classification and descriptions

It is also critical that the collateral over which the lender has been given security is properly classified. For example, equipment that is leased or sold by a borrower should be classified in a *PPSA* financing statement as "Inventory" not "Equipment." To avoid errors in classification of collateral on financing statements, out of an abundance of caution, some secured creditors will register against all classes of collateral even though they may only have specific security. This is permitted as long as the borrower does not request that certain collateral classifications be removed. If the borrower requests, a secured creditor may also be required to provide a specific collateral description in the financing statement or amend an inaccurate collateral description (s. 56(2.1)).

The *PPSA* permits a secured creditor to complete a collateral description in the financing statement; however, caution should be taken by a secured creditor in doing so: s. 46(2.1) of the *PPSA* provides that if the financing statement or financing change statement sets out a classification of collateral and also contains words that appear to limit the scope of the classification, the secured party can claim a security interest perfected by registration only in the collateral as limited. Out of an abundance of caution, lenders typically do not complete collateral descriptions, especially if the security is a general security interest or general assignment of accounts receivable. Collateral descriptions are typically completed by equipment financiers/lessors who wish to avoid inquiries from other creditors by providing notice to others that their security over "Equipment" or "Inventory" is limited to the specific equipment or inventory set out in the collateral description.

As part of the amendments to the *PPSA* that have received Royal Assent but have not been proclaimed into force, Ontario will be finally eliminating the "check the box" system. However, this will not take effect for some time since the implementation of this change will require a massive upgrade of the existing *PPSA* computer systems.

3.3.4 Registration periods

Financing statements can be registered (and subsequently renewed by financing change statements) for any period from one to 25 years (at $8.00 per year) or perpetually (for $500) except in the case of consumer goods, where the registration period cannot exceed five years at any one time.

3.3.5 Application to one or more security agreements

Except in the case of consumer goods, the *PPSA* permits a secured creditor to perfect security interests given under one or more security agreements by filing a single financing statement. Subsection 45(4) of the *PPSA* provides that one financing statement may perfect one or more security interests created or provided for in one or more security agreements between the parties, whether or not (1) the security interests or security agreements are part of the same transaction or related transactions, or (2) the security agreements are signed by the debtor before the financing statement is registered. If the creditor wants to rely on a previously filed financing statement, it should ensure the financing statement does not contain limitations in the collateral description that would prevent the financing statement from being effective for other security agreements.

3.4 Perfection of security interest in investment property

Subject to special exceptions, there are three general ways to perfect a security interest in "investment property" under the rules established by the *STA* and related *PPSA* provisions. "Investment property" means a security, whether certificated or uncertificated, a security entitlement, securities account, futures contract, or futures account. The rules are as follows:

1. Perfection by registration: A security interest in securities can be perfected by registration under s. 23 of the *PPSA*. However, given that special priority can be obtained by "control," it is generally recommended that "control" of the securities also be obtained.
2. Perfection by possession: A secured creditor can continue to perfect by "delivery" of the certificated securities into the possession of the secured creditor or someone on the secured creditor's behalf (*PPSA*, ss. 22(2)–(3)). The secured creditor obtains "control" where the securities are appropriately endorsed for transfer to the secured party.
3. Perfection by control: "Control" means that the secured creditor has the ability to transfer the securities without further action by the borrower (*PPSA*, s. 22.1). "Control" is the best method to perfect a security interest in securities, whether in the direct or indirect holding system, because of the priority rules established under the *STA* and *PPSA*.

There are special priority rules under the *PPSA* for investment property, and these should be carefully reviewed. Generally, the basic priority rules are as follows:

- Control has priority over non-control: A security interest perfected by control (by possession in the case of a certificated security and by control agreement in the case of an uncertificated security) has priority over another security interest perfected otherwise than by control (ss. 30.1(2)–(3)).
- Two security interests perfected by control rank according to priority in time (s. 30.1(4)).
- A securities intermediary has priority over other secured parties unless it otherwise agrees (s. 30.1(5)).
- Cut-off rules:
  - (a) A "protected purchaser" takes security free of any adverse claim (*STA*, s. 70): "Protected purchaser" means a purchaser (which includes a pledgee/secured creditor) of a certificated or uncertificated security or of an interest in the security who
    - (i) gives value;
    - (ii) does not have notice of any adverse claim to the security; and
    - (iii) obtains control of the security (*STA*, s. 1(1)).
  - (b) A purchaser other than a secured creditor takes security free of the security interest if the purchaser
    - (i) gives value;
    - (ii) does not know the transaction breaches the security agreement; and
    - (iii) obtains control of the security (*PPSA*, s. 28(6)).
  - (c) No action based on adverse claim may be brought against a person acquiring security entitlement for value and without notice of the adverse claim (*STA*, s. 96).

The *PPSA* also establishes a set of complex conflict of law rules dealing with investment property. It is important that these conflict of law rules also be reviewed with the priority rules set out above, in order to determine what

priority a secured creditor has over certain investment property.

3.5 Registration errors

Mistakes in completing the financing statement can be fatal to a secured creditor's security, by rendering the security interest unperfected and resulting in the secured creditor's security becoming subordinate in priority to other perfected security interests or the interests of a trustee-in-bankruptcy.

Not all registration errors are fatal. Subsection 46(4) of the *PPSA* provides that a financing statement is not invalidated nor is its effect impaired by reason only of an error or omission therein or in its execution or registration, unless a reasonable person is likely to be misled materially by the error or omission.

If an error or omission is discovered, steps should be taken to correct the error or omission as soon as possible by registering a financing change statement or a new financing statement. Depending on the specific circumstances, it is possible to correct an error or omission and still be able to retain the same priority or at least some priority over other secured creditors and a trustee-in-bankruptcy.

3.6 Maintaining perfection

The *PPSA* also requires that in certain circumstances, the secured creditor must file a financing change statement within certain prescribed time limits, such as when the borrower transfers its interest in the collateral or if the borrower changes its name. Failure to do so within the time limits set out in the *PPSA* will result in the loss of perfection pursuant to s. 48 of the *PPSA* until the required financing change statement is filed. The security interest is re-perfected with the filing of a financing change statement but will be subject to any interests that have arisen during the intervening period between the time the secured party should have filed the financing change statement and the time it actually did file.

4. Taking security under s. 427 of the Bank Act

4.1 General

Security under s. 427 of the *Bank Act* is available only to a chartered bank and enables a bank to acquire security over specified assets of certain types of borrowers who are

- wholesale or retail purchasers, shippers, or dealers;
- manufacturers;
- aquaculturists;
- farmers;
- fishers; and
- forestry producers.

Section 427 security can only be taken over specific classes of assets. These assets are generally inventory, but in the case of farmers and fishers, security can also be taken against agricultural implements and fishing vessels and equipment and can also be taken on certain things that are consumed in the course of production or dealing. Security is also available under s. 426 of the *Bank Act* for mines, minerals, and hydrocarbons such as oil and gas.

Section 427 security can only be provided by a borrower, and not a third party such as a guarantor.

Section 427 *Bank Act* security is comprised of four elements:

- an application for credit;
- a notice of intention;
- a grant of security or assignment of inventory; and
- an agreement concerning loans and advances.

4.2 Application for credit

The prescribed form of application for credit contains a written promise by the borrower to provide the bank with s. 427 security.

4.3 Notice of intention

After the bank receives an application for credit and not more than three years prior to the grant of security under s. 427, the bank must file the prescribed form of notice of intention with the Bank of Canada. The filing must be made with the agency of the Bank of Canada located in the province or territory in which the borrower has its place of business or in which the borrower's head office is located if the borrower has more than one place of business.

Regulations under the *Bank Act* provide that a notice of intention registered with the Bank of Canada is effective for five years. In March of each year, each bank must send by registered mail to each Bank of Canada agency where it has notices of intention registered, a statement listing the notices of intention scheduled to expire before December of the same year that the bank wishes to preserve. Upon receipt of that statement, the notices of intention listed in the statement are renewed/extended for one year. If a notice of intention is not on the statement by the bank in accordance with the foregoing timeline or such statement is not delivered, it will be removed from the register upon expiry.

4.4 Grant of security/assignment of inventory

Following the bank's registration of the notice of intention, the borrower will execute an assignment of the property in one of the two forms prescribed by the *Bank Act*: "security on particular property" or "security on all property of specified kinds." These documents create or grant the security interest in favour of the bank.

4.5 Agreement concerning loans and advances

Concurrently with the execution of the assignment of property, the borrower will execute an "agreement concerning loans and advances." This document constitutes the loan agreement between the bank and the borrower and sets out the bank's rights and remedies in the event of a default by the borrower. It will typically permit the bank to occupy and use the premises, plant, and equipment of the borrower for the purposes of realizing upon the inventory covered by the s. 427 security.

4.6 Transfer of title

Subsection 427(2) provides that the effect of taking s. 427 security is to transfer title of the assets to the bank. This transfer of title results in certain benefits for s. 427 security where title matters. For example, if the borrower occupies leased premises, the landlord will not be able to exercise its distress rights on the borrower's assets subject to s. 427 security and located on the premises because a landlord's distress rights can only attach to assets of its tenant. If the borrower's assets have been pledged to the bank under s. 427, the borrower no longer holds title to those assets, title having been transferred to the bank under s. 427.

The mechanism of title transfer can result in certain limitations for s. 427 security. For example, s. 427 security is subordinate to security interests created under conditional sale arrangements, whether or not PMSI priority is obtained, because in such circumstances title is never transferred to the borrower and, therefore, the borrower has no title to transfer to the bank under s. 427.

Two recent Supreme Court of Canada decisions have also emphasized the significance of pre-existing encumbrances on title even if the encumbrances are not known to the bank. The court held that *Bank Act* security will be subordinate to pre-existing security granted under the *PPSA,* even if that *PPSA* security has not been perfected and the bank could not be aware of it, because the bank can take no greater rights in collateral than the debtor has at the time the *Bank Act* security is granted. Accordingly, if property is charged but not perfected under the *PPSA* prior to the grant of *Bank Act* security, the bank takes the property subject to the charge and is subordinate to the *PPSA* security holder.

As a result, best practice for banks desiring both *Bank Act* and *PPSA* security in Ontario is to take security and perfect that security under both statutes. That way, even if the *Bank Act* security is subordinate to another creditor's pre-existing unperfected *PPSA* security, the bank's perfected *PPSA* security will have priority.

5. Guarantees

5.1 General

Although not strictly security in the sense of creating a charge over assets, in lieu of or in addition to security over a borrower's assets, a lender can also "secure" payment of the obligations of the borrower to it by obtaining a guarantee of the borrower's obligations from a guarantor.

A guarantee is a contract or promise by one party (the guarantor) to accept liability for the indebtedness of another party (the primary debtor). Guarantees can be an effective and relatively easy way to secure payment of a borrower's obligations, provided of course that the guarantor is solvent and has the financial ability to satisfy its obligations under the guarantee.

5.2 Types of guarantees

5.2.1 Unlimited and limited guarantees

Guarantees may be unlimited in that they guarantee all present and future liabilities of the borrower to the lender of whatever kind and however incurred. Alternatively, guarantees may be limited in the maximum amount guaranteed by the guarantor and/or in respect of the type of indebtedness guaranteed.

5.2.2 Secured and unsecured guarantees

A guarantor's obligations under a guarantee can be secured by security, or they can be unsecured. If secured, the bank may require security in any of the different forms mentioned above.

5.3 Types of guarantors

The guarantor can be an individual or a corporation. In either case, the guarantor will typically be a person or corporation related to the borrower. In the case of a corporate borrower, an individual guarantor is typically a shareholder or related person, and a corporate guarantor is typically an affiliate, subsidiary, or parent company of the borrower.

5.4 Guarantor defences

Although a guarantee is a relatively simple instrument to obtain, there are many defences that may be available to a guarantor that would render the guarantee unenforceable, such as forgery, fraud, material misrepresentation, duress, undue influence and *non est factum*, etc. Accordingly, certain precautions should be taken when taking a guarantee, particularly in the case of individual guarantors.

Pursuant to the *Statute of Frauds*, all guarantees must be in writing and executed by the guarantor.

5.5 Special considerations relating to individual guarantors

In the case of individual guarantors, it is important to ensure that the signature of the individual guarantor is witnessed. While independent legal advice is not legally required to render a guarantee enforceable, it is also important in certain circumstances to ensure that the individual guarantor has obtained independent legal advice prior to executing the guarantee in order to avoid future challenges to the validity and/or enforceability of the guarantee against the guarantor. These precautions are particularly important where the proposed guarantor is a person lacking in business sophistication, is elderly, has a limited knowledge of the English language, or is the spouse of a shareholder who is not involved in the business of the borrower. Any independent legal advice must truly be independent of the lender and the borrower.

When acting for a guarantor, it is appropriate to specifically review with the guarantor the nature and scope of the guarantee being given. Counsel should advise the guarantor in clear and unequivocal terms of the guarantor's potential liability under the guarantee. The solicitor who gives independent legal advice, must be satisfied the client understands their obligations under the guarantee document.

In describing the guarantee to the guarantor, counsel should highlight the fact that the lender does not need to exhaust its recourse against the borrower before being entitled to repayment from the guarantor. In fact, the lender will usually proceed against a guarantor if obtaining funds from the guarantor is easier than proceeding against the security granted by the borrower. Many guarantees will also contain a subordination of the guarantor's rights of subrogation in favour of the lender, which results in the guarantor not being entitled to claim repayment against the borrower until the borrower's indebtedness to the lender has been satisfied in full.

5.6 Confirmations of guarantees

In order to address any challenges to the enforceability of the guarantee based on the fact that the lender has materially altered the underlying debt obligation, confirmations of guarantee should be obtained from guarantors any time there is an amendment to the loan agreement that could result in a material variation in risk to the guarantor, such as an extension of the term of a loan, increase in principal amount of the loan, or increase in the interest rates. Each case will be fact specific and depend on the precise language in the guarantee as to whether the guarantor has sufficiently waived any defences resulting from a specific change or amendment to the primary obligations.

In order to avoid any risk that a particular amendment may allow the guarantee to be successfully challenged, it is recommended that a confirmation of guarantee be obtained every time there is an amendment to the loan agreement and at least every two years in the case of demand loans. In addition, so as not to lose the right to enforce the guarantee under Ontario's limitations legislation, the confirmations should also contain certain acknowledgements to lessen the impact of limitation periods.

5.7 The requirement to register guarantees under the PPSA

A guarantee does not require registration under the *PPSA* unless it contains an assignment of claim. Provided that the Ontario *PPSA* applies to the security interest, a financing statement should be registered against the guarantor showing a security interest against the "Accounts" and "Other" collateral of the guarantor. A mere postponement of claim does not require registration under the *PPSA*. In the case of individual guarantors, the *PPSA* contains special rules for registering against individuals, and therefore special care should be taken to ensure that such rules are followed and the pitfalls avoided in order to obtain perfection. In addition, to address any privacy law issues, the individual guarantor's consent should be obtained for the disclosure of his or her personal information (i.e., date of birth and address) required for the *PPSA* filing.

6. Real property security

Mortgages over real property may be taken either from the borrower or from a guarantor. Where the borrower or guarantor is an individual, s. 418 of the *Bank Act* provides that the amount of the loan made by a bank secured by the real property, together with the amount then outstanding of any mortgage, cannot be more than 80% of the value of the property at the time of the loan (Schedule I Banks under the *Bank Act* can lend greater

than 80% of the value of the property if the mortgage is properly insured). This restriction does not, however, apply to real property owned by corporations or lenders who are not subject to the *Bank Act*.

If the leasehold interests of a borrower or guarantor are a valuable asset, a lessee may mortgage its leasehold interest. In order to effectively obtain a mortgage of leasehold interests, the co-operation and/or consent of the landlord is usually required because of restrictions in the underlying lease agreement.

The *Land Registration Reform Act* governs the method of taking mortgage security over land and the registration requirements.

7. Miscellaneous

Although not strictly security, the following are examples of other mechanisms that lenders can use to support the repayment of obligations from a borrower. These can be obtained in lieu of, or in addition to, the taking of any of the security described above.

7.1 Subordination of indebtedness

A lender may require that other indebtedness of a borrower be subordinated to the indebtedness of the lender. A subordination of indebtedness is distinguishable from a subordination of security. A common example of subordination of indebtedness is the case where a loan is made by a shareholder to the corporation. A subordination of the indebtedness would involve the shareholder agreeing not to seek repayment of the shareholder loan until such time as the indebtedness to the lender has been repaid in full. Where the shareholder has obtained security for its loan, the lender may require a subordination of both the indebtedness and the security.

7.2 Negative pledge

In lieu of security, a lender may choose to rely on a "negative pledge" by the borrower not to mortgage, charge, pledge, or otherwise encumber some or all of its assets. The negative pledge will be contained in the loan agreement or security agreements if security has been given. The lender may have remedies for breach of contract against the borrower but security may have been given to other parties to the prejudice of the lender. The lender may seek to enjoin a breach of the negative pledge, if it becomes aware of an intended breach in advance. It may also be possible to have recourse against the parties who have taken security with knowledge of the negative covenant by asserting a tort of inducement of breach of contract.

7.3 Insurance

Insurance can provide financial compensation in the event of a loss caused by damage to property, business interruption, and other hazards that have a significant impact on the financial condition of a business. It is common for lenders to take an assignment of insurance or require that the lender be noted as a "loss payee" on material insurance policies of a borrower and/or guarantor.

8. Impact of Limitations Act, 2002

8.1 General

The *Limitations Act, 2002* (*LA, 2002*) came into force on January 1, 2004. This *Act* has significant implications for lenders in respect of creating and recovering debt obligations. The *LA, 2002* replaced the various limitation periods and rules under the former *Limitations Act* with two basic limitation periods.

8.2 Limitation periods

Under the former *Limitations Act*, the limitation period for actions "for simple contract or debt" was six years. Under the *LA, 2002,* there are two limitations periods applicable to debt and security claims.

8.2.1 Basic limitation period

Under the *LA, 2002*, there is a two-year "basic" limitation period, which runs from the date on which the claim is discovered or, if not actually discovered, when it should have been discovered by a reasonable person (s. 4). With the two-year basic limitation period, lenders must act promptly with respect to claims or potential claims against borrowers.

A claim is defined in s. 1 as "a claim to remedy an injury, loss or damage that occurred as a result of an act or omission."

8.2.2 Ultimate limitation period

The *LA, 2002* also contains a 15-year "ultimate" limitation period, which runs from the date an act or omission on which a claim is based took place, regardless of whether the claim has been discovered within that period (s. 15). The purpose of the ultimate limitation period is to achieve certainty and finality.

There are certain exceptions to the ultimate limitation period, such as actions for conversion against good faith purchasers for value of personal property, which cannot be commenced more than two years after the property was converted (s. 15(3)).

There is also no limitation period for certain kinds of claims, including proceedings by a debtor in possession

of collateral in order to redeem it or by a creditor in possession of collateral in order to realize on it (s. 16(1)).

Given that discoverability of a claim is typically not an issue in debt and security enforcement claims, lenders should be most concerned with the basic two-year limitation period.

8.2.3 Transitional provisions/application

The new limitations periods apply to all claims that arose after December 31, 2003, and to claims that arose prior to January 1, 2004, but were discovered or discoverable on or after January 1, 2004, and for which the limitation period under the former *Limitations Act* had not yet expired.

8.3 Demand loans/notes

With respect to the loans that are repayable on demand by the lender (demand loans, demand promissory notes, or demand notes), there were initial uncertainties about when the applicable limitation period commenced running due to the wording of the *Act*.

Under the common law, limitation periods for demand notes start running from the time of delivery of the demand note by the debtor to the creditor, and pursuant to the *LA, 2002*, the basic limitation period does not run until a "claim" is discovered. In *Hare v. Hare*, the Ontario Court of Appeal held that the common law applied to demand promissory notes and that the limitation period for demand promissory notes ran from the date of delivery of the demand note to the creditor (rather than the date of demand for payment) and that such date was the date on which the claim is discovered.

In response to *Hare v. Hare*, the *LA, 2002* was amended to include s. 5(3), which provides that an injury, loss, or damage, triggering the two-year limitation period, occurs under a demand note on the first day following a demand on which the obligation is not performed. Subsection 5(4) provides that this "day following demand" trigger date applies to all demand obligations created on or after January 1, 2004. Therefore, for any demand obligations created prior to January 1, 2004, to the extent possible, it is strongly recommended that formal written acknowledgements be obtained from borrowers to restart the applicable limitation periods within two years from the date of the demand loan or from the date of the last payment made by the borrower under the demand loan, unless the parties have agreed pursuant to s. 22 of the *LA, 2002* to lengthen the statutory two-year period.

8.4 Term loans

In respect of loans (commonly referred to as term loans) that are not repayable on demand but at the end of a specific term (maturity date), unless an event of default occurs earlier, the occurrence of an event of default should not trigger the commencement of a limitation period unless the event of default is a failure to pay when due. This is because the occurrence of an event of default would not ordinarily result in an "injury, loss or damage" to the lender. Instead, the event of default gives the lender the contractual right to commence enforcement by accelerating the loan and demanding payment. Only when the borrower fails to pay could the lender be said to have suffered any "injury, loss or damage." However, certain loan agreements contain automatic acceleration clauses. These clauses provide that all amounts become automatically due and payable by the borrower upon the occurrence of a specified event of default, without the lender having to take any action or the requirement for notice to first be given to the borrower. In such a case, the limitation period could be found to have commenced on default even if no demand was ever formally made. In order to avoid this risk, automatic acceleration clauses should be used in loan agreements with caution.

8.5 Acknowledgements and renewals of limitation periods

8.5.1 General

The *LA, 2002* codifies the common law on the effect of acknowledgments of liability. Section 13 provides that the new limitation periods can be renewed either automatically through the occurrence of certain acts or events or through a written acknowledgement of claim executed by the obligor or the obligor's agent. Subsection 13(1) provides that the act or omission on which a claim is based is deemed to have taken place on the day the acknowledgement is made. The acknowledgement has the effect of restarting both the basic and ultimate limitation periods.

Subsection 13(9) provides that an acknowledgement is effective to restart limitation periods only if made before the expiry of the applicable limitation period and only to the person with the claim, the person's agent, or an Official Receiver or trustee under the *Bankruptcy and Insolvency Act*.

8.5.2 Automatic acknowledgements

Under the *LA, 2002*, the limitation periods are automatically renewed by

- part payment of a liquidated sum by the borrower (s. 13(11)); or
- by the borrower's performance of its obligations under a security agreement (s. 13(4)).

(a) Part payment of debt

Any payment by the borrower on account of the debt, even interest only, has the same effect as a written acknowledgement signed by the debtor or the debtor's agent and constitutes an acknowledgment of liability for the entire debt, principal, and interest and therefore automatically renews the limitation period for the entire debt from the date of the last payment.

(b) Borrower's performance of obligations under security agreement

Any performance by the debtor of an obligation under a security agreement is an acknowledgement by the debtor of its liability in respect of a claim for realization on the collateral subject to the security agreement. For example, if the security agreement provided that the borrower was obligated to do a certain act upon request by the lender and such request was made and the borrower complied, this would result in an automatic renewal from the date of such performance. It is not clear whether the routine performance or observance of covenants in a security agreement (such as negative covenants not to dispose of assets outside the ordinary course) is sufficient to trigger an acknowledgement that has the effect of renewing limitation periods. Accordingly, it is recommended that instead of relying on the routine performance or observance of obligations or covenants under security agreements, the lender should obtain written acknowledgments in order to renew limitation periods.

8.5.3 Written acknowledgements

Under s. 13 of the *LA, 2002*, written acknowledgements will be effective to renew limitation periods for the following types of claims:

- payment of liquidated sums;
- recovery of personal property;
- enforcement of a charge against personal property; and
- relief from enforcement of a charge against personal property.

The written acknowledgement should be an acknowledgement of both principal and interest in all cases.

Section 13 contains the following additional rules relating to acknowledgements:

(1) If a person acknowledges liability for a liquidated sum, the acknowledgment restarts the limitation period, even if the person making the acknowledgement refuses or does not promise to pay the amount still owing (s. 13(8)).

(2) If a person acknowledges liability in respect of a claim to realize on or redeem collateral under a security agreement or to recover money in respect of collateral, any other person who later comes into possession of the collateral is bound by the acknowledgement (s. 13(3)).

(3) If a creditor accepts a debtor's payment or performance of an obligation under or in respect of a security agreement, the creditor acknowledges liability in respect of the debtor's claim to redeem the collateral under the security agreement (s. 13(5)).

(4) If a trustee makes an acknowledgement, successor trustees of the same trust are bound by that acknowledgement (s. 13(6)).

(5) If a person in possession of personal property acknowledges liability in respect of a claim to recover or enforce an equitable interest in the personal property, any other person who later comes into possession of it is bound by the acknowledgement (s. 13(7)).

It is recommended that in addition to obtaining acknowledgements on regular intervals from borrowers, particularly in the case of demand loans created prior to January 1, 2004, a lender should also obtain a written acknowledgement from its borrower each time the parties enter into a renewal, extension, amendment, or forbearance agreement.

8.5.4 Guarantees

Although guarantees should include acknowledgements by the guarantor that the lender and borrower may renew limitation periods without the necessity of obtaining the guarantor's consent, it is recommended that confirmations and acknowledgements from guarantors be obtained at the same time the acknowledgements are obtained from a borrower.

8.6 No contracting out

Prior to being amended, s. 22(1) of the *LA, 2002* prohibited parties from varying or excluding the new limitation periods by agreement. This not only precluded tolling agreements, but also was widely seen as limiting the ability of commercial parties to contract for longer or shorter times within which to bring claims for breach of warranty or covenant. The amended s. 22 provides the following:

(1) A limitation period under the *LA, 2002* may be varied or excluded by an agreement made before January 1, 2004.

(2) Any agreement made after October 20, 2006, may extend or suspend (i.e., lengthen) the basic two-year limitation period.

(3) The ultimate 15-year limitation period may be extended or suspended by agreement only after the claim has been discovered.

(4) Where the agreement is a "business agreement" entered into after October 20, 2006, the basic two-year limitation period may be varied or excluded (i.e., shortened or lengthened). However, parties to a "business agreement" cannot extend or suspend the ultimate 15-year limitation period until the claim is discovered.

(5) A "business agreement" is defined as an agreement made by parties none of whom are "consumers" as defined in the *Consumer Protection Act, 2002*.

Chapter 26
Searches and opinions

In a purchase and sale transaction or a financing, it is typical for searches to be conducted and legal opinions delivered before the closing of these transactions. This chapter reviews the types of searches that are typically conducted and the types of legal opinions that are typically rendered in a sale transaction or financing.

Part I: Searches

1. Introduction

1.1 Purchase and sale transactions

In a purchase and sale transaction, purchaser's counsel will typically conduct a variety of searches in order to determine the extent of liens or encumbrances on the assets being purchased in the case of an asset acquisition, or on the assets of the corporation whose shares are being purchased in the case of a share acquisition. In the case of an asset transaction, the searches should be conducted against the vendor of the assets. In the case of a share acquisition, the searches should be conducted against both the vendor of the shares and the corporation whose shares are being purchased, and in all cases, against the subsidiaries of the target corporation.

1.2 Financing transactions

In a financing transaction, either the lender's or borrower's counsel (upon the lender's request) will conduct a number of searches against the borrower in order to determine the extent of liens or encumbrances on the assets of the borrower that will be granted to the lender as security for the borrower's indebtedness to the lender.

1.3 Types of searches

Set out below are the different types of searches that are typically conducted in a purchase and sale transaction or financing. Which of these searches should be conducted in any given transaction or financing will be dependent on a number of factors, including the nature of the transaction and the type of collateral involved.

All searches should be conducted against the full legal name of the vendor, corporation, or debtor, including any English or French versions of the name, any prior names, predecessor corporations, and any business names of the vendor, corporation, or debtor. Prior names are former names of a corporation that have been changed pursuant to an amendment to the corporation's articles. A predecessor corporation is a corporation that has amalgamated with one or more other corporations to form the vendor, debtor, or guarantor, as the case may be. Where a specific motor vehicle is being acquired or financed, searches should also be conducted, where available, against the vehicle identification number.

The cost of these searches is typically not significant (approximately $50 per search, per name) but can add up if there are multiple vendors, borrowers, or guarantors or the relevant assets are located in multiple jurisdictions.

2. Standard corporate searches

2.1 Corporate searches

With respect to corporations incorporated under the *Canada Business Corporations Act* (*CBCA*) and Ontario's *Business Corporations Act* (*OBCA*), corporate searches will confirm the following:

- the corporation's legal name, including any changes to the legal name as a result of a change of name or amalgamation (because most searches require the corporation's full legal name, it is important to confirm the corporation's full legal name, including any English or French version);
- that the corporation has not been dissolved;
- that there are no restrictions contained in the charter documents that would prevent the corporation from taking the action it proposes, such as borrowing money or giving security over its assets, in the case of a financing transaction;
- the corporate history of a corporation in order to ascertain all prior names and predecessor corporations of the corporation that should be searched (where there are prior names and predecessor corporations, corporate and other searches should be conducted against those prior names and predecessor corporations); and
- the location of the registered office to determine the appropriate municipality for conducting certain searches against the corporation and its property.

A Corporation Profile Report can be obtained; it sets out various facts about a corporation, including information on a corporation's status, its current directors and officers, registered office address, and corporate history, such as amalgamations and name changes. Although the Corporation Profile Report sets out the status of a corporation as either active or dissolved, it is recommended that a certificate of status also be obtained

to confirm the status of a corporation. The certificate of status will certify the date of incorporation, continuation, or amalgamation of the corporation and that the corporation has not been dissolved as at the date of the certificate of status.

Under the *CBCA* and *OBCA*, a corporation is required to file the following documents with the relevant companies' registrar:

- copies of its charter documents (i.e., articles of incorporation, amalgamation, or continuance, as applicable);
- any amendments thereto; and
- such other documents required to be filed by the *CBCA* or *OBCA* or other statute.

Copies of such charter documents and corporate filings made by the corporation are also obtainable through corporate searches.

For corporate searches against *OBCA* or extra-provincially registered corporations in Ontario, corporate searches are conducted at the Ministry of Government Services, 393 University Avenue, Toronto, Ontario, or online through a third-party searching service.

For corporate searches of a *CBCA* corporation, searches can be conducted either online at www.strategis.ic.gc.ca or by request to Corporations Canada, Industry Canada (Industry Canada) in Ottawa either by telephone or in writing. A summary report called "Strategis Report," similar to the Corporation Profile Report for Ontario corporations, is available from Industry Canada. The Strategis Report contains the same type of information as the Corporation Profile Report but without information on the corporation's officers.

In order to confirm the status of a *CBCA* corporation, a certificate of compliance for the corporation should be obtained. The certificate of compliance will certify that the corporation is a corporation incorporated or continued under the *CBCA* and that it has not been dissolved. The certificate of compliance will also state that the corporation has filed its annual returns with the director; paid all fees required under the *CBCA*; and if the corporation has made a distribution to the public, filed its financial statements required to be filed under the *CBCA*.

2.2 Business name search

The *Business Names Act* (*BNA*) requires a corporation that carries on business or identifies itself to the public in Ontario by a name other than its full legal name to register this name with the Ministry of Government Services. Although most personal property searches require a search against the corporation's full legal name, it is recommended that when searching against an Ontario corporation, searches should also be conducted against the business names registered by that corporation.

Business name registration searches are conducted by reviewing the database maintained by the Ministry of Government Services or online through a third-party searching service.

2.3 Partnership name search

The *BNA* also requires persons associated in partnership to register with the registrar appointed under the *BNA*. Limited liability partnerships must register under the *Limited Partnerships Act*.

In a transaction in which a vendor or borrower is an individual engaged in a business or partnership, it is important to search against the partnership name and the partners of the partnership that are also disclosed by such search. Partnership name searches are conducted by reviewing the database maintained by the Ministry of Government Services or online through a third-party searching service.

Searches against the name of the partnership as well as against the individual partners are important. Under the *Personal Property Security Act* (*PPSA*), a financing statement against a partnership that has been registered under the *BNA* or the *Limited Partnerships Act* must set out the registered name of the partnership. If the partnership has not been registered under one of these statutes, then the financing statement must indicate the name of the partnership as set out in the security agreement and the name of at least one of the partners.

2.4 Corporations Information Act and annual returns

The *Corporations Information Act* (*CIA*) requires *OBCA* incorporated, amalgamated, or continued corporations to file an initial return within 60 days after incorporation, amalgamation, or continuance. This initial return sets out, among other matters, the name and registered office address of the corporation and the names and addresses of its directors and officers as at the date of filing (s. 2). Extra-provincial corporations are required to file an initial return within 60 days of carrying on business in Ontario (s. 3). In addition, the *CIA* requires a notice of change to be filed within 15 days of a change in the address of its registered or head office, and any change or correction in any other information contained in a return filed under the *CIA* (s. 4).

Each year thereafter, annual returns are required to be filed. Annual returns must be filed within six months of the financial year-end of the corporation. The annual

return is a schedule to the Ontario corporate tax return and is filed with the Ontario Ministry of Finance, which shares the information with the Ministry of Government Services. There is no filing fee payable. Failure to file the annual return can have material consequences. In addition to fees, penalties, and personal liability for directors and officers, a corporation that fails to file a return or notice or that has unpaid fees or penalties is not capable of maintaining a proceeding in a court in Ontario in respect of the business carried on by the corporation except with leave of the court (*CIA*, s. 18(1)).

For *CBCA* incorporated corporations, an annual return or report is required to be filed with Industry Canada. Industry Canada has also developed an integrated filing process for annual returns and corporation tax returns with the Canada Revenue Agency (CRA).

3. Standard security searches

The following searches are the standard searches that should be conducted to reveal liens and encumbrances against personal property located in Ontario. In certain cases, a corporation may have assets located outside of Ontario. In addition, security interests over the intangible personal property of an Ontario corporation may require security searches to be conducted in jurisdictions in addition to Ontario. Accordingly, it is important to determine in every acquisition and financing matter, whether searches need or should be conducted in jurisdictions in addition to Ontario. Special requirements exist for collateral located in Quebec.

3.1 Personal Property Security Act

3.1.1 Introduction

The *PPSA* sets out a comprehensive set of rules governing the rights of creditors and debtors with respect to personal property. The purpose of a *PPSA* search is to ascertain whether any secured party has perfected, by registration, any security interest in respect of any of the personal property of the debtor situated in Ontario. Note that perfection by possession and, in certain cases, temporary perfection without registration or possession are also possible but would not be disclosed by a *PPSA* search.

The registration system established under the *PPSA* is a province-wide system, and therefore, a *PPSA* search would disclose any registrations effected in Ontario only. The registration system established under the *PPSA* also discloses any registration made under the *Corporation Securities Registration Act*, which was repealed on October 10, 1989.

All unexpired registrations that match the search criteria will be included in an inquiry response, so it is critical to the accuracy and completeness of the search that the proper search criteria is used by the searcher or all relevant registrations may not be disclosed by the search.

3.1.2 Application of the PPSA

The *PPSA* applies to every transaction that in substance creates a security interest in personal property. In addition, an absolute transfer of an "account" or "chattel paper," even though the transfer may not secure payment of a debt, is required to be registered under the *PPSA* (s. 2(b)).

The *PPSA* is a notice-based system. Copies of the security agreements are not filed. Instead, a financing statement must be filed against the debtor corporation, setting out the class of collateral (namely, "Accounts," "Equipment," "Inventory," "Other," "Motor Vehicles," and in the case of an individual debtor, "Consumer Goods") over which the debtor has granted a security interest in favour of the creditor. The filing of a financing statement acts as notice to any person conducting a search under the *PPSA* of the security interests claimed by a party over a debtor's personal property.

3.1.3 No presumption

A filing of a financing statement does not create a presumption that the *PPSA* applies to the transaction to which the registration relates. Similarly, the filing of a financing statement does not necessarily mean that a security interest has been granted, since the *PPSA* is a self-reporting system and does not require any evidence from the registering party that it actually holds a security interest from the debtor. If someone registers a *PPSA* financing statement against a debtor's assets but has not been granted a security interest in that collateral or any collateral, the debtor has remedies under the *PPSA* to obtain an appropriate discharge of such registration or parts thereof.

3.1.4 Obtaining copies of security agreements and particulars

Although a copy of the relevant security agreement is not filed under the *PPSA*, the secured party can be required to furnish a copy of the security agreement and related particulars, such as the amount of the indebtedness secured by the security, pursuant to a request under s. 18 of the *PPSA*.

3.1.5 Fixtures and real property interests

Where a security agreement secures property in the nature of real property such as "fixtures or goods that may become fixtures or crops, or minerals or

hydrocarbons to be extracted, or timber to be cut" or "a right to payment under a lease, mortgage or charge of real property to which ... [the *PPSA*] applies," registration should also be made by the secured creditor in the appropriate land registry office in the prescribed form, and therefore, searches should also be conducted against title to the relevant real property (*PPSA* s. 54).

3.1.6 Search criteria

(a) Corporations

Searches should be conducted against the full legal name of the corporation being searched and any prior names (where there have been name changes) and predecessor corporations (where there have been amalgamations) as disclosed by the corporate searches. Searches should also include any business names and the French language version and combined French/English and English/French versions of the corporation, as disclosed by the corporate searches.

(b) Sole proprietorships and partnerships

In the case of individuals carrying on business or partnerships, searches should be conducted against both the partnership name and the name of the partners.

(c) Individuals

The *PPSA* requires that a financing statement against an individual must set out the first given name, the initial of the second given name, if any, the surname, and the date of birth (Minister's Order under the *PPSA*, ss. 16(1) and 3(1)(c)).

Unlike for corporate debtors, there is no certified search registry available to confirm an individual's name. The *PPSA* does not set out how a creditor is to confirm an individual debtor's name. These problems are compounded by the fact that an individual may have several valid legal versions of his or her name, particularly in the case of individuals born outside of Canada. For example, a person's birth certificate can list one name, while the name on his or her passport is different, and the name on his or her driver's licence may again be different. Thus, it is important to obtain as much identification from the individual as possible or reasonable in the circumstances, i.e., the individual's birth certificate, passport, citizenship certificate, social insurance card, and/or driver's licence to determine the legal name or names of the individual. To address any issues arising from privacy laws, a creditor should ensure that it obtains the individual debtor's consent to the disclosure of his or her personal information as part of a *PPSA* filing. This consent can be inserted into the security agreement.

There are two types of searches that are available under the *PPSA* system for individuals. The first search, called the "individual specific search," is conducted using the search criteria of the individual's first and last name, middle initial, and date of birth. The second search, called the "individual non-specific search" is conducted against the first and last name without any middle initial or birth date. To the extent that there are different legal versions of the individual's name both these searches may still not adequately address the issues arising from different legal names. Thus, it is recommended that where there are any issues about the legal name of an individual, searches be conducted against all possible versions of the name as indicated by the individual's various pieces of identification.

(d) Motor vehicles

If the personal property is or includes a motor vehicle, the system also provides a means to search against the vehicle identification number (VIN) of the motor vehicle. It is recommended that where motor vehicles are involved, searches using the VIN number be conducted. This is particularly important because of the issues associated with obtaining proper searches against individual debtor names.

3.1.7 Types of searches

Two types of searches are available under the *PPSA* system:

- *Verbal/Uncertified*: This "verbal search" is available almost immediately online through a third-party service provider. The search report is provided in written form, but it is not certified by the Registrar of Personal Property Security and therefore does not have the protections of the Personal Property Security Assurance Fund (Assurance Fund), a fund established under s. 44(1) of the *PPSA* to provide monetary recourse for errors in any certificates provided by the registrar. This type of search is also limited in size and will not be available where there are a large number of registrations filed against the corporation. This type of search is usually used where certain actions are required to be implemented immediately without the usual 24-hour delay it takes to obtain certified searches. The verbal/uncertified search should always be confirmed with a certified search.
- *Certificate*: This is a computer-generated certificate certified by the registrar. If there is any error or omission in the certificate, those who relied on the certificate and suffered loss or damage as a result of relying on an incorrect certificate have recourse against the Assurance Fund (s. 44(4)). As a matter of practice, a certified search should be obtained in all cases, especially where an opinion is being delivered that is based in any part on a *PPSA* search.

3.1.8 Currency date of searches

PPSA search responses are usually current to 4:30 p.m. one day preceding the date of the search. Both the "file currency date" and date that the search was conducted are set out on the certificate. In order to avoid any serious issues with the delay, it is common practice for a lender to require that the *PPSA* financing statement be filed in advance of the execution of documents and advance of funds, in order to confirm that its security interest has been registered in priority to all other interests, except purchase-money security interests (PMSIs) and encumbrances that are permitted by the lender—otherwise known as "permitted encumbrances."

3.1.9 Unregistered rights and interests

Certain rights and interests can be obtained against assets by third parties without the necessity for any kind of public notice or filing. These unregistered rights and interests will not be disclosed in a properly conducted *PPSA* search. The fact that a *PPSA* search discloses no prior registrations over a debtor's assets does not necessarily mean that no other person has rights against those assets that may have priority over the rights of the lender or the purchaser. For example, it is possible for a third party to perfect a security interest by possession in certain collateral (s. 22). If part of the collateral is located on leased premises, a landlord may have distress rights that may rank in priority to the rights of a lender or purchaser. In addition, there are a variety of other common law and statutory liens and deemed trusts that could attach to a debtor's assets in priority to a lender's security even though such lien or deemed trust is not registered.

3.1.10 No searches of title to personal property

The *PPSA* does not record title. Accordingly, the fact that no registrations have been filed against a particular corporation does not mean that the corporation is the owner of the relevant asset or collateral. With certain limited exceptions such as for motor vehicles and certain intellectual property, there is no title registry for personal property in Ontario.

3.2 Repair and Storage Liens Act

The *Repair and Storage Liens Act* (*RSLA*) is companion legislation to the *PPSA*. The *RSLA* sets out the rights of persons entitled to claim a lien for the repair and/or storage of personal property. Searches under the *PPSA* system will disclose any *RSLA* non-possessory registered liens.

3.3 Section 427 of the Bank Act

Where a lender is a chartered bank, security can also be obtained over certain assets of a debtor under s. 427 of the *Bank Act*. Section 427 of the *Bank Act* enables chartered banks to acquire security over specified inventory and specified assets of certain types of borrowers. The purpose of this search is to ascertain whether the debtor has granted security to a Canadian chartered bank pursuant to s. 427 of the *Bank Act* that has been registered in the Province of Ontario.

A search for notices of intention filed under s. 427 of the *Bank Act* can be conducted online through a third-party service provider in the following jurisdictions (as applicable):

- the province in which the place of business of the person by whom or on whose behalf a notice of intention is signed is located;
- if that person has more than one place of business in Canada and the places of business are not in the same province, the province in which the principal place of business of that person is located; or
- if that person has no place of business, the province in which the person resides (in respect of any notice of intention registered before June 1, 1992, this means the province in which registration was required to be made by the law in force at the time of such registration).

If a s. 427 search discloses any outstanding notices of intention, the bank or banks involved should be contacted to confirm whether the borrower has granted security over its inventory and whether the assets subject to the s. 427 *Bank Act* security covers the same assets that are intended to be purchased in a purchase and sale transaction or to be secured in the case of a financing transaction.

3.4 Bankruptcy searches

3.4.1 General

Searches are also often conducted to determine whether a corporation or individual is bankrupt or subject to a formal insolvency process, such as receivership or formal reorganization proceedings under the *Bankruptcy and Insolvency Act* (*BIA*) or *Companies' Creditors Arrangement Act* (*CCAA*) (for companies only). The purpose of these searches is to determine whether a corporation or individual may be restricted from disposing or encumbering its assets. Although these searches are referred to as "bankruptcy searches," they disclose whether a corporation or individual is subject to formal insolvency proceedings and not just a bankruptcy.

3.4.2 Court searches

The first search is for any recordings filed with the Registrar in Bankruptcy, Superior Court of Justice. The Office of the Registrar of the Superior Court of Justice in Bankruptcy is located in Toronto and is responsible for all of the Province of Ontario. This first search involves a review of the court's computer database for legal proceedings commenced by or against the corporation or individual and should be conducted using two different systems. The first system, called the FRANK system, searches everything filed with the court after April 2008 and any court files from before April 2008 that were transferred to the FRANK system. Accordingly, in order to catch files that may not have been transferred, it is necessary to search the second system, known as the Sustain system (the predecessor to the FRANK system). Both FRANK and Sustain searches will disclose any bankruptcy or insolvency proceedings involving the corporation, including court receiverships and reorganization proceedings commenced under the *CCAA*. Results from the FRANK system do not disclose a formal history of court proceedings, and as a result, the court files that are named in the result of the search must be retrieved and reviewed to determine particulars, if necessary. Moreover, any insolvency proceedings that are not commenced with the court will not be disclosed by either the FRANK or Sustain searches; such matters as private receiverships and notices of intention to make a reorganization proposal under the *BIA* will not be disclosed by these searches.

Neither the FRANK nor Sustain searches are certified. The FRANK search is conducted by submitting a request to a court clerk, who then returns the search results, or by attending at the court and using a publicly available computer terminal. The Sustain search is typically conducted by corporate and litigation law clerks online.

Because receivers can also be appointed under the *Courts of Justice Act*, a search should also be conducted with the Superior Court of Justice in the region where the debtor carries on business for any court receivership filings

3.4.3 Superintendent of Bankruptcy searches

A search should also be conducted for any recordings filed with the Office of the Superintendent of Bankruptcy. This search is conducted at the National Office of the Superintendent of Bankruptcy in Ottawa, Ontario, and gives information for all proceedings across Canada. This search discloses any filings made by a corporation or individual, trustee-in-bankruptcy, receiver, court-appointed monitor or similar official who is required by statute to make such a filing with the Office of the Superintendent of Bankruptcy or Official Receiver's Office. The Superintendent will provide a certificate indicating the results of its search.

Typically, the Superintendent of Bankruptcy is given notice of all insolvency proceedings commenced in the Ontario Superior Court of Justice within one to two business days of the commencement of any proceedings, so there may be some duplication in doing both the court and the Superintendent searches. *CCAA* proceedings were not formerly required to be reported to the Superintendent; however, recent amendments to the *CCAA* require the court-appointed monitor to file with the Superintendent a variety of forms setting out details of the proceedings within one to five business days of the commencement of the *CCAA* proceedings (the time to file varies with each form). The Superintendent maintains on its website a database of *CCAA* proceedings commenced after the *CCAA* amendments came into force (September 18, 2009).

3.4.4 Search limitations

The bankruptcy searches should be viewed with some caution in terms of both their accuracy and completeness for the following main reasons: First, the currency date of the searches can be several days old. Second, the requirement and deadlines for filings with the Office of the Superintendent of Bankruptcy or Official Receiver's Office is generally not strictly enforced. Third, the statutory deadlines for certain filings with the Superintendent or Official Receiver can be quite long (i.e., 10 days after a receiver is appointed). Consequently, the fact that the bankruptcy searches do not disclose an insolvency filing by or against a particular corporation or individual does not necessarily mean that an insolvency filing has not occurred.

3.5 Execution Act searches

In order to collect on a judgment, the *Execution Act* requires a judgment creditor to file an execution in the sheriff's office in each region or regional municipality in which the debtor has resided or resides or in which the judgment debtor's assets are located. The purpose of this search is to ascertain whether any writs of execution have been filed against the debtor, which would bind the personal or real property of the debtor.

When conducting an execution search, the search should be conducted against the full legal name of the party (including French versions), as well as against prior names, predecessor corporations, and any registered business or partnership names and partners, as applicable.

An Ontario-wide search for executions can be conducted. This search will disclose in which region or regional municipality executions have been filed against the debtor. Searches in any listed region or regional municipality then need to be made to obtain particulars of the executions filed against the debtor.

3.6 Bulk Sales Act searches

The *Bulk Sales Act* (*BSA*) requires that filings be made by the purchaser of its purchase of stock in bulk within five days of the completion of the sale. The purpose of this search is to determine whether there are any filings in respect of any dispositions by the debtor of its "stock in bulk" out of the usual course of business. The registration system established by the *BSA* is a decentralized one, and filings are made with the local registrar of the court in the region or regional municipality where the sale took place. Due to the difficulties in complying with the *BSA*, filings are rare.

Copies of *BSA* exemption orders, which exempt compliance from the *BSA*, are obtainable through a search of the records of the court in the region or regional municipality where the sale took place.

Because the *BSA* searches do not reveal unregistered sales in bulk (i.e. sales in bulk that have not complied with the *Act* or for which an exemption order has not been obtained), *BSA* searches are generally not very useful. As a result, some practitioners are no longer conducting these searches as part of their customary package of searches.

3.7 Intellectual property and other searches

If any of the assets being purchased or being granted as collateral security are intellectual property of material value, it is recommended that searches be conducted in the applicable copyright, patents, or trade-marks office even though the searches have significant limitations in terms of accuracy and currency. Filings of security interests are permitted in these registries by filing a copy of the actual security agreement. These registries were not established to act as security registries in the way that the *PPSA* registry system acts, and therefore searches can be cumbersome. In addition, as a result of filing backlogs, the currency date of any search results may be significantly delayed. Nevertheless, where intellectual property is of significant value, these searches will usually be conducted out of an abundance of caution.

In addition to the searches described above, there are a number of other searches that may be relevant in transactions involving unique assets, such as assets subject to the *Mining Act* or *Canada Shipping Act, 2001* or other similar statutes.

4. Real property searches

Where the acquisition or financing involves real property, it will be necessary to conduct a full search or a subsearch of the real property and to obtain an appropriate opinion to confirm title and/or liens or encumbrances against title to the real property.

Part II: Opinions

5. Introduction

Legal opinions are typically required in acquisitions and financings by the purchaser or lender, as the case may be. The following sets out the general characteristics of the type of opinions that would typically be requested and rendered in these situations.

6. Scope and structure of an opinion

The scope and structure of an opinion will vary depending upon the nature and complexity of the transaction, as well as the actual requirements that the purchaser or the lender, as the case may be, has for the opinion. Generally, the typical opinion will contain the following matters:

- a brief description of the transaction, including the agreements that are the subject matter of the opinion.
- a list of the documents, certificates (such as officer's certificates with respect to certain factual matters), or searches reviewed and relied upon by the counsel in delivering the opinion.
- the jurisdiction under which the opinion is given.
- a list of the assumptions and qualifications made in rendering the opinion.
- in the case of a financing opinion, the particulars of any security registrations made in connection with the security granted.
- opinions with respect to the following:
  - The corporation is a subsisting corporation under the laws of the jurisdiction of incorporation.
  - The corporation has the corporate power and capacity to enter into the relevant agreements.
  - The corporation has taken all necessary steps to authorize the entering into of the relevant agreements.
  - All relevant agreements have been duly executed, delivered, and in the case of a financing, registered.
  - The execution and delivery of the relevant agreements do not breach or constitute a default under the corporation's articles or by-laws or result in a breach of any law of Ontario or the federal laws of Canada.

- Searches have been conducted under the *PPSA* and other relevant statutes, and the results of such searches are outlined in a schedule or exhibit to the opinion.
- The agreements are legal, valid, and binding obligations of the corporation, enforceable against the corporation in accordance with their respective terms.
- In the case of a financing, the relevant security agreements create a valid security interest in the collateral set out in the security agreements, and such security interest has been perfected.

7. Standard assumptions and qualifications

The assumptions and qualifications in an opinion will depend on the scope of the opinion that is being delivered. The following is a short list of some of the standard assumptions and qualifications that are generally found in an acquisition or financing opinion.

7.1 Authenticity of documents

This assumption relates to the authenticity of the documents reviewed in giving the opinion. This assumption typically reads as follows:

> We have assumed the genuineness of all signatures (whether on originals or copies of documents), the authenticity of all documents submitted to us as originals, and the conformity to authentic original documents of all documents submitted to us as notarial, certified, photostatic, or electronically transmitted copies or facsimiles thereof.

7.2 Currency of searches

In many cases, it is not practical that the certificates and searches relied upon in giving an opinion are dated the same date of the opinion, although the searches should be as close to the date of the opinion as possible. It is therefore appropriate to specify the date and currency date, if applicable, of any searches or certificates relied upon in the opinion.

7.3 Enforcement subject to creditors' rights and equitable remedies

The typical opinion will provide that the enforceability of the agreements to which the opinion relates is subject to and limited by laws affecting creditors' rights generally. The usual qualification would read something similar to the following:

> The enforceability of any [Documents] and the rights and remedies set out therein may be limited by any applicable bankruptcy, insolvency, winding-up, reorganization, arrangement, moratorium, or other laws affecting creditors' rights generally.

This qualification is intended to cover the fact that statutes such as the *PPSA* may restrict certain remedies otherwise available to creditors, and that the stay of proceedings provisions in the *BIA* and the stay orders made under the *CCAA* typically prevent creditors from exercising remedies otherwise available under contract or provincial statute.

In addition, it is common practice to insert a further qualification that the enforceability of any agreement is subject to equitable remedies, such as specific performance and injunctions, which are discretionary and may not be awarded by a court in any particular instance. A typical clause will look similar to the following:

> The enforceability of any [Document] and the rights and remedies set out therein may be limited by general principles of equity and the obligation to act in a reasonable manner, and no opinion is given as to any specific remedy that may be granted, imposed, or rendered (including equitable remedies such as those of specific performance and injunction).

7.4 Judgment currency

Where an obligation is expressed in an agreement in a foreign currency, counsel rendering an opinion should add a qualification providing that Canadian courts may only award judgments in Canadian currency. A typical qualification would be as follows:

> Pursuant to the *Currency Act (*Canada), a judgment by a court in any province in Canada may be awarded in Canadian currency only.

7.5 Agreements binding on others

It is common for an opinion to contain an assumption with respect to the enforceability of an agreement as to other parties to that agreement. A usual assumption would be the following:

> We have assumed that the [Documents] constitute a legal, binding, and enforceable obligation of each party thereto other than the Corporation.

7.6 Title to personal property and priority of security interests

There is no title registry for personal property in Ontario, and accordingly, no opinion should be given as to title to personal property.

Also, in the financing transaction where security over personal property is being granted, the opinion should expressly note that no opinion is given in respect of the relative priority of the security interests granted by the security agreements referred to in the opinion.

The usual qualification would be as follows:

> No opinion is given as to the title of the Corporation to any property, or as to the priority of any mortgage, assignment, pledge, charge, or security interest provided for in any of the [Documents].

7.7 Other laws

A solicitor who is qualified to practise law only in Ontario cannot properly express an opinion on the laws of any other jurisdiction. Accordingly, where a transaction involves questions of law in jurisdictions other than Ontario, local counsel should be retained to provide an opinion as to those laws only. The typical qualification would be as follows:

> The opinions expressed herein relate only to the laws of the Province of Ontario and the laws of Canada applicable therein, and no opinions are expressed herein with respect to the laws of any other jurisdiction.

8. Standard opinions

The following is a description of some of the standard types of financing and acquisition opinions and the nature of investigations normally required to give such opinions.

8.1 Corporate capacity and power

> Relying solely upon the Certificate of [Status/Compliance], the Corporation is a subsisting corporation under the laws of the Province of Ontario. The Corporation has the corporate power and capacity to own its property and to carry on its business as it is now being carried on by it in the Province of Ontario.
>
> The Corporation has the corporate power and capacity to execute and deliver the [Documents] and to perform its obligations thereunder.

It is usual when expressing this opinion to obtain and rely upon a current certificate of status or certificate of compliance for that part of the opinion addressing the subsistence of the corporation. Note that "good standing" is not a term used in Ontario with respect to either Ontario or federal corporations and that opinions are typically not given that a corporation is "duly incorporated" or "duly organized" unless the counsel giving the opinion actually incorporated the corporation.

This opinion also addresses the corporation's power and capacity to enter into the various transactions contemplated by the agreements subject to the opinion. A review should be conducted of the corporation's articles and by-laws to confirm that there are no restrictions on the corporation to engage in the activities or transactions contemplated in the agreements.

8.2 Authorization, execution, and delivery

> The Corporation has taken all necessary corporate action to authorize the execution and delivery of the [Documents] and the performance of its obligations thereunder. The [Documents] has been duly executed and delivered by the Corporation.

In rendering this opinion, counsel should review applicable corporate statutes and examine the corporation's articles, by-laws, and any shareholder agreements to determine whether any particular requirements or restrictions are applicable. Counsel should review the appropriate resolutions of the corporation's directors to ensure that the authorization for the proposed transactions has been given and that such authorization is broad enough to permit the execution and delivery of the applicable agreements. It may also be necessary to have the shareholders' consent to the transaction in certain cases, such as where all or substantially all of the assets of a corporation are being transferred.

8.3 Valid and binding obligation enforceable in accordance with its terms

> The [Documents] constitute a legal, valid, and binding obligation of the Corporation enforceable against the Corporation by the other party thereto in accordance with its terms.

This enforceability opinion can only be expressed after all of the previous opinions have been given and a general review of the law applicable to the agreement in question has been made in order to ensure that its terms are lawful. This enforceability opinion cannot be given if the agreements are governed by the laws of any jurisdiction other than where counsel giving the opinion is qualified to practise.

It is usual to qualify this opinion with respect to the availability of equitable remedies, such as specific performance, and the application of bankruptcy laws, etc.

8.4 Registration

If the opinion includes security agreements, counsel will be required to provide an opinion that the appropriate security registration(s) has/have been duly made in all offices within Ontario where such registration is necessary to preserve and protect the security created thereby.

A typical provision in this regard would be:

> The [Documents] have been registered in all public offices provided for under the laws of the Province of Ontario where such registration is necessary or desirable to preserve or protect the security interests created by the [Documents] in favour of [the secured party] in the collateral.

8.5 Rank of security

Given the uncertainties and complexities involved in personal property security and the limitations of the

PPSA registry system, an opinion given in the context of an acquisition or financing will not generally speak to the priority of any security over personal property. It is common for an opinion to reference the filings made with respect to the security, the sufficiency of such filings, and the results of searches conducted against the vendor or debtor.

Due to the existence of real property registries, it is typical for an opinion with respect to real property to indicate the priority of a charge.

8.6 Authorized share capital

Typically, in a share purchase transaction, the vendor's counsel will be called upon to express certain opinions with respect to the capitalization of the corporation and the authorized, issued, and outstanding share capital. Counsel will often be asked to express an opinion as to the authorized capital of a corporation. Caution should be exercised with respect to expressing an opinion on the issued and outstanding shares, as corporate records are often neither current nor complete. No opinion should be expressed as to title to shares.

Chapter 27
Unsecured creditors' rights and remedies

Part I
Bankruptcy and other unsecured creditors' remedies

1. Introduction

An unsecured creditor is a person who is owed a debt by another person (the debtor) where the indebtedness is not secured by any of the debtor's assets.

Unsecured indebtedness of a business can arise in various ways. For example, most trade indebtedness (for the supply of goods and services) is unsecured. Obligations to employees and claims for damages and breach of contract are also unsecured. Lastly, unsecured claims can arise from loans and guarantees of a corporation that are not secured by its assets.

This chapter provides an overview of the rights and remedies available to unsecured creditors to recover the indebtedness owing to it by a debtor.

2. Judgments, executions, and garnishments

2.1 Judgments and executions

If a creditor is unsecured, the first step to recovery is to prove the existence and amount of the indebtedness owed to it by the debtor through a judgment of the court. Once a judgment is obtained, the *Rules of Civil Procedure* provide a judgment creditor with several ways to attempt to satisfy the judgment. For example, a judgment creditor can obtain a writ of seizure and sale, otherwise known as a writ of execution, and file it in the local sheriff's office in the jurisdiction where the judgment creditor believes the debtor has assets. Once filed with the local sheriff's office, the writ of execution attaches to all of the personal property and real property of the judgment debtor located in that jurisdiction and allows the sheriff to seize and sell such assets to be distributed to the debtor's creditors in accordance with the *Creditors' Relief Act, 2010*. Subsection 4(7) of the *Creditors' Relief Act, 2010* provides that creditors who have executions against personal property only, against real property only, or against personal and real property are entitled to share rateably with all other execution creditors any money realized under an execution or attachment order.

The writ can only attach to the judgment debtor's interest in its assets, and therefore, the judgment creditor's rights are generally subordinate to the rights of secured creditors.

2.2 Garnishments

A judgment creditor can also seek recovery through garnishment of amounts owed by third parties (garnishees) to the debtor. A garnishment involves the interception of third-party payments to the debtor for the benefit of the debtor's creditors. It is commenced by a notice of garnishment issued by the court registrar or clerk and is served on both the local sheriff where the judgment debtor resides, as well as the judgment debtor and garnishees. Once served with a notice of garnishment, the garnishee must pay all amounts owed to the judgment debtor (up to the maximum amount of the judgment) to the person identified in the notice of garnishment, usually the sheriff, for distribution to the debtor's creditors in accordance with the *Creditors' Relief Act, 2010*.

2.3 Priority in bankruptcy

Under the *Bankruptcy and Insolvency Act* (*BIA*), a trustee-in-bankruptcy has priority over all executions, garnishments, and other similar processes. This priority is subject only to

- executions, garnishment, etc. that have been completely executed by payment to the creditor or his agents; and
- the rights of secured creditors.

2.4 Distinction from secured creditors

While the remedies of judgment, execution, and garnishment are also available to secured creditors, secured creditors rarely use these remedies. Unlike unsecured creditors, a secured creditor can usually seize the assets that are subject to its security without having to first obtain a judgment or an order of the court. Secured creditors also have the right to sell the assets subject to the security that they have seized without the intervention of the court or any court official such as a sheriff. The security that the secured creditor holds gives it the right to take possession of the collateral, the power to sell the collateral, and the right to the proceeds of sale pursuant to its power of sale, subject to the rules governing priority under applicable federal or provincial legislation.

3. Unpaid suppliers

3.1 General

Section 81.1 of the *BIA* provides an exception to the basic rule in bankruptcy that all unsecured creditors should rank rateably. Prior to the enactment of s. 81.1, unpaid suppliers who supplied goods to insolvent purchasers had no greater rights than ordinary unsecured creditors of the insolvent purchaser except for some limited rights to repossess goods in transit under the *Sale of Goods Act*.

Section 81.1 now gives unpaid suppliers special rights over and above their status as unsecured creditors by giving unpaid suppliers a qualified right to recover goods supplied by the supplier to an insolvent purchaser for use in the insolvent purchaser's business.

3.2 Limitations

While s. 81.1 can give certain unpaid suppliers priority over other creditors, including secured creditors, there are significant limitations on an unpaid supplier's rights under s. 81.1. For example, the rights under s. 81.1 can only be exercised where a trustee-in-bankruptcy (trustee) or receiver has been appointed over the purchaser's assets, either privately by a secured creditor or by the court under the *Courts of Justice Act*. The rights do not apply when an interim receiver is appointed under the *BIA*. Section 81.1 rights cannot be exercised in reorganization proceedings under the *Companies' Creditors Arrangement Act* (*CCAA*) or during proposal proceedings under the *BIA*.

Section 81.1 only gives unpaid suppliers special rights of repossession. It does not give unpaid suppliers any priority over proceeds.

Unpaid suppliers are only entitled to the special rights of repossession under s. 81.1 if all the requirements under it are satisfied. These requirements can be quite onerous.

3.3 Requirements and procedures

To obtain the benefit of the s. 81.1 rights, the unpaid supplier must satisfy and comply with the following requirements and procedures.

First, the supplier must deliver a written demand in a prescribed form to the purchaser, trustee, or receiver within 15 days after the purchaser becomes bankrupt or subject to a receivership (unless the 15 days is extended by the trustee, receiver, or court). Only goods delivered within 30 days of the bankruptcy or receivership will be subject to the supplier's right of repossession and only if the goods are still in the possession of the trustee or receiver. It therefore becomes important that the supplier deliver the written demand as soon as possible after learning of a bankruptcy or receivership of its purchaser.

In the event that the insolvent purchaser files a proposal or notice of intention to file a proposal under the *BIA* or for protection under the *CCAA*, the s. 81.1 rights are not triggered. Although the 30-day period is suspended during this period, the purchaser is not restricted from selling the supplier's goods during this period. As a result, even if the proposal or *CCAA* plan fails and a receiver or trustee is ultimately appointed, it would be too late to have any real benefit for the unpaid supplier, since its goods are likely to have been used or disposed of during the intervening period.

Second, s. 81.1(1)(c) requires that at the time the written demand is presented to the purchaser, trustee, or receiver, the goods being claimed by the unpaid supplier must

- be in the *possession* of the purchaser, trustee, or receiver;
- be *identifiable* as goods delivered to the purchaser by the supplier and not fully paid for;
- be in the *same state* as they were on delivery;
- have *not been resold* at arm's length; and
- not be subject to any agreement for sale at arm's length.

Provided the foregoing requirements have been satisfied, on receipt of the demand for repossession, the purchaser, trustee, or receiver must return the goods to the supplier or pay the supplier the amount outstanding for the goods demanded.

3.4 Priority

Pursuant to s. 81.1(6) of the *BIA*, the supplier's right to repossession has priority over any other claim or right against the purchaser, including secured creditors with security over the purchaser's inventory, but is subordinate to the rights of a *bona fide* subsequent purchaser of the goods for value without notice that the supplier had demanded repossession.

Under s. 81.1(2), if the goods have been partly paid for by the purchaser, the supplier is only entitled to repossess that portion of the goods equal to the unpaid amount. Alternatively, the supplier may repossess all qualifying goods on payment to the purchaser, trustee, or receiver of an amount equal to all partial payments previously made by the purchaser to the supplier.

3.5 The Wage Earner Protection Program Act

On July 7, 2008, the federal government enacted the *Wage Earner Protection Program Act* (*WEPPA*) and related amendments to the *BIA*. The *WEPPA* establishes a program run by the federal government through which

employees can be compensated directly by the government to a maximum of the greater of $3,000 in actual unpaid wages or an amount equal to four times the maximum weekly insurable earnings under the *Employment Insurance Act* (currently approximately $3,400).

An individual is eligible to receive a payment from the Wage Earner Protection Program (the "WEPP") if all of the following requirements have been met:

- The individual's employment is terminated as a result of a "definitive and permanent breach" of the employment contract, meaning that a period of at least seven days has passed during which no work is performed for the employer and during which no wages are payable.
- The former employer is bankrupt or subject to a receivership occurring on or after July 7, 2008.
- The individual is owed wages by the former employer in respect of wages earned during the six months immediately preceding the date of the bankruptcy or the first day on which there was a receiver in relation to the former employer.

Certain individuals who might otherwise be eligible to receive a payment from the WEPP are deemed ineligible if any of the following is true:

- They have a controlling interest in the business of their former employer.
- They occupied a managerial position with their former employer.
- They were an officer or director of the former employer.
- They did not deal at arm's length with any of the foregoing individuals.

An individual is deemed to have a "controlling interest" in the business if such individual owned

- more than 40% of the voting shares in the business;
- a block of voting shares that is large enough such that no one shareholder or coalition of shareholders can block a motion; or
- enough shares in the business to control the business's policy.

An individual is deemed to have occupied a "managerial position" with their former employer if the responsibilities of the individual included making binding financial decisions affecting the business of the former employer or binding decisions with respect to the payment or the non-payment of wages by the former employer.

"Wages" recoverable by employees under the *WEPPA* include salaries, commissions, compensation for services rendered, vacation pay, and following a recent amendment to the *WEPPA*, termination and severance pay.

The *WEPPA* provides that once it has paid claims, the federal government is then subrogated to the rights of the employee for the amounts paid under the program. Through this subrogation right, the government obtains the right to pursue directors for the unpaid wages under Ontario's *Business Corporations Act* (*OBCA*) and the *Employment Standards Act, 2000* and the right to pursue the statutory priority charge created for unpaid wages up to a maximum of $2,000 (plus $1,000 of disbursements for travelling salespeople) under ss. 81.3–81.4 of the *BIA* (however, this priority is not available for severance or termination pay paid by the federal government through the WEPP). If there are insufficient current assets to cover the amounts covered by the statutory charge, the amount that is not fully secured by current assets will be a preferred claim in bankruptcy under s. 136(1)(d) of the *BIA* (amounts for termination and vacation pay do not receive a priority under s. 136(1)(d)).

4. Landlords and rights of distress

Landlords can become unsecured creditors for any arrears of rent, claims in respect of damages to leased premises, and other claims arising under the lease and any breaches thereof. Under the common law, the *Commercial Tenancies Act*, and usually the terms of the lease itself, landlords have limited rights to seize and sell assets owned by the tenant on the premises in order to satisfy rent arrears.

Landlords also have a preferred claim in bankruptcy for up to three months' arrears and three months' accelerated rent to the extent provided for under the terms of the lease, up to the realizable value of the assets located on the leased premises.

5. Bankruptcy

5.1 Status of a bankrupt

Bankruptcy is a legal process governed by the *BIA*. A debtor can only become bankrupt in one of three ways:

(1) making an assignment for the general benefit of its creditors under s. 49 of the *BIA*;

(2) filing a proposal to its creditors that is either rejected by its creditors (s. 57) or accepted by its creditors but not approved by the court (s. 61(2)); or

(3) the granting of a bankruptcy order by the court on the application of one or more of the debtor's creditors (s. 43).

5.2 Who can become bankrupt

The *BIA* prescribes who can become bankrupt. A debtor must be insolvent to be a bankrupt.

An "insolvent person" is defined in s. 2 of the *BIA* and means a person

(1) who is not bankrupt;

(2) who resides, carries on business, or has property in Canada; and

(3) whose liabilities to creditors provable as claims under the *BIA* amount to $1,000 and

   (a) who is for any reason unable to meet its obligations as they generally become due;

   (b) who has ceased paying his or her current obligations in the ordinary course of business as they generally become due; or

   (c) the aggregate of whose property is not, at a fair valuation, sufficient or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all its obligations, due and accruing due.

The test referred to in (a) and (b) above is commonly termed the "cash flow test," and the test referred to in (c) above is commonly termed the "balance sheet test."

The *BIA* defines a "person" broadly to include partnerships, corporations, and unincorporated associations. "Person" does not include banks, insurance companies, trust companies, loan companies, or railway companies. The insolvency of these types of organizations is governed by different statutes such as the *Winding-up and Restructuring Act*.

5.3 Involuntary bankruptcy and the bankruptcy application

5.3.1 General

A person can be involuntarily put into bankruptcy by an application (a bankruptcy application) by a creditor (the applicant creditor or applicant) to the court for a bankruptcy order declaring an insolvent person to be bankrupt and appointing a trustee-in-bankruptcy over the bankrupt's assets.

A secured creditor can be an applicant creditor for any unsecured portion of its claim that is not fully covered by the value of its security. In certain circumstances, a secured creditor may benefit from a "strategic bankruptcy," which results in a reversal of priorities in the secured creditor's favour.

In order for the court to issue a bankruptcy order against a debtor, it is not enough just to prove that the debtor is insolvent. The applicant creditor must also prove to the court's satisfaction that the debtor has committed an "act of bankruptcy" within the six months preceding the issuance of the bankruptcy application.

5.3.2 Acts of bankruptcy

Acts of bankruptcy are listed in s. 42(1) of the *BIA*. The most common act of bankruptcy cited in bankruptcy applications is that the insolvent person has ceased to meet its liabilities generally as they become due (s. 42(1)(j)). Other common acts of bankruptcy cited include the debtor making a fraudulent transfer or fraudulent preference of its property or assets (ss. 42(1)(b)–(c)) and the insolvent person exhibiting to any meeting of its creditors any statement of its assets and liabilities that shows it is insolvent or any admission in writing of its inability to pay its debts (s. 42(1)(f)).

5.3.3 Procedure

In Ontario, a bankruptcy application under the *BIA* is commenced in the Ontario Superior Court of Justice by the issuance of a bankruptcy application in the prescribed form by the registrar, a court officer appointed under the *BIA*. There is no special "bankruptcy court" in Ontario; however, there is a dedicated section of the Superior Court of Justice in Toronto that hears only bankruptcy and insolvency matters.

The onus is on the applicant to demonstrate the facts upon which the bankruptcy application is issued (that the debtor is insolvent, the debt owing to the applicant creditor and/or other creditors amount to $1,000 or more, and the debtor has committed one or more acts of bankruptcy within the six months preceding the filing of the bankruptcy application). These facts are verified by an affidavit of statements in the application (affidavit of truth) filed by the applicant creditor or a representative of the applicant who has personal knowledge of the facts alleged in the bankruptcy application (s. 43(3)).

When the registrar issues the bankruptcy application, it is endorsed with a notice of the time and place when the registrar will hear the bankruptcy application. The debtor must be served with notice of the bankruptcy application at least 10 days before the hearing or such shorter period as the court may order (*Bankruptcy and Insolvency General Rules* (*BIA Rules*), s. 70(1)).

5.3.4 Disputed applications

If the debtor disputes the bankruptcy application, the registrar must refer the bankruptcy application to a judge of the Ontario Superior Court of Justice for hearing. A debtor may dispute a bankruptcy application by filing a notice of dispute with the court and serving a copy of the notice on the applicant at least two days before the hearing of the bankruptcy application by the registrar

(*BIA Rules*, s. 74). The notice of dispute must set out the allegations on the bankruptcy application being contested and the grounds for contesting them.

If the debtor has filed a notice of dispute, it may cross-examine the applicant creditor or the representative of the applicant creditor who swore the affidavit of truth as a way of obtaining some pre-trial discovery of the applicant's case (*BIA Rules*, s. 14(2)). Applicants have no opportunity to obtain discovery of the debtor.

5.3.5 Remedies

After hearing submissions of the applicant and the debtor, the court must do one of the following four things:

- make a bankruptcy order declaring the debtor bankrupt and appointing a trustee-in-bankruptcy (*BIA*, ss. 43(6) and (9));
- dismiss the bankruptcy application (s. 43(7));
- stay the bankruptcy application indefinitely; or
- stay the bankruptcy application for a limited period of time (ss. 43(10)–(11)).

The court is given broad discretion under the *BIA* to dismiss a bankruptcy application, even if it is established that an act of bankruptcy has been committed by the debtor, as long as the court is satisfied that the debtor can pay its debts or "that for other sufficient cause no order ought to be made" (s. 43(7)).

If the debtor disputes the facts alleged in the bankruptcy application, the court may stay the bankruptcy application until a trial of the issues relating to disputed facts (s. 43(10)).

In addition to the court's power to stay the bankruptcy application pending the trial of issues in dispute, the court has a general power under s. 43(11) of the *BIA* to stay any bankruptcy application "for other sufficient reason." The courts rarely exercise this general power.

5.4 Trustees-in-bankruptcy

5.4.1 General

Upon the bankruptcy of a debtor, the debtor ceases to have legal capacity to dispose of or otherwise deal with its property. Pursuant to s. 71 of the *BIA*, a trustee is appointed, and all of the bankrupt's property automatically vests in the trustee (except property it holds in trust for others, property held in a registered retirement savings plan or registered retirement income fund that was deposited at least 12 months prior to the date of bankruptcy, or property that would be exempt from seizure by creditors under applicable provincial law).

Trustees are persons, typically chartered accountants or firms, who hold a trustee's licence issued by the Superintendent of Bankruptcy. Trustees are not government officials. Once appointed, trustees become officers of the court and therefore have a duty to act impartially in the best interests of the creditors generally. The trustee's fees and expenses incurred in the administration of the bankruptcy's estate are paid in priority to other preferred creditors and ordinary unsecured claims pursuant to s. 136(1)(b) of the *BIA*.

5.4.2 Trustee's duties and powers

Once appointed, the trustee is required to give notice of the bankruptcy to all known creditors of the bankrupt, to convene meetings of the creditors of the bankrupt, and to report periodically on the progress of its administration of the bankrupt estate (ss. 27(1) and 102(1)).

The trustee's main role is to liquidate the assets of the bankrupt's estate and to distribute the proceeds to the bankrupt's creditors in accordance with the priorities set out in s. 136 of the *BIA*. In order to do so, the trustee is required to take possession of the property of the bankrupt and make an inventory of the property of the bankrupt as soon as possible after the bankruptcy order is made (s. 16(3)). If creditors or other parties have possession of the bankrupt's property, they are required to give up possession to the trustee unless such property has been seized by a secured creditor (s. 17(1)). The trustee also has the power to enter onto the bankrupt's premises and any other premises on which the bankrupt's property may be located to obtain possession (s. 16(3)) but, in the case of third parties, only with consent or upon obtaining a warrant (s. 16(3.1)).

The trustee's duty to liquidate the bankrupt's property, its rights to occupy leased premise, and its obligations to distribute proceeds of liquidation are discussed below.

Section 30 of the *BIA* sets out certain restrictions on the trustee's power to administer the bankrupt's estate, providing that if there are inspectors, certain listed powers can only be exercised by the trustee with the permission of the inspectors; if there are no inspectors, the trustee can exercise all of its powers on its own accord, except dispose of assets to a party related to the bankrupt, a power that may only be exercised with the court's permission.

The trustee is also responsible for scrutinizing the actions of the bankrupt prior to the bankruptcy; reporting to creditors on transactions that may be attackable as fraudulent preferences (*BIA*, s. 95) or transfers at undervalue (*BIA*, s. 96); and, where appropriate, commencing proceedings to challenge such transactions.

5.4.3 Treatment of secured creditors in a bankruptcy

The rights of the trustee to deal with the assets of the bankrupt are generally subject to the rights of secured creditors over the assets of the bankrupt.

A secured creditor is "a stranger to the bankruptcy" in that it is generally free to enforce its security to recover the indebtedness owed to it by the bankrupt notwithstanding the bankruptcy and the appointment of a trustee. When requested, the secured creditor must prove its security to the trustee (s. 128(1)). The trustee also has a right under s. 128(3) of the *BIA* to redeem or acquire the secured creditor's security over the assets of the bankrupt for the amount of indebtedness owed to the secured creditor by the debtor. Redemption of security could be beneficial to the bankrupt estate where there is equity available to the bankrupt's estate over and above the amount owed to the secured creditor.

6. Stay of proceedings

6.1 General

When an insolvent person files an assignment in bankruptcy or if a bankruptcy order is made against an insolvent person, all proceedings by unsecured creditors to assert claims provable in bankruptcy against the bankrupt or the bankrupt's property are stayed by s. 69.3 of the *BIA*. Secured creditors are not generally stayed from enforcing their security as secured creditors. Instead of proceeding to judgment to prove their claims, unsecured creditors must prove their claims by filing a proof of claim in the prescribed form with the trustee (s. 124(1)).

What qualifies as a claim provable in bankruptcy is set out in ss. 121–122 of the *BIA*. Generally, all debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge by reason of any obligation incurred before the day on which the bankrupt becomes bankrupt are deemed to be claims provable under the *BIA* (s. 121(1)). There are special rules for contingent and unliquidated claims (s. 121(2)), debts payable at a future time (s. 121(3)), family support claims (s-. 121(4)), and claims provable in bankruptcy following a proposal under the *BIA* (s. 122).

The purpose of the stay of proceedings is to provide the trustee and the court with control over the manner in which the claims of creditors are dealt with in the bankruptcy. The claims procedure provides a single, faster, and more streamlined procedure for unsecured creditors to prove their claims against the bankrupt.

6.2 Leave to lift stay

In certain circumstances, with leave of the court, a person may be permitted to commence or continue proceedings against the bankrupt under the usual court process. For example, leave may be granted if the court can be satisfied of either of the following (s. 69.4):

- The person seeking leave will likely be materially prejudiced by the stay.
- It is equitable to declare the stay does not apply to such creditor or person.

Generally, the courts have granted leave in the following situations:

- The proceeding involves co-defendants who are not bankrupt.
- The claims are so complex that a summary procedure under the claims process is inappropriate.
- The claim involves insurance coverage issues.
- The claim is not a claim that will be discharged at the end of the bankruptcy.

In respect of the continuation of existing proceedings, leave may be granted if the trial of a disputed claim is at a stage that completing the existing process is more efficient than restarting a fresh review of the claim under the claims process.

7. Administration of bankrupt's estate

7.1 First meeting of creditors

Within five days of its appointment, the trustee must send to all known creditors of the bankrupt a notice of the bankruptcy and notice of the first meeting of the bankrupt's creditors (s. 102(1)). The meeting must be held within 21 days of the trustee's appointment and no earlier than 10 days after the notice is sent (*BIA*, s. 102(1); *BIA Rules*, s. 108(2)).

The meeting is held at the office of the Official Receiver or at such other place designated by the Official Receiver. The Official Receiver is a government official for each provincial bankruptcy division who reports to the Superintendent of Bankruptcy. The Official Receiver also chairs the first meeting.

Generally, a first meeting of creditors is held to address the following three primary matters (s. 102(5)):

- the affirmation of the trustee's appointment;
- a review of the bankrupt's affairs, including the delivery of the initial statement of the bankrupt's affairs, a report by the trustee, and a report by the Official Receiver on the results of its examination of the bankrupt; and

- the appointment of the inspectors of the bankrupt's estate.

7.2 Affirmation of trustee

The appointment of the trustee by a bankruptcy order or an assignment in bankruptcy must be affirmed at the first meeting of creditors. Under s. 115 of the *BIA*, the affirmation of the trustee must be passed by an "ordinary resolution" (requiring a simple majority of votes with one vote for each dollar of provable claim of the creditors present at the meeting, personally or by proxy). If the trustee's appointment is not affirmed by ordinary resolution, the trustee will continue until a "special resolution" (requiring a majority of the creditors in number representing 75% in value of the provable claims present at the meeting, personally or by proxy) is passed to remove the trustee and substitute a new trustee. Alternatively, a creditor may apply to the court for an order removing the trustee and substituting another in its place.

Creditors may object to the bankrupt or applicant creditor's choice of trustee for a variety reasons. For example, in certain cases, creditors may question the objectivity of the particular trustee as either being too much in favour of the bankrupt and/or bankrupt's management or in favour of the interests of the applicant creditor.

7.3 Review of bankrupt's affairs

At the first creditors' meeting, the creditors are provided with a copy of the bankrupt's statement of affairs, which is a sworn statement by the bankrupt listing the bankrupt's assets and its liabilities at the date of bankruptcy. The trustee will also give a preliminary report to the creditors on its administration of the bankrupt's estate to the date of the meeting.

Both the initial statement and trustee's preliminary report should be reviewed with caution in terms of its completeness and accuracy as both are preliminary in nature, having been prepared without the benefit of a comprehensive review and analysis by the trustee. In most cases, the value of the assets stated in the initial statement is the book value of the assets, which is usually less than the realizable value of the assets. In addition, the liabilities of the bankrupt are usually much higher than initially stated, since the bankrupt's books and records would not necessarily set out all possible contingent and unliquidated claims against the bankrupt nor any claims that would have resulted from the bankruptcy (i.e., as a result of termination of contracts).

Prior to the first meeting of creditors, the Official Receiver is required to conduct an examination of the individual bankrupt or officer of the corporate bankrupt under s. 161 of the *BIA*. This examination is conducted under oath following a standard questionnaire. The purpose of the questionnaire is to identify the shareholders, officers, and directors of the bankrupt, the reasons for the bankruptcy, and any unusual payments or transfers of assets made by the bankrupt in the time leading up to bankruptcy. The questionnaire may be supplemented by questions from the trustee.

At the first meeting of creditors, the Official Receiver provides a report concerning the examination of the bankrupt. The creditors are given an opportunity at the meeting to question the trustee and the bankrupt. Pursuant to s. 158(h) of the *BIA*, the bankrupt must submit to an examination at the first meeting of creditors.

7.4 Inspectors

7.4.1 General

At the first creditors' meeting, creditors who have filed proven claims prior to the meeting elect the inspectors of the bankrupt's estate. The inspectors act as a board of directors of the bankrupt's estate. They supervise, instruct, and consult with the trustee with respect to the proper administration of the estate. Certain actions by the trustee require the approval of the inspectors.

Up to five inspectors may be elected by ordinary resolution (s. 115). Decisions of the inspectors are made by majority vote. To avoid a deadlock, an odd number of inspectors is usually elected. While the main creditors of the estate usually nominate inspectors, inspectors are not required to be creditors of the estate and, in fact, can be secured creditors. Not everyone can be an inspector. For example, any person who is party to any contested action or proceeding by or against the estate cannot be an inspector (s. 116(2)).

The first meeting of inspectors is usually held immediately after the first meeting of creditors. As a general matter, at the first meeting, the inspectors will usually authorize the trustee to retain legal counsel and to conduct examinations under s. 163 of the *BIA* of persons having information concerning the affairs of the bankrupt in order to investigate possible fraudulent preferences and transfers. The inspectors will also consider any other important issues affecting the estate where they wish to provide guidance to the trustee or, if appropriate, authorization to the trustee.

7.4.2 Powers of trustee requiring inspector approval

Section 30 of the *BIA* provides that certain powers of the trustee, such as the sale or other disposition of the

unencumbered assets of the estate, cannot be exercised in a proceeding with inspectors without the approval of the inspectors. The following are other powers that are only exercisable by the trustee with the permission of inspectors (when there are inspectors):

- lease real property;
- carry on the business of the bankrupt;
- institute or defend proceedings;
- borrow money or give security on the bankruptcy property;
- elect to retain or disclaim any lease; and
- compromise and settle debts owing to the bankrupt or compromise any claim by or against the bankrupt estate.

Where there are no inspectors, the trustee can exercise any of the above powers on his or her own accord.

7.4.3 Conflicts with inspectors

If there is a conflict between the directions given to the trustee by the inspectors and those given by the creditors at a general meeting of creditors, the directions given by the creditors prevail (s. 119(1)).

If there is a conflict between the trustee and the directions given by the inspectors, the trustee has the right to apply to the court to review any directions given by the inspectors (s. 119(2)).

7.5 Proof of claims and voting at first creditors' meeting

7.5.1 Proof of claim

In order to vote at the first meeting of creditors, creditors must have filed a proof of claim setting out a provable claim with the trustee prior to the time set for the commencement of the meeting (s. 109(1)).

The proof of claim is a prescribed form under the *BIA* that is verified by the claimant's certificate. In the proof of claim, the creditor sets out the amount of its claim, whether it is secured by assets of the bankrupt (and if so, the value of the security), and whether preferred creditor status is claimed. Preferred creditors are unsecured creditors who have claims that fall within one of the listed claims under ss. 136(1)(a)–(j) of the *BIA*.

7.5.2 Secured creditors

The bankruptcy process does not affect the rights of secured creditors. To the extent that the secured creditor may suffer a deficiency in its security because the value of the security is insufficient to repay the bankrupt's indebtedness in full, the secured creditor is entitled to file a proof of claim for the amount of its unsecured deficiency. The secured creditor is also entitled to participate in the bankruptcy process as an unsecured creditor in respect of the unsecured portion of its claim, including being entitled to vote at any creditors' meeting and to receive its *pro rata* share of distributions (s. 112).

7.5.3 Rights to share in distribution

Creditors who do not prove their claims will not be entitled to share in any distribution (s. 124(1)). If creditors fail to file a proof of claim by the time of the creditors' meeting, they will not be able to vote at the creditors' meeting but are not prohibited from subsequently filing a proof of claim for distribution purposes.

7.5.4 Restricted parties

To ensure objectivity in the administration of the bankrupt's estate, including the trustee's review of related party transactions, certain related persons, such as family members in the case of an individual bankrupt, and officers, directors, employees, or wholly-owned subsidiaries in the case of a corporate bankrupt, are prohibited from voting on the appointment of the trustee or inspectors unless authorized by the court (s. 113(3)).

8. Personal liability of trustee

A trustee may encounter environmental issues in connection with real property owned by the bankrupt that potentially can put the trustee at risk of personal liability. In addition, if the trustee operates the business of the bankrupt with a view to selling the business as a going-concern, the trustee can also potentially be exposed to successor-employer liabilities. Receivers are also subject to both types of liabilities.

8.1 Labour/employee-related liabilities

Because of concerns that existing provisions in the *BIA* were not sufficient to adequately protect receivers and trustees from these kinds of employment-related liabilities, as part of the amendments to the *BIA*, effective as of September 18, 2009 (the 2009 *BIA* Amendments), s. 14.06(1.2) of the *BIA* was amended to explicitly provide that, notwithstanding any federal or provincial law to the contrary, a "trustee" is not personally liable in respect of any liability, including successor-employer liability, that is in respect of employees or former employees, including pension plan obligations. The amended s. 14.06(1.1) of the *BIA* provides that for the purpose of this statutory protection, a "trustee" includes an interim receiver, a receiver appointed under s. 243, or any other person who has lawfully taken possession or control of the property of an insolvent person or bankrupt used to carry on the business of that insolvent person or bankrupt.

These amendments were intended by Parliament to address the residual issues over whether the previous provisions of the *BIA* were adequate to protect receivers and trustees from personal liability for employment-related liabilities and are generally considered by insolvency professionals to accomplish that objective. However, since these amendments have only recently been proclaimed in force, these new provisions have not been tested before the courts.

The statutory protections under the *BIA*, as amended by the 2009 *BIA* Amendments, are not absolute. Trustees continue to be personally liable for any liabilities that arise following their appointment, and accordingly, great care must be taken with respect to decisions made that could create new liabilities, including with respect to labour and employment and environmental issues.

Finally, there are complex transition rules in connection with the 2009 *BIA* Amendments, and these should be reviewed carefully to determine whether the 2009 *BIA* Amendments apply to a particular trustee-in-bankruptcy or receiver.

8.2 Environmental liabilities

8.2.1 General

A trustee-in-bankruptcy may encounter environmental issues arising from certain of the real property owned by the debtor or bankrupt during the course of the administration of a bankruptcy. Under the *Environmental Protection Act* (*EPA*), the receiver and trustee could be liable for environmental discharges and spills and other environmental conditions. The *EPA* imposes a broad range of liabilities on non-owners of the property. Under the *EPA*, liability is imposed on all "persons" who permit or control the source of pollution, regardless of when the pollution may have started. Therefore, by virtue of being in possession, a receiver or trustee may be ordered to repair damage due to discharges or spills that occurred during its possession of the property.

If a trustee takes possession of property that is contaminated, the trustee could become responsible for cleaning up the property even if the cost of doing so exceeds the value of the property.

In an effort to shield receivers and trustees from personal liability for environmental claims, the *BIA* was amended in 1997 to provide some protection for "trustees" in respect of environmental matters (ss. 14.06(1)–(6)).

8.2.2 Protections from personal liability

Subsection 14.06(2) provides that a trustee is not personally liable for

- any environmental condition that arose or environmental damage that occurred before the date of the trustee's appointment; or
- environmental conditions or environmental damage that arose or occurred after the date of the trustee's appointment unless as a result of the trustee's gross negligence or wilful misconduct.

The *BIA* does not release the trustee of its obligations to make any report or disclosure required under federal or provincial legislation (s. 14.06(3)).

8.2.3 Compliance with environmental remediation orders

Under s. 14.06(4) of the *BIA*, where an order is made requiring an environmental condition or damage on real property owned by a debtor to be remedied, the trustee has the following four options:

(1) comply with the order within 10 days of the order or, if the order existed prior to the trustee's appointment, within 10 days of the appointment (s. 14.06(4)(a)(i));

(2) on notice to the person who issued the order, abandon, dispose of, or otherwise release any interest in any real property affected by the condition or damage within 10 days of the order or, if the order existed prior to the trustee's appointment, within 10 days of the appointment (s. 14.06(4)(a)(ii));

(3) apply for a stay of the order for the purpose of contesting the order (s. 14.06(4)(b)(i)); or

(4) apply for a stay of the order for the purpose of allowing the trustee to assess the economic viability of complying with the order (s. 14.06(4)(b)(ii)).

If the trustee exercises options (1) or (2) above, the trustee will not be personally liable for failure to comply with the order or the costs that are or would be incurred by any person in carrying out the terms of the order. If the trustee exercises options (3) or (4) above, the trustee will not incur personal liability during the period of the stay granted. The trustee will also incur no personal liability if it had abandoned, renounced, or divested any interests in the real property affected by the environmental condition or damage before the order was made (s. 14.06(4)(c)).

8.2.4 Priority charge for remediation costs

Where the government has to remedy an environmental condition or environmental damage, s. 14.06(7) of the *BIA* provides that the cost of remedying the environmental condition or environmental damage constitutes a first charge over the real property and any real property of the debtor that is contiguous to that property and that is related to the activity that caused the condition or damage. Trustees, like anyone else, are

responsible for preventing the escape or discharge of pollutants from assets while such assets are in their control or possession.

9. Liquidation of bankrupt's assets

9.1 General

Subject to the approval of the inspectors (if there are inspectors), the trustee may sell the unencumbered assets (assets not subject to valid security) of the bankrupt's estate by tender, public auction, or private contract (s. 30(1)(a)); however, the trustee may not sell or otherwise dispose of assets to related parties of the bankrupt without court approval. "Related parties" caught by this restriction include directors and officers of the bankrupt, persons who currently or formerly had control of the bankrupt, and any persons related to such parties (ss. 30(4)–(5)).

When considering whether to approve a related party sale by the trustee, the court must consider the process giving rise to the sale, the extent to which creditors were consulted, the effect of the sale on interested parties, whether the consideration received is fair in the circumstances, and whether good faith efforts were made to sell the assets to an unrelated party (s. 30(6)).

By whatever means the assets of the bankrupt's estate are sold, the disposition is usually done on an "as is, where is" basis, without any representation or warranty by the trustee as to the title of the assets and other matters relating to the assets other than as to the trustee's authority to sell. The trustee can only sell whatever right, title, and interest has been vested in it pursuant to the *BIA*.

9.2 Sale of real property

9.2.1 General

If the assets include real property, the bankruptcy order or assignment will need to be registered against title to the real property before the conveyance by the trustee to the purchaser can be registered against title.

Once the bankruptcy order or assignment has been registered against the real property, the trustee may transfer the property to a purchaser by registering against the real property a transfer/deed accompanied by a declaration outlining the particulars of the trustee's authority and power to transfer the property. The trustee usually excludes the covenants implied by the *Land Registration Reform Act* in the transfer/deed.

9.2.2 Special considerations for the matrimonial home

If the bankrupt is a spouse, the ability of the trustee to transfer a matrimonial home and quiet and exclusive possession to a purchaser is subject to the provisions of the *Family Law Act* (*FLA*) that give spouses a right to possession over the matrimonial home even if the spouse is not registered as a co-owner of the home. Neither the *BIA* nor the *FLA* permit a trustee to override a spouse's right to possession of the matrimonial home. Accordingly, as in non-bankruptcy situations, it remains important for purchasers of real property that could be considered to be a matrimonial home to seek assurances that the non-titled spouse is prepared to give up any rights of continued possession of the property after the sale.

10. Rights of occupation of leased premises and assignment of leases

10.1 Occupation rights

Section 146 of the *BIA* provides that provincial law governs the rights of landlords. In Ontario, a trustee has a statutory right under the *Commercial Tenancies Act* to occupy leased premises of the bankrupt for up to three months, even if rent arrears may have been owing by the bankrupt. This gives the trustee time to take an inventory of the assets of the bankrupt and prepare for the liquidation of the estate. During this time, the trustee must pay occupation rent, which is calculated to be the rent payable under the lease by the bankrupt before its bankruptcy. At the end of the three months, the trustee must elect to retain the leased premises of the bankrupt for the whole or any portion of the unexpired term of the lease and any renewals thereof or disclaim the lease (*Commercial Tenancies Act*, ss. 38–39).

In some cases, a lease itself may be a valuable asset of the estate because it has favourable terms (for example, less than market rate rents) and/or a favourable location. In this case, the lease can be assigned for value by the trustee. In other cases, where the business of the bankrupt is being sold on a going-concern basis, it may be important for the purchaser to obtain the leased premises as part of those operations.

10.2 Election to retain and right to assign leases

Under the *Commercial Tenancies Act*, if the trustee elects to retain a lease for the whole term, it may pay all arrears of rent and then assign the lease and the right of occupation to an assignee with the consent of the landlord. If the landlord will not consent to the assignment, the trustee may assign the lease by order of

the court as long as the assignee covenants to observe and perform the terms of the lease. The assignee cannot conduct on the leased premises a trade or business that is reasonably of a more objectionable or hazardous nature than that of the bankrupt (*Commercial Tenancies Act*, s. 38(2)). The right to assign the lease supersedes any right of the landlord to terminate the lease.

10.3 Disclaimer of leases

If the trustee disclaims the lease, the landlord is entitled to claim preferred creditor status under s. 136(1)(f) of the *BIA* for up to three months' arrears accrued prior to the date of bankruptcy and up to three months' accelerated rent (if entitled to do so under the leases). The total amount claimed cannot exceed the realizable value of the bankrupt's assets on the leased premises as at the date of bankruptcy. Any payments for occupation rent are deducted from this amount. In Ontario, once a lease is surrendered or disclaimed by a trustee, the landlord cannot claim for rent for the remainder of the term of the lease, because the surrender or disclaimer of the lease by the trustee terminates all rights and obligations under the lease to pay rent. If the debtor makes a proposal and repudiates a commercial lease pursuant to s. 65.2(1) of the *BIA*, there is no claim for accelerated rent.

11. Distribution of the assets of the estate

Section 136 of the *BIA* sets out the scheme of distribution of the proceeds of disposition of the assets in the bankrupt's estate. Subject to the rights of secured creditors to realize upon assets covered by their security, the proceeds realized by the trustee are distributed in the following order:

(1) first, in payment of the funeral costs of the bankrupt;

(2) next, to the costs of any person directed by the Superintendent of Bankruptcy to conserve the property of a bankruptcy estate under s. 14.03(1)(a) of the *BIA*;

(3) next, to the costs of administration of the estate incurred by the trustee, including legal fees incurred by the trustee;

(4) next, to the Superintendent's levy payable under s. 147 (all distributions from the estate are subject to a minimum 5% levy in favour of the Superintendent pursuant to s. 147 of the *BIA*);

(5) next, to unpaid workers, the amount of unpaid wages, salaries, commissions, compensation, or disbursements referred to in ss. 81.3–81.4 that was not paid (not to exceed $2,000 per claimant);

(6) next, to secured creditors, the amount equal to the difference between what they would have received were it not for the priority charge created for unpaid wages in ss. 81.3–81.4 and what they actually received;

(7) next, to secured creditors, the amount equal to the difference between what they would have received were it not for the priority charge created for unpaid pension contributions in ss. 81.5–81.6 and what they actually received;

(8) next, to the preferred creditors in the order listed through ss. 136(1)(d.1)–(j), including alimony, maintenance, or support payments of a child or spouse in the year preceding the date of bankruptcy, municipal taxes assessed or levied within two years of the bankruptcy, and landlords' claims resulting from a disclaimer of leases by the trustee;

(9) then finally, to the ordinary unsecured creditors on a *pro rata* basis.

Distributions are made among creditors who prove their claims in the estate by filing proofs of claim. Even when the trustee is disputing significant claims, the trustee may make interim distributions to creditors with proven claims, as long as the trustee is able to satisfy the court that it has retained sufficient moneys to satisfy any disputed claims that may ultimately be proven. Any creditor who proves its claim prior to a distribution is entitled to share in that distribution.

12. Interim receivers under s. 46

In circumstances where a creditor is concerned about the preservation or depletion of assets during the period of time between the issuance of the bankruptcy application and the making of a bankruptcy order, particularly when the bankruptcy application is disputed, the creditor may seek the appointment of an interim receiver under s. 46 of the *BIA*. Under s. 46, an applicant creditor may apply to the court for the appointment of a licensed trustee as interim receiver. An interim receiver may also be appointed if the debtor has filed a proposal under the *BIA* (s. 47.1(1)) or by a secured creditor under s. 47(1) if a notice of intention to enforce security pursuant to s. 244 has been filed or is about to be filed.

An interim receiver appointed under s. 46 has more limited powers than an interim receiver appointed under s. 47 or 47.1 of the *BIA* (and a receiver appointed under s. 243 of the *BIA*). It does not take possession or control of the debtor's assets or business. Its only role is to preserve the assets of the debtor and to ensure that they are not used improperly or depleted. A s. 46 interim receiver has no power to interfere with the day-to-day operations of the debtor's business.

13. Discharge of bankrupt

13.1 Discharge of corporate bankrupt

A bankrupt corporation cannot obtain a discharge unless its debts are repaid in full, which almost never happens (s. 169(4)).

13.2 Discharge of individual bankrupt

13.2.1 General

If the bankrupt is an individual, the bankrupt may obtain a discharge of his or her debts even if his/her debts are not repaid in full. The discharge provisions of the *BIA* were recently overhauled as part of the 2009 *BIA* Amendments.

13.2.2 Automatic discharge

If an individual bankrupt has never been bankrupt before and is not a "personal income tax debtor," as described below, he or she is entitled to an automatic discharge from bankruptcy nine months after the bankruptcy order or assignment in bankruptcy, unless the Superintendent of Bankruptcy, the trustee, or a creditor objects to the automatic discharge or unless the bankrupt has been required to make payments to the bankrupt estate under s. 68 of the *BIA*. If payments have been ordered under s. 68 and there is no automatic discharge after nine months, the bankrupt will be automatically discharged 21 months after the date of bankruptcy, unless objections are filed.

The 2009 *BIA* Amendments now allow a person who has been bankrupt once before and who is not a personal income tax debtor to be automatically discharged 24 months after the date of bankruptcy if there are no objections and no payments have been ordered under s. 68, or 36 months after the date of bankruptcy if s. 68 payments have been ordered and there have been no objections.

For all automatic discharges, once the relevant time period has elapsed and no objections have been filed, the bankrupt will automatically be discharged without the need for any further hearing. If there is an objection, the bankrupt's application for discharge is heard by the court in the manner described in the following paragraphs.

A bankrupt may also apply for a discharge hearing prior to the date of automatic discharge, which hearing will be subject to the considerations set out in the following paragraphs.

13.2.3 Non-automatic discharge

If an individual bankrupt has been bankrupt more than twice and is not a personal income tax debtor, the trustee can apply for a hearing of the bankrupt's discharge within three months and not later than one year after the date of bankruptcy (s. 169(2)). Alternatively, the bankrupt can apply for a discharge hearing himself or herself at any time after the bankruptcy commences. For the purposes of the discharge hearing, the trustee is required to prepare a report in the prescribed form outlining the conduct of the bankrupt in the administration of the estate to assist the court in the hearing of the discharge application (s. 170(1)).

13.2.4 Discharge of personal income tax debtors

The 2009 *BIA* Amendments added the new concept of a "personal income tax debtor," with important consequences on automatic discharges. A personal income tax debtor is a bankrupt with $200,000 or more in personal income tax debt and whose income tax debt represents 75% or more of the bankrupt's total, proven unsecured debt. A personal income tax debtor cannot be automatically discharged, even if he or she has never been bankrupt before.

If the personal income tax debtor has not been bankrupt before, he or she may apply for a discharge hearing nine months after the date of bankruptcy if no payments have been ordered under s. 68 of the *BIA*, or 21 months after the date of bankruptcy if s. 68 payments have been required. If a personal income tax debtor has been bankrupt before, the application for a discharge hearing may be made 24 months after the date of bankruptcy if no s. 68 payments have been ordered, or 36 months after the date of bankruptcy if s. 68 payments have been required.

13.2.5 Notice to creditors

The trustee must provide notice to the bankrupt's creditors of the date of the bankrupt's automatic discharge or the time and place of the bankrupt's discharge hearing, as applicable (s. 169(6)). If the creditor serves a written objection to the discharge and files it with the court, the court will hear the bankrupt's discharge application. If the individual bankrupt is not a first-time bankrupt and no objection is filed, the registrar will hear the discharge application and may make an order either for absolute discharge, suspended discharge, or discharge subject to certain conditions.

13.2.6 Mandatory mediation

By operation of the 2009 *BIA* Amendments, s. 170.1(1) requires that the trustee apply for mediation in the event that a discharge is opposed on the basis that the bankrupt failed to make payments as required by an order under s. 68 of the *BIA* or that a party alleges the

bankrupt could have made a viable proposal to its creditors but chose bankruptcy as a way of having its debts discharged.

If the mediation is successful and the bankrupt complies with the conditions established therein, the trustee is required to issue a certificate of discharge (discharging all debts except for debts not released by discharge, as set out below). If the meditation does not result in a resolution or the bankrupt fails to fulfill conditions established therein, the trustee is required to bring the matter before the court for a hearing of the issues.

13.2.7 Facts for which a discharge may be refused, suspended, or granted conditionally

Section 173 of the *BIA* sets out facts for which a discharge may be refused, suspended, or granted conditionally. These include the following:

- The value of the bankrupt's assets do not equal 50 cents on the dollar of the bankrupt's unsecured liabilities (s. 173(1)(a)).
- The bankrupt continued to trade after becoming aware that he or she was insolvent (s. 173(1)(c)).
- The bankrupt has brought on or contributed to the bankruptcy by rash and hazardous speculations, by unjustifiable extravagance in living, by gambling, or by culpable neglect of the bankrupt's business affairs (s. 173(1)(e)).
- The bankrupt has within the three months preceding the bankruptcy, given an undue preference to any of the bankrupt's creditors (s. 173(1)(h)).
- The bankrupt has been previously bankrupt or made a proposal to creditors (s. 173(1)(j)).
- The bankrupt chose bankruptcy rather than a proposal to creditors as the means to resolve the indebtedness (s. 173(1)(n)).

At the hearing of a discharge that is opposed by a creditor and/or the trustee, the court will hear evidence as to whether any of the facts listed in s. 173 of the *BIA* existed. If none of the facts under s. 173 are proven to exist and the bankrupt is not a personal income tax debtor, the court can make any one of the following four orders (s. 172(1)):

- order for absolute discharge;
- order suspending the operation of the order for a specified period of time;
- order for discharge subject to specific terms and conditions with respect to any after-acquired earnings, income, or property; or
- order that the discharge is refused.

If any of the facts under s. 173 are proven or the bankrupt is a personal income tax debtor, the court cannot grant an absolute discharge but can make any one of the following three orders:

- order a suspension of the discharge for a specified period of time;
- order a discharge conditional on the bankrupt's performance of such acts, payments, consents to judgments, or compliance with such other terms as the court may direct; or
- order that the discharge is refused.

At a hearing for the discharge of a personal income tax debtor, the court must take into account, in addition to the s. 173(1) factors discussed above, (a) the circumstances of the bankrupt at the time the personal income tax debt was incurred, (b) the efforts made by the personal income tax debtor to pay the income tax debt, (c) whether the bankrupt paid other debts while failing to pay the personal income tax debt, and (d) the bankrupt's financial prospects for the future (s.172.1(4)).

13.2.8 Conditional discharges

Most conditional discharges will require the bankrupt to make regular periodic payments over a specified period of time to the trustee for distribution to creditors. The amount of any such payments will vary in each case and usually take into account the bankrupt's income, reasonable living expenses, and the bankrupt's family responsibilities.

13.2.9 Suspension of discharges

If after taking into account the bankrupt's income and reasonable living expenses, there are no surplus funds to pay the trustee, the court can suspend the discharge for a certain period of time, so that the discharge will only be effective after the suspension has expired.

13.2.10 Debts not released by discharge order

Upon a bankrupt's discharge, the bankrupt is released from all debts incurred prior to bankruptcy, except those debts listed in s. 178 of the *BIA*. Among the debts that are not released are as follows:

- damage awards for bodily harm, sexual assault, or wrongful death resulting from bodily harm or sexual assault (s. 178(1)(a.1));
- debts for alimony or support of a spouse or child living apart from the bankrupt (s. 178(1)(c);
- debts or liabilities incurred under public student loan programs within seven years prior to the bankruptcy (s. 178(1)(g)); and

- debts or liabilities for obtaining property or services by false pretences or fraudulent misrepresentation (s. 178(1)(e)).

14. Discharge of trustee

When the estate has been administered, the trustee may apply to the registrar for a discharge from his or her duties. Creditors are entitled to receive notice of the trustee's application for discharge and may object. A creditor may object because it believes that there remain outstanding matters in the estate for the trustee to administer.

At the trustee's discharge hearing, the trustee will submit a final statement of receipts and disbursements of the estate, together with a final bill of costs for the trustee and its solicitors for taxation by the registrar.

Part II
Fraudulent conveyances and preferences and transfers at undervalue

In the event of a debtor's bankruptcy, certain pre-bankruptcy transactions of the debtor, particularly those between the debtor and related parties, will be subject to scrutiny by the trustee and/or creditors of the debtor's estate. The purpose of this scrutiny is to ensure that these pre-bankruptcy transactions did not have a prejudicial effect of preferring one creditor over other creditors or reducing the assets available to creditors generally.

One of the trustee's key roles in the administration of the bankrupt's estate is to scrutinize the actions of the bankrupt prior to the bankruptcy to determine whether the assets available to the bankrupt's creditors have been reduced or prejudiced by any such actions. Where such actions are found to have occurred, there are various remedies available to a trustee and creditors of the bankrupt under both the *BIA* and provincial statutes. These remedies are not mutually exclusive and can be utilized concurrently by the trustee and creditors of the bankrupt. The availability of the remedies under the *BIA* and the provincial statutes will be dependent on the facts of each case. The remedies under the *BIA* are only available to a trustee or to creditors who have taken an assignment of the trustee's rights under s. 38 of the *BIA*.

The elements required to successfully challenge a transaction are generally easier to establish under the *BIA*, mainly because there is no requirement to prove the fraudulent intent of the transferor and the concurrent intent of the transferee. As a result, recourse to the *BIA* remedies is usually preferred over the provincial statutes.

If it can be established that the consideration paid for the impugned transfer was "good consideration," "valuable consideration," "fair and reasonable consideration," or not "conspicuously" less than fair market value, the impugned transaction will almost always survive any challenge.

The 2009 *BIA* Amendments changed the treatment of these kinds of transactions under the *BIA*. In particular, the amendments have removed the concepts of "settlements" and "reviewable transactions" and replaced them with the concept of "transfer at undervalue," discussed in detail below. Conforming amendments to the *CCAA* have also introduced to that statute the concepts of preferential payments and transfers at undervalue.

15. The Fraudulent Conveyances Act

15.1 The required elements of a fraudulent conveyance under the Fraudulent Conveyances Act

Section 2 of Ontario's *Fraudulent Conveyances Act* (*FCA*) sets out the three elements that must be established to attack a transaction as a fraudulent conveyance:

- there must have been a conveyance;
- of real or personal property of the debtor;
- made with the intent to defeat, hinder, delay, or defraud creditors or others.

15.2 The meaning of "conveyance"

The term "conveyance" in the *FCA* includes a gift, grant, alienation, charge, or encumbrance of real property or personal property. The definition is not exhaustive, and the courts have interpreted the term broadly to include any transfer of property.

15.3 The meaning of property

The definitions of "personal property" and "real property" in the *FCA* are also not exhaustive and appear to include every type of property.

To the extent property conveyed in a transaction does not form part of the property of the transferor that would be vested in a trustee upon the transferor's bankruptcy, conveyances of these kinds of property have been considered as immune from attack under the *FCA*. Such property would not have been available to unsecured creditors in a bankruptcy, and therefore no intent could be established, and no detriment or prejudice to unsecured creditors could have been suffered. Examples of these kinds of property are property held by the transferor in trust or for the benefit of others (and therefore not the debtor's property) and property exempt from execution and seizure under s. 2 of the *Execution*

Act, neither of which vests in the trustee under s. 71 of the *BIA*.

The exemption for trust property is based on the principle that creditors of a transferor should have no rights to property in which the transferor has no interest. If the transferor has no interest in the property, it is logical that the *FCA* should not apply to such transfers. The exclusion of property that is exempt from seizure from the *FCA* is based on a weaker argument. For example, once the transferor has transferred his "tools of the trade," the policy reason for exempting certain "tools of the trade" from seizure under the *Execution Act* (i.e., to allow the debtor to have continued access to the tools of his trade) no longer appears applicable—the transferor has transferred these assets to another.

15.4 Intent and the "badges of fraud"

The most relevant and significant issue in establishing a fraudulent conveyance is whether the transferor had the intent to defeat, hinder, delay, or defraud creditors or others. The onus is on the plaintiff to prove the requisite intent.

The transferor's intention is determined by reviewing the circumstances of the transfer and considering what the courts have termed "badges of fraud." Among the "badges of fraud" identified by the courts are the following:

- The conveyance was general (i.e., a transfer of substantially all of the transferor's property).
- The transferor continued in possession and used the goods as his or her own, including selling them.
- The conveyance was secret.
- The conveyance was made in the face of an ongoing legal process.
- The conveyance amounted to a trust of the goods.
- The deed contained the self-serving and unusual provision "that the gift was made honestly, truly, and *bona fide*."
- The deed gives the transferor a general power to revoke the conveyance.
- The deed contains false statements as to the consideration.
- The consideration is grossly inadequate.
- There is unusual haste to make the conveyance.
- Some benefit is retained under the settlement by the settlor.
- Cash is taken in payment instead of a cheque.
- A close relationship exists between the parties to the conveyance.

The foregoing is not an exhaustive list of badges of fraud, and the establishment that one or more badges of fraud exist does not necessarily determine whether fraudulent intent existed. If it can be shown that a number of badges of fraud exist, a transferee will have a difficult time convincing a court that the conveyance was made without fraudulent intent. Conversely, if no badges of fraud can be shown, a trustee, creditor, or other person seeking to challenge the conveyance will generally have a more difficult time establishing the existence of a fraudulent intent.

15.5 Exemptions

A conveyance otherwise falling within the definition of s. 2 of the *FCA* can be "saved" from being challenged under the *FCA* if it falls within s. 3 of the *FCA*. The saving provision under s. 3 involves two basic elements. Both elements must be satisfied in order for the saving provision to apply:

- The property was conveyed upon *good consideration*.
- The conveyance was made in *good faith* to a person at the time of the conveyance *without notice or knowledge* of the intent to defeat, defraud, or hinder creditors.

(a) Good consideration

For "good consideration" to be established, it is not necessary to show that the full value of the property was paid, only that there was "valuable consideration," which is consideration that is more than "nominal" or that is not grossly inadequate consideration.

(b) Good faith and the concurrent intent

Even if good consideration is established, the saving provision under s. 3 will only protect the transferee if it participated in the transaction in "good faith" and "without notice or knowledge" of any fraudulent intent of the transferor. This is known as the "concurrent intent" requirement, that is, there must be a concurrent intent of the transferee to defeat, hinder, delay, or defraud creditors of the transferor.

Concurrent intent is difficult to establish. Even though the words "without notice or knowledge" are used in s. 3, mere knowledge by the transferee of the transferor's fraudulent intent may not be sufficient to establish the existence of the concurrent interest of the transferee. Instead, the case law suggests that there must be more; it must be shown that the transferee was privy to or assisted the transferor in carrying out his or her fraudulent intent. The result is that where it can be shown that good consideration was given for the

conveyance, it will be very difficult to successfully attack such conveyance.

15.6 Remedy

A conveyance that meets the requirements under s. 2 of the *FCA* is "void" as against creditors or others of the transferor. The property in the hands of the transferee becomes available for execution or seizure by the creditors or others of the transferor. Typically, an order is made by the court directing the transferee to make the property available to satisfy the claims of creditors. Where the property is more than sufficient to satisfy the claims of creditors, the surplus remains with the transferee.

15.7 Proper parties

Section 2 of the *FCA* applies to conveyances made with the intent to defeat, hinder, delay, or defraud "creditors or others." The words "creditors or others" have been interpreted broadly to include judgment creditors, secured creditors, creditors with liquidated claims, and even persons with contingent or unliquidated claims, whether the claims of these persons arose before, at, or after the time of the transaction being attacked. To proceed with an action under the *FCA*, persons with contingent or unliquidated claims do not need to have reduced their claims to judgments, but they must at least establish the validity of their claims against the transferor.

15.8 Limitation period

Although there is no limitation period under the *FCA*, a challenge under the *FCA* is subject to the limitation periods prescribed by the *Limitations Act, 2002*.

16. The Assignments and Preferences Act

While the *FCA* applies only to fraudulent conveyances, Ontario's *Assignments and Preferences Act* (*APA*) enables a creditor to attack fraudulent conveyances and unjust preferences.

16.1 Attacking fraudulent conveyances under the APA

The fraudulent conveyance provisions of the *APA* are similar to those under the *FCA*. The main differences are set out below.

16.1.1 The required elements of a fraudulent conveyance under the APA

Subsection 4(1) of the *APA* sets out four elements that must be present to attack a transaction as a fraudulent conveyance under the *APA*:

- there must be a gift, conveyance, assignment, transfer, delivery over, or payment;
- of real or personal property;
- made by a person when insolvent or unable to pay the person's debts in full or when the person knows that he, she, or it is " on the eve of insolvency";
- with intent to defeat, hinder, delay, or prejudice creditors or any one or more of them.

The most significant difference between the fraudulent conveyance provisions in the *FCA* and those of the *APA* is that the *APA* requires that the challenging party must prove that at the time of the transaction, the debtor was insolvent, unable to pay its debts in full, or knew that it was on the eve of insolvency.

The *APA* does not define "insolvent" or "insolvency," and therefore, reference must be made to case law. The courts have distinguished between "legal insolvency" (where the debtor does not have sufficient property to pay all his debts if sold under legal process) and "commercial insolvency" (where the debtor does not have the means to pay off and discharge its commercial obligations as they become due in the ordinary course of business). Based on the case law, it would appear that evidence of both commercial insolvency and legal insolvency are relevant in establishing insolvency under the *APA*, although proof of commercial insolvency (inability to pay debts as they become due) will often mean that the debtor has insufficient assets to meet its current debts.

The balance of s. 4(1) of the *APA* is similar to s. 2 of the *FCA*.

16.1.2 Exemptions

Subsection 5(1) of the *APA* sets out certain exemptions from the application of s. 4(1). If the transferor can establish that any one of these applied to the impugned transfer, the transaction will be exempt from attack under s. 4(1):

- a sale or payment made in good faith in the ordinary course of trade or to an innocent purchaser or person;
- any payment of money to a creditor;
- a conveyance made in good faith in consideration of a present actual payment of money;
- a conveyance by way of security for a present actual advance of money; or
- a conveyance made in consideration of a present actual sale or delivery of goods or other property where the money paid or the goods or other property sold or delivered bear "fair and reasonable" relative value to the consideration provided.

16.1.3 Proper parties

In order to bring an action under the *APA*, the plaintiff must have been a creditor of the transferor at the time the alleged unjust preference was made. Unlike the *FCA*, persons who become creditors of the transferor after the alleged transaction cannot claim under the *APA*.

16.2 Attacking unjust preferences under the APA

16.2.1 The required elements of an unjust preference under the APA

Subsection 4(2) of the *APA* sets out the three elements that a creditor must establish to attack a transaction as an unjust preference:

- A gift, conveyance, assignment, transfer, or payment was made by the debtor.
- The transfer was made when the debtor was in insolvent circumstances, unable to pay his or her debts in full, or with the knowledge that he or she was on the eve of insolvency.
- The transfer must have been made with the intent to give the transferee an unjust preference over other creditors.

16.2.2 The 60-day presumption

Pursuant to s. 4(3) of the *APA*, where an action is commenced within 60 days of the date of the impugned transfer, the transfer will be presumed, in the absence of evidence to the contrary, to have been made with fraudulent intent and to be an unjust preference within the scope of the *APA* whether the transfer was made voluntarily or under pressure. As a result, there is only a short period of time after a preference has occurred when a plaintiff must commence an action. This makes it very difficult to obtain the benefit of the presumption. This is significant because it is quite difficult to establish the intent and concurrent intent necessary under the *APA*. Pressure cannot be used to rebut the presumption.

16.2.3 Intent and concurrent intent

The same standard required for intent and concurrent intent for fraudulent conveyances under the *FCA* and *APA* applies to unjust preferences under the *APA*.

16.2.4 Exemptions

The exemptions listed in s. 5(1) of the APA for fraudulent conveyances summarized above also protect certain transactions from attack under s. 4(2) of the *APA*.

One of the exemptions contained in s. 5(1) is "any payment of money to a creditor." This has been broadly interpreted by the courts, which have held that any payment of money to a creditor in respect of past indebtedness, even where the debtor is insolvent, will not be open to attack under s. 4(2) of the *APA*. As most payments to creditors are payments of money, this exemption creates a wide exception to the application of s. 4(2).

Where a creditor receives a preference that is set aside in circumstances where the creditor had security for the debt but gave it up in return for payment, the creditor is entitled to have the security restored or its value made good (ss. 5(4) and (5)(b)).

Subsection 5(5) of the *APA* contains additional exemptions. For example, s. 5(5)(c) of the *APA* exempts the exchange of security of one kind for another so long as the security obtained by the creditor in the exchange is of equivalent value. Clause 5(5)(d) of the *APA* provides that nothing in the *APA* invalidates a security given to a creditor for a pre-existing debt, where, in exchange for giving the security, the creditor made an advance in money to the debtor in the creditor's belief that the advance would enable the debtor to continue the debtor's trade or business and to pay the debts in full. In other words, a creditor can obtain security for a pre-existing unsecured indebtedness if both of the following occur:

- At the same time, the creditor makes a new advance of money to the debtor.
- The creditor makes that advance in the *bona fide* belief that the advance will enable the debtor to both continue in business and pay its debts in full.

16.2.5 Proper parties

In order to maintain an action under the *APA*, the plaintiff must have been a creditor of the debtor at the time the alleged unjust preference was made (just as with the fraudulent conveyance provisions under the *APA*).

16.2.6 Remedy

The remedy for a fraudulent conveyance or preference under the *APA* is the same as that under the *FCA* for fraudulent conveyances.

16.2.7 Limitation periods

As with the *FCA*, actions under the *APA* are subject to the *Limitations Act, 2002*.

17. Remedies under the BIA

17.1 Introduction

The *BIA* contains various provisions enabling the trustee to challenge transactions that have diminished the property of the bankrupt available for distribution to creditors or that offend the principle that no one creditor should be preferred over another. These provisions relate to unjust preferences, the new concept of transfers at

undervalue, the payment of improper dividends, and the redemption of shares.

In some cases, there may not be sufficient assets in the estate to fund any challenge. Under s. 38 of the *BIA*, where a trustee refuses or neglects to take proceedings after being requested to do so by a creditor, the creditor may make an application to the court for an order authorizing the creditor itself to take proceedings in its own name and at its own expense and risk.

The creditor's application under s. 38 is usually required to be on notice to all other creditors of the estate who have proven claims with the trustee. Other creditors will be entitled to participate in the proceedings with the applicant creditor provided they contribute on a pro rated basis to the cost of the proceeding. If so, they will be entitled to benefit *pro rata* in accordance with the proven claims of the participating creditors. If the proceeding results in surplus recovery in excess of the proven claims of all participating creditors plus their costs, any surplus is to be paid over to the trustee.

17.2 Preferences under the BIA

Section 95 of the *BIA* provides a remedy to a trustee where the bankrupt has, prior to the bankruptcy, given an unjust preference to a creditor.

17.2.1 The required elements of a preference

For s. 95 to apply to a transaction, the following elements must be established:

- There must be
  - a conveyance or transfer of property;
  - a provision of services;
  - a charge on a property;
  - a payment made;
  - an obligation incurred; or
  - a judicial proceeding taken or suffered.
- The parties must have been in a debtor-creditor relationship.
- The debtor was an "insolvent person" at the time of the transaction.

Prior to the 2009 *BIA* Amendments to s. 95, there was a requirement that the transferor "intend" to prefer the transferee, no matter who the transferee was. This intent to prefer is still a requirement for transfers made to transferees dealing at arm's length with the transferor. For a trustee to succeed in an application pursuant to s. 95 of the *BIA* with respect to an arm's length transferee, the trustee must prove, to the satisfaction of the court, that the bankrupt intended to prefer the transferee over other creditors. The test of intention is an objective one; intention may be deduced from the conduct of the bankrupt and the circumstances surrounding the transaction. Additionally, the fact of a preference having occurred creates a presumption that such a preference was intended; however, the bankrupt or transferee may lead evidence to rebut this presumption (s. 95(2)).

With respect to non-arm's length parties, the amended s. 95(1)(b) provides that the intention to prefer is not required in order for a transaction to be impugned. For transfers to non-arm's length parties, the mere fact of preference is sufficient. Significantly, because there is no requirement that the bankrupt intended to prefer the transferee, there is no cause to lead evidence that no preference was intended, so the conduct of the parties and circumstances surrounding the transaction are irrelevant.

For transactions between arm's length parties, s. 95 requires that the impugned transaction occur within three months of the bankrupt's initial bankruptcy event as defined in the *BIA*. The review period for transactions between non-arm's length parties is 12 months.

17.2.2 The meaning of "insolvent person"

The term "insolvent person" is defined in s. 2 of the *BIA*.

17.2.3 Meaning of "arm's length"

The 2009 *BIA* Amendments added the new s. 4(5), which provides that for the purposes of determining preferential payments, persons who are "related" to each other are deemed not to deal at arm's length, absent evidence to the contrary. Subsection 4(2) of the *BIA* sets out an extensive definition of "related persons," which generally includes, in the case of individuals, blood relatives and close family relatives, and in the case of corporations, persons having control and subsidiary, affiliate, and parent corporations. Reference should be made to this definition before an insolvent person makes a transfer to ensure that such a transfer will not constitute a non-arm's length transaction subject to scrutiny under s. 95.

17.2.4 The s. 95(2) presumption

If a trustee can establish that the bankrupt was insolvent on the date of the transaction, that an arm's length transaction was entered into within three months of the initial bankruptcy event, and that the transaction had "the effect of giving the creditor a preference" over other creditors, then a presumption arises under s. 95(2) that the transaction was entered into with the requisite intent to prefer. This presumption makes challenging

preferences under the *BIA* preferable to doing so under the *APA*.

The presumption is rebuttable, and it will be a question of fact for the court whether the presumption has been rebutted. There are a number of "defences" that may be raised to rebut this presumption. For example, if the creditor can show that the transaction (including security given to secure pre-existing indebtedness) was entered into in a *bona fide* expectation that it would result in the debtor being able to continue in business, this could rebut the presumption.

The existence of pressure upon the debtor to pay is expressly rejected under the *BIA* as grounds for rebutting the presumption (s. 95(2)).

Security granted to secure pre-existing obligations may be a preference. However, if the security was granted pursuant to an undertaking or covenant given by the debtor more than three months prior to the initial bankruptcy event or at a time when the debtor was not insolvent, the security may be valid.

Security given to secure new advances provided to the debtor will be valid to the extent of the amount of the new advances, even if the debtor was insolvent at the time the security was granted, on the basis that the creditor provided valuable consideration (the new advances) in exchange for the new security.

Preferred claims have priority to certain unsecured creditors under s. 136 of the *BIA*. Accordingly, payment to such preferred creditors in the amount entitled to under the *BIA* would not ordinarily amount to a preference.

Generally, payments made to secured creditors are also not deemed to be a preference on the reasoning that the claims of secured creditors rank in priority to unsecured creditors and therefore do not constitute a preference. Where the security is of no value (because the assets are insufficient to satisfy prior ranking secured claims or are of a value less than the amount of the payments), such payments are open to challenge as a preference.

17.2.5 Initial bankruptcy event

The relevant timeframes for fraudulent preferences are triggered by the date of the initial bankruptcy event. The *BIA* defines the date of the initial bankruptcy event to be the earliest of following:

- An assignment in bankruptcy is made by or in respect of a debtor.
- A proposal is made by a debtor.
- A notice of intention to file a proposal is filed.
- In certain cases, the first application for a bankruptcy order against a debtor is filed.
- Proceedings are commenced against a debtor under the *CCAA*.

These dates are similarly important for determining the relevant timeframes for establishing a transfer at undervalue, discussed below.

17.2.6 The remedy

A transfer or payment found to be an unjust preference is deemed to be fraudulent and void as against the trustee. If the preference was the payment of money, the trustee will be entitled to a judgment against the creditor in the amount received by the creditor. If the preference consisted of the return of goods by the bankrupt to the creditor, the trustee will be entitled to judgment in the amount of the value of the goods at the time they were returned. If the preference was the giving of security, the security is void as against the trustee.

17.3 Transfers at undervalue

17.3.1 General

As a result of the 2009 *BIA* Amendments, the new s. 96 of the *BIA* introduces the concept of "transfer at undervalue," which replaces the former concepts of "settlement" (formerly s. 91) and "reviewable transaction" (formerly s. 100). Section 96 permits a trustee to attack transactions entered into by a debtor prior to a bankruptcy in which no consideration is received or for which the consideration received by the debtor is conspicuously less than the fair market value of the consideration given by the debtor.

17.3.2 The required elements of a transfer at undervalue

(a) General

As is the case with fraudulent preferences, the requirements for establishing a transfer at undervalue are different depending on whether the debtor was dealing with an arm's length or a non-arm's length party. In either case, the following two factors must be established:

- There must have been a disposition of property or provision of services.
- The debtor must receive no consideration, or the consideration received by the debtor must be conspicuously less than the fair market value of the consideration given by the debtor.

(b) Arm's length transactions

If the above two factors are satisfied and the debtor was dealing with an arm's length party, a transfer at

undervalue will be established if all of the following are true:

- The transfer occurred within one year of the initial bankruptcy event.
- The debtor was insolvent at the time of the transfer or rendered insolvent by it.
- The debtor intended to defraud, defeat, or delay a creditor.

(c) Non-arm's length transactions

If the first two factors are satisfied and the debtor was dealing with a non-arm's length party, the transfer at undervalue will be established without further requirement if the transfer occurred within one year of the initial bankruptcy event. For transfers to non-arm's length parties, a transfer at undervalue will also be established if the transfer occurred within five years of the initial bankruptcy event and either of the following circumstances is true:

- The debtor was insolvent at the time of the transfer or was rendered insolvent by it.
- The debtor intended to defraud, defeat, or delay a creditor.

The transferee in a transfer at undervalue does not need to be a creditor of the debtor.

17.3.3 "Arm's length"

Subsection 4(5) of the *BIA* provides that persons who are "related" are deemed not to deal at arm's length for the purposes of determining a transfer at undervalue. This is a rebuttable presumption. The definition of "related persons" is discussed above in the context of fraudulent preferences. Persons not related to each other can still be found to be dealing with each other not at arm's length. Subsection 4(4) of the *BIA* provides that it is a question of fact whether persons not related to one another were at a particular time dealing with each other at arm's length.

17.3.4 Fraudulent intent

For transfers to arm's length parties and transfers to non-arm's length parties made more than one year prior to the initial bankruptcy event where the debtor was insolvent or made insolvent by the transfer, the trustee is required to prove that the debtor intended to defraud, defeat, or delay a creditor. Unlike fraudulent preferences, however, the *BIA* does not create a presumption of fraudulent intent based on the fact of a transfer for below market value. Section 96 has not yet been tested by the courts, and accordingly it appears that a trustee would have to rely on the common law to prove fraudulent intent, discussed previously in this chapter with respect to the *FCA*.

17.3.5 Consideration conspicuously less than fair market value

The requirement that the consideration received be "conspicuously less than fair market value" is a concept that was formerly contained in s. 100 of the *BIA* in the context of settlements. "Fair market value" has been found to be the highest price available in an open and unrestricted market between informed and prudent parties acting at arm's length and under no compulsion to act. The determination of fair market value can be a complex process and involves consideration by the court of various expert reports as to assessments of fair market value.

Some of the complexity involved with determining fair market value has been removed by the inclusion of s. 96(2) of the *BIA*, which requires that a trustee include with its application under the new s. 96 a report setting out its opinion of what fair market value should be for the particular transfer. The court will accept the trustee's valuation, absent evidence to the contrary. When a trustee's valuation is challenged, however, evidence contradicting the trustee's valuation will reintroduce the complexities set out in the previous paragraph.

Under the old s. 100 respecting settlements, the test as to whether the consideration was "conspicuously" less than fair market value was an objective one. Courts have found "conspicuous" to mean "remarkable" and "noteworthy" or "striking," "manifest," "notable," or "flagrant." For example, a difference of $1 million between the fair market value and the consideration received by a debtor has been found to be conspicuous. This issue will continue to be relevant with respect to transfers at undervalue.

17.3.6 The remedy

If a transaction is found to be a transfer at undervalue, the transfer is void as against the trustee, and the court may order that the transferee or "any other person who is privy to the transfer," or all of them, pay to the estate the difference between the fair market value of the consideration given by the debtor and the consideration actually received by the debtor.

Subsection 96(3) of the *BIA* provides that a "person who is privy" to the transaction is any person not dealing at arm's length with the party to the transfer who, by reason of the transfer at undervalue, directly or indirectly, receives a benefit or causes a benefit to be received by another person. The concept of persons "privy" to a transaction was formerly used in the *BIA* with respect to

settlements and has in that context been found to be any person who partakes or has any part or interest in the transaction.

17.4 Payment of dividend or redemption of shares

17.4.1 General

Section 101 of the *BIA* gives a trustee the right to obtain recovery from directors or shareholders of a bankrupt corporation where the bankrupt corporation has, within one year before the initial bankruptcy event redeemed shares or paid a dividend when the corporation was insolvent or that resulted in the insolvency of the corporation.

17.4.2 The required elements

It is necessary for a trustee to establish the following elements to be entitled to relief under s. 101:

- Shares of the corporation were redeemed or dividends paid within one year before the initial bankruptcy event.
- The corporation was insolvent at the time of the redemption or payment of dividends or the redemption or payment resulted in the insolvency of the corporation.

The onus is on the directors of the bankrupt corporation to show that the bankrupt corporation was not insolvent at the time the dividend, redemption, or repurchase was made or that the directors had reasonable grounds to believe that at the time of the transactions the corporation was not insolvent or that the transaction would not render the corporation insolvent (s. 101(5)).

These transactions may also be challenged under the *OBCA* or the *Canada Business Corporations Act* (*CBCA*).

17.4.3 Exemptions

Subsection 101(3) exempts from the application of s. 101(2), any director who protested against the payment of the dividend, redemption, or purchase for cancellation of shares. However, if that director is also a shareholder, then judgment may go instead against the shareholder pursuant to s. 101(2.2). In such case, the onus then falls on the shareholder to show that the corporation was not insolvent at the time or that the redemption or payment did not result in the corporation's insolvency (s. 101(6)).

17.4.4 The remedy

The court may give judgment to the trustee against the directors of the corporation in the amount of the dividend, redemption, or purchase price together with interest. The court may also give judgment to the trustee against a shareholder who is related to any one or more of the directors or to the corporation or who is a director who protested against the payment of the dividend, redemption, or purchase for cancellation of shares.

18. Other legislation

18.1 The Bulk Sales Act

18.1.1 General

The primary objective of the *Bulk Sales Act* (*BSA*) is to protect trade creditors of a corporation in circumstances where the corporation disposes of its "stock in bulk" out of the ordinary course of business without ensuring that trade creditors are paid.

18.1.2 Application of the Bulk Sales Act

Generally, the *BSA* applies to every sale in bulk out of the usual course of business of a seller. Section 2 of the *BSA* provides that the *BSA* applies to every sale in bulk except a sale in bulk by, among others, a creditor realizing upon security, a receiver, or a trustee.

18.1.3 The required elements

The terms "sale in bulk," "stock," and "stock in bulk" are defined in s. 1 of the *Act*. "Sale in bulk" means a sale of stock in bulk out of the usual course of business or trade of the sellers.

"Stock" is defined as

- the goods, wares, merchandise, or chattels ordinarily the subject of trade and commerce;
- 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
- the fixtures, goods, and chattels with which a person carries on a trade or business.

Case law suggests that the *BSA* can apply to certain intangibles in certain circumstances, but it does not apply to shares.

"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.

18.1.4 Compliance, waiver or exemption

If the *BSA* applies to a transaction, the parties have one of three options:

(1) The parties comply with the *BSA*.

(2) The buyer waives compliance with the *BSA* and relies instead on an indemnity from the seller or a party related to the seller or assumes the risks of non-compliance if all creditors of the seller are not paid in full.

(3) The parties obtain a judicial exemption from compliance with the *BSA*.

18.1.5 Compliance with Bulk Sales Act

To comply with the *BSA*, a three-step compliance process is required.

(a) Step 1: Delivery of statement of trade creditors

Prior to paying any of the proceeds of the sale, the buyer is required to demand, and the seller is required to deliver, a statement in the prescribed Form 1 to the *BSA* (the Form 1 Statement) listing the

- names of its creditors;
- addresses of its creditors;
- amounts of indebtedness or liability due, owing, payable, accruing due, or to become due and payable;
- if there are secured creditors, a description of the security and whether the claims are due or will become due on the date of the sale.

Section 6 of the *BSA* does allow for a permitted deposit to be paid by the buyer to the seller prior to the delivery of the statement of trade creditors. The permitted deposit may comprise not more than 10% of the purchase price, which shall form part of the proceeds of sale and which the seller shall hold in trust according to the terms enumerated in the *BSA*.

(b) Step 2: Completion of sale

After the buyer receives the Form 1 Statement, the buyer may complete the sale in bulk if one of the five following events occurs:

(1) The Form 1 Statement and any notices the buyer may have received do not reveal aggregate claims of either the secured creditors or the unsecured creditors separately as groups exceeding $2,500 (s. 8(1)(a)).

(2) Adequate provisions are made for the immediate payment of the secured and unsecured creditors of which the buyer has notice (s. 8(1)(c)).

(3) Payment of the proceeds of the sale are made to the trustee upon the seller delivering to the buyer (i) consents of at least 60% (both in number and amount of the claims that exceed $50) of the unsecured trade creditors of whose claims the buyer has notice; and (ii) an affidavit verifying that the seller has delivered to all secured and unsecured trade creditors of the seller at least 14 days before closing, a copy of the sale agreement, the Form 1 Statement, and a statement of affairs in Form 4 and deposing that the affairs of the seller as described in Form 4 have not materially changed since it was made (s. 8(2)(a)–(b)).

(4) A statement (verified by affidavit) is delivered by the seller to the buyer showing that all unsecured and all secured creditors of the seller of which the buyer has received notice have been paid in full (s. 8(1)(b)).

(5) A waiver from creditors sufficient to satisfy one of the aforementioned items is obtained by the seller.

(c) Step 3: Post-closing filings

Section 11 of the *BSA* states that within five days after the completion of a sale in bulk, a buyer must file in the office of the court of every county or district in which all or part of the stock in bulk is located an affidavit setting out:

- the particulars of the sale, including the subject matter;
- the name and address of the trustee involved, if any;
- as an exhibit, duplicate originals of a statement of the seller's creditors (Form 1 Statement);
- as an exhibit, duplicate originals of a statement stating that all creditors of which the buyer has notice have been paid in full, if any;
- as an exhibit, duplicate originals of creditor waivers, if any; and
- as an exhibit, duplicate originals of consents and affidavits required for delivery of the proceeds of the sale to a trustee, if any.

18.1.6 Judicial exemption order

Section 3 of the *BSA* provides that a seller may apply to a judge for an order exempting a sale in bulk from the application of the *BSA*. The judge is entitled to make an exemption order if the judge is satisfied based 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.

In making an exemption order, the judge may require notice of the application for the order to be given to the creditors of the seller or some of them and may in the order impose such terms and give such directions with respect to the disposition of the proceeds of the sale or otherwise as the judge considers appropriate.

If an exemption order is granted, the *BSA* will not apply to the sale in respect of which the exemption is granted, with the exception of s. 7 of the *BSA*. Section 7 entitles any creditor of the seller to obtain particulars of the sale in bulk.

Pursuant to s. 3 of the *BSA*, the seller must establish certain conditions before an exemption order is made. First, the seller must satisfy the court that the sale is advantageous to the seller. Second, the seller must satisfy the court that the sale will not impair the seller's ability

to pay its creditors in full. This usually means the court will have to be satisfied that the seller will have sufficient moneys after the sale to pay all of its creditors in full or has made appropriate arrangements for its liabilities to be paid in full, such as the assumption of the liabilities of the seller by the buyer. If there is an assumption of liabilities by the buyer, the court will require financial disclosure from the buyer to establish the buyer's financial ability to satisfy the assumed liabilities.

18.1.7 Remedies

If a buyer of stock in bulk does not comply with the *BSA* and compliance has not been waived by judicial exemption, a creditor of the seller (or trustee if the seller becomes bankrupt) may take proceedings to set aside the transaction (s. 16(1)).

An action to attack a bulk sale should be brought by the plaintiff creditor on behalf of all creditors of the seller.

If the transfer of possession of the stock in bulk from the seller to the buyer has not yet completed the sale, the plaintiff is entitled to an order that the sale is void. The creditor can obtain judgment against the seller and enforce that judgment as can any other judgment creditor against the seller's assets.

Where the buyer has received or taken possession of the stock in bulk, the *BSA* provides that the buyer is personally liable to account to the creditors of the seller for the value of the stock in bulk received (s. 16(2)). Where the proceeds of sale are paid to secured creditors on an account of their priority security, the buyer is not required to account to an unsecured creditor for the value of its claim if the unsecured creditor would not have otherwise been entitled to any proceeds.

18.2 The oppression remedy

18.2.1 The required elements

Subsection 248(2) of the *OBCA* provides that where the court is satisfied that in respect of a corporation or any of its affiliates

- any act or omission of the corporation or any of its affiliates effects or threatens to effect a result;
- the business or affairs of the corporation or any of its affiliates are, have been, or are threatened to be carried on or conducted in a manner; or
- the powers of the directors of the corporation or any of its affiliates are, have been, or are threatened to be exercised in a manner

that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director, or officer of the corporation, the court may make an order to rectify the matters complained of.

18.2.2 Proper parties

Any "complainant" can bring an oppression remedy application. "Complainant" is defined in s. 245 to include a former or current shareholder, director, officer, or "any other person who, in the discretion of the court, is a proper person to make an application." The courts have permitted an unsecured creditor to make an application pursuant to s. 248.

18.2.3 The remedies

If an application by a creditor is permitted and oppressive conduct can be shown, the remedies available are virtually unlimited. Subsection 248(3) of the *OBCA* provides that in connection with an application under s. 248, the court may make any interim or final order it "thinks fit," including

- an order restraining the conduct complained of;
- an order appointing a receiver or receiver-manager;
- an order varying or setting aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract; and/or
- an order compensating an aggrieved person.

18.2.4 Oppression remedy under the CBCA

In respect of a corporation to which the *CBCA* applies, the oppression remedy provisions contained in Part XX of the *CBCA* are substantially similar to the foregoing *OBCA* provision.

Chapter 28
Secured creditors' rights and remedies

Part I: Priorities

1. Why priorities matter

The basic rule under the *Bankruptcy and Insolvency Act* (*BIA*) is that ordinary unsecured creditors share the proceeds of the bankrupt's assets rateably in proportion to the relative sizes of their claims (s. 141).

Certain creditors can obtain priority over unsecured creditors by obtaining security over the assets of the debtor. In addition to the rights of secured creditors, certain other creditors are given special rights against particular assets of the debtor in priority to ordinary unsecured creditors, such as landlord rights of distress for rental arrears; liens and deemed trusts given by statute to various government agencies for unpaid remittances; and most recently, statutory charges for unpaid wages and unpaid pension contributions. In certain circumstances, these priority claims will rank ahead of the rights of secured creditors.

2. Personal Property Security Act security

A lender and other creditors can obtain priority for their claims against a debtor over other creditors by taking security. This security can take various forms and can vary in scope, from security over the debtor's entire personal and real property, to security over specific assets only. The effect of the security in each case is to give the secured creditor rights against particular assets of the debtor in priority to the debtor's other creditors when the security becomes enforceable.

To achieve priority, it is not enough for a secured creditor to obtain a written security agreement executed by the debtor. In order to obtain priority against other creditors and a trustee-in-bankruptcy, a secured creditor must also take certain steps to perfect the security interests created by the security agreement.

2.1 Perfecting security

In the case of security that is governed by the *Personal Property Security Act* (*PPSA*), the secured creditor must follow the appropriate steps to obtain a "perfected" security interest. Perfection generally requires that attachment has occurred pursuant to s. 11(2) of the *PPSA* and a financing statement has been registered, in the prescribed form, pursuant to s. 23 of the *PPSA* and s. 16 of the Minister's Order under the *PPSA*, or the secured creditor has obtained possession of the collateral.

Attachment occurs when (a) the secured party obtains a written security agreement, signed by the debtor and describing the collateral; (b) value is given; and (c) the debtor has rights in the collateral.

In lieu of registration of a *PPSA* financing statement, it is also possible to perfect a security interest in many kinds of collateral by possession or, in the case of uncertificated securities, by control. Perfection by possession is most common with respect to certificated securities, because perfection by possession of other types of personal property would prevent the debtor from having use of the collateral and therefore is unpractical.

2.2 The relevance of title/ownership

2.2.1 PPSA security

Title or ownership of the debtor's assets (or more precisely, the lack thereof) is not relevant to establishing priority under the *PPSA*. Even if the debtor does not legally hold title to the assets, the consensual security interests created by it or non-consensual liens imposed on the debtor's assets may still attach to those assets.

Section 2 of the *PPSA* applies to any transaction that in substance is found to create a security interest, without regard to form. If the *PPSA* applies to the transaction, the priorities of claims over the assets subject to that transaction will be governed by priority rules in the *PPSA* regardless of whether there has been a retention of title by the other party to the transaction, such as in a personal property lease or conditional sale contract.

A reservation of title only matters if the *PPSA* does not apply to the transaction (that is, the transaction does not in substance create a security interest). The *PPSA* lists both conditional sale contracts and leases of personal property as transactions to which the *PPSA* could apply if in substance they create a security interest. If the *PPSA* applies, a lessor or conditional sale vendor may lose its rights to its goods unless it can establish priority to those goods under the *PPSA* priority rules. Case law is clear that where a conditional sale contract reserves title until payment is received from the purchaser in full, the *PPSA* applies to that transaction because title is being reserved to secure the payment of the purchase price. With respect to leases, the case law is not as clear, and reference needs to be made to the various indicia established by the

courts to distinguish between leases that in substance create a security interest (financing leases) and leases that do not (true leases).

2.2.2 Non-PPSA security

Outside of the *PPSA*, ownership of the collateral may be relevant to determining the priority of non-*PPSA* security. For example, in determining the priority of security granted under s. 427 of the *Bank Act*, title does matter. Title also matters in determining the priority of a landlord's distress rights.

The priority issues arising in respect of both s. 427 *Bank Act* security and landlord distress rights are discussed below.

3. Non-PPSA security

In the case of security that is governed by a statute other than the *PPSA*, it is necessary to ensure that the formalities and registration requirements of the applicable statute have been satisfied. For example, in order for a real estate mortgage to have priority over subsequent transfers or encumbrances, it must be in the form required by the *Land Registration Reform Act* and must have been registered against the title to the land.

4. Secured creditor priorities

4.1 PPSA priorities

4.1.1 "First to register" rule

The *PPSA*'s general priority rules for collateral other than for "investment property" are set out in s. 30. Under s. 30(1)1, where priority is to be determined between two security interests perfected by registration, priority will be determined by the order of registration regardless of the order of perfection. This rule is important because s. 45(3) of the *PPSA* permits a secured creditor to file a financing statement prior to the execution of a security agreement with respect to any collateral other than consumer goods. The result is that a secured creditor who has registered a financing statement first in time may obtain priority over a subsequently registered secured creditor, even though the subsequently registered secured creditor may have obtained its security from the debtor first.

Moreover, where a priority contest is between a security interest perfected by registration and a security interest perfected other than by registration (i.e., possession), s. 30(1)2 provides that priority is determined by when the security interest perfected by registration was registered (not when it was perfected). If the security interest perfected by registration was *registered* before the security interest perfected other than by registration was *perfected*, the former has priority.

The benefits of registering first can be even more significant when s. 45(4) of the *PPSA* is taken into consideration. Subsection 45(4) provides that a single financing statement may perfect security interests created in more than one security agreement.

4.1.2 "First to perfect" rule

Where the priority contest is between two security interests perfected other than by registration, s. 30(1)3 states that priority is determined by the first to perfect.

4.1.3 "First to attach" rule

Where priority is to be determined between unperfected security interests, priority is to be determined by the first to attach (s. 30(1)4).

4.1.4 Deemed trusts

Subsection 30(7) of the *PPSA* provides that a security interest in an account or inventory and its proceeds is subordinate to the interest of a person who is the beneficiary of a deemed trust arising under the *Employment Standards Act, 2000* or the *Pension Benefits Act*.

4.1.5 Unperfected security interests

The consequences of failing to perfect a security interest are significant. For example, an unperfected security interest is subordinate to the interest of (a) a person who has a perfected security interest in the same collateral (s. 20(1)(a)(i)); (b) a person who has a lien given under any other Act or by a rule of law or who has a priority under any other Act (s. 20(1)(a)(i)); (c) a person who causes the collateral to be seized through execution, attachment, garnishment, charging order, equitable execution, or other legal process (s. 20(1)(a)(ii)); and (d) all persons entitled by the *Creditors' Relief Act, 2010* or otherwise to participate in the distribution of the property over which a person described in clause (c) above has caused seizure of the collateral or the proceeds of such property (s. 20(1)(a)(iii)). In addition, an unperfected security interest is not effective against (a) a trustee-in-bankruptcy (s. 20(1)(b)); (b) a transferee of chattel paper, documents of title, instruments, or goods who takes under a transaction that does not secure payment or performance of an obligation and who gives value and receives delivery thereof without knowledge of the security interest (s. 20(1)(c)); and (c) a transferee of intangibles other than accounts who takes under a transaction that does not secure payment or performance of any obligation and who gives value without knowledge of the security interest (s. 20(1)(d)).

Therefore, if a secured creditor has an unperfected security interest at the date of bankruptcy, it will be too late for the secured creditor to obtain priority over a trustee-in-bankruptcy. If it perfects its security interest after the bankruptcy, it will be subordinate to the rights of the trustee-in-bankruptcy.

4.1.6 Purchase-money security interests (PMSIs)

An important exception to the "first to register" rule is the priority that can be obtained by a creditor obtaining a purchase-money security interest (PMSI). A PMSI is a security interest taken or reserved in collateral to secure payment of all or part of its price or taken by a person who gives value for the purpose of enabling the debtor to acquire rights in or to the collateral. If the holder of a PMSI follows the requirements set out in s. 33 of the *PPSA*, the PMSI will have priority over any other security interest in the same collateral granted by the same debtor. In other words, the PMSI will have priority over pre-existing security interests in the same collateral.

To obtain PMSI priority, a creditor with a security interest in collateral other than inventory (i.e., equipment or intangibles) must perfect its security interest by registration before or within 15 days after the debtor (or a third party at the debtor's request) obtains possession of the collateral as a debtor (s. 33(2)(a)) or, in the case of an intangible, before or within 15 days after the attachment of the PMSI in the intangible (s. 33(2)(b)). If the collateral is inventory, the secured creditor must do the following under s. 33(1) in order to obtain PMSI priority:

(i) perfect its security interest by registration;

(ii) give notice in writing to every other secured party who has registered a financing statement showing inventory as collateral before the secured creditor's registration; and

(iii) complete steps (i) and (ii) above before the debtor (or third party) obtains possession of the collateral.

The PMSI notice in (ii) must state that the person giving it has or expects to acquire a PMSI in inventory of the debtor, described by item or type (s. 33(1)(c)).

If more than one PMSI has been granted in the same collateral, s. 33(3) gives priority to the seller of the goods.

In order to establish PMSI priority, it is important for the PMSI holder to retain evidence as to when the equipment was delivered into the debtor's possession in order to demonstrate that the creditor satisfied the timelines necessary to establish PMSI priority. Accordingly, many agreements include an express, dated acknowledgement of delivery by the debtor.

If the creditor does not follow the applicable steps under s. 33, but is otherwise perfected, it would not have acquired the special priority of a PMSI under s. 33 and therefore would not obtain priority over pre-existing security interests in the same collateral. Subject to s. 20(3) of the PPSA, if a PMSI in collateral is unperfected, it will be subordinate to the trustee-in-bankruptcy and any person who causes the collateral to be seized through execution, attachment, garnishment, charging order, equitable execution, or other legal process.

Subsection 20(3) deals with situations where an execution creditor or representative of creditors takes control over collateral before the holder of a PMSI in that collateral has perfected its PMSI. Subsection 20(3) allows a holder of a PMSI to obtain priority if it registers a *PPSA* financing statement within the timelines set out therein even if it is not so registered at the time control is assumed by a legal process or on the date a person's status as a representative of creditors of the debtor begins. The subsection provides that a PMSI in collateral, other than an intangible, perfected by registration before or within 15 days after the debtor (or a third party at the debtor's request) has obtained possession of the collateral has priority over a trustee-in-bankruptcy, any person who causes the collateral to be seized through execution, attachment, garnishment, charging order, equitable execution, or other legal process, and any transferee of collateral that forms all or part of a sale in bulk within the meaning of the *Bulk Sales Act*(s. 20(3)(c)-(d)). If the PMSI collateral is an intangible, similar priority is accorded to the PMSI provided that the PMSI is perfected by registration before or within 15 days after the attachment of the security interest in the intangible.

If a lease transaction is part of a sale-leaseback, the equipment lessor will not be able to claim PMSI priority because the definition of "purchase-money security interest" in s. 1(1) of the *PPSA* expressly excludes a transaction of sale by and lease back to the seller.

An equipment lessor or conditional sale vendor who has registered a proper financing statement under the *PPSA* but who has failed to meet the timing or notice requirements under s. 33 to obtain PMSI priority, may still be able to obtain priority over other secured creditors with an interest in the same collateral by obtaining estoppel, waiver, or no interest letters or subordination agreements from the prior registered competing creditors.

There are certain priority provisions in the *PPSA* that provide additional protection to PMSIs. For example, s. 30(8) of the *PPSA* provides that the priority given to

vacation pay and pension deemed trusts under s. 30(7) of the *PPSA* does not apply to PMSIs. As well, the special priority provisions relating to accessions under s. 35(2)(b) of the *PPSA*, discussed below, expressly do not apply to PMSIs.

4.1.7 Special priority rules for fixtures and accessions

(a) Fixtures

The *PPSA* contains special registration and priority rules for "fixtures" and "accessions."

A "fixture" is not defined in the *PPSA*. Therefore, reference must be made to the common law to determine whether the special rules for fixtures under s. 34 of the *PPSA* apply. Generally, in determining whether a good is a fixture, the courts have looked to the degree of annexation and whether the good constitutes an improvement to the real property.

For the purposes of obtaining priority in a fixture under the *PPSA*, the creditor should register notice of the security interest in the prescribed form against title to the real property pursuant to s. 54 of the *PPSA*, commonly called a "fixture filing." With limited exceptions, registration of a fixture filing against title to the real property will give priority to the holder of the security interest over all subsequent interests acquired in the real property after registration of the notice. The nature and extent of a secured creditor's priority will be affected by the timing of the creditor's security interest attachment to the fixture.

Section 34 of the *PPSA* sets out the special rules relating to fixtures. Subject to s. 34(2), a security interest in goods that attached before the goods became a fixture, has priority as to the fixture over any person with an interest in the real property. If the security interest in the good attached after the good became a fixture, the security interest only has priority over any subsequently acquired interest in real property, but not over any person with a registered interest in the real property at the time the security interest attached, unless that person has consented in writing to the security interest in the fixture or disclaimed an interest in the fixture (s. 34(1)).

A security interest in the goods attaches when the debtor executes a security agreement, the secured creditor gives value, and the debtor has rights in the collateral (s. 11(2)).

Subsection 34(2) provides that notwithstanding the foregoing, a security interest in fixtures is always subordinate to the interest of a subsequent purchaser for value of an interest in the real property and a creditor with a prior encumbrance of record on the real property, to the extent that the creditor makes subsequent advances, if the purchase or subsequent advance was made or contracted for without knowledge of the security interest and before registration of the fixture filing against title to the real property. Therefore, it is important to register a fixture filing to obtain priority over purchasers and subsequent advances.

(b) Accessions

"Accessions" are defined in s. 1(1) of the *PPSA* as "goods that are installed in or affixed to other goods." Like the special priority rules for fixtures, subject to ss. 35(2)–(3) and 37 of the *PPSA*, the priority of a security interest in accessions is affected by the timing of the attachment of the creditor's security interest to the accession. A security interest in goods that attached before the goods became an accession, has priority as to the accession over the interest of any person with an interest in the whole. If the security interest in the good attached after the good became an accession, the security interest only has priority over any subsequently acquired interest in the whole, but not over any person with a registered interest in the whole at the time the security interest in the accession attached, unless that person has consented in writing to the security interest in the accession or disclaimed an interest in the accession (s. 35(1)).

Subsection 35(2) provides that notwithstanding the foregoing, a security interest in an accession is always subordinate to

- the interest of a subsequent purchaser for value of an interest in the whole and a creditor with a prior encumbrance of record on the whole to the extent that the creditor makes subsequent advances, if the subsequent sale or subsequent advance under the prior perfected security interest is made or contracted for before the security interest is perfected (s. 35(2)(a)); and
- except in the case of a valid PMSI, the interest of a creditor of the debtor who assumes control of the whole through execution, garnishment, or other legal process, if such control is assumed before the security interest is perfected (ss. 35(2)(b)–(3)).

4.1.8 Special priority rules for investment property

The *Securities Transfer Act, 2006* (*STA*) together with related amendments to the *PPSA*, which were proclaimed in force on January 1, 2007, create a complex set of rules that govern the rights and obligations of issuers of securities, securities intermediaries, investors, and secured creditors. The *STA* and related *PPSA* amendments establish the concept of "control" over "investment property." "Investment property" is defined in the *PPSA* as a security, whether certificated or

uncertificated, security entitlement, securities account, futures contract, or futures account.

Section 30.1 of the *PPSA* sets out the special priority rules of "investment property." These new rules should be carefully reviewed when determining the priority of a secured creditor over a borrower's investment property. Generally, the basic priority rules are as follows:

- Control has priority over non-control: A security interest perfected by control (by possession in the case of a certificated security and by control agreement in the case of an uncertificated security) has priority over another security interest perfected otherwise than by control (*PPSA*, ss. 30.1(2)–(3)).
- Two security interests perfected by control rank according to priority in time (*PPSA*, s. 30.1(4)).
- Securities intermediaries have priority over other secured parties unless it otherwise agrees (*PPSA*, s. 30.1(5)).
- Cut-off rules:
  - (a) A "protected purchaser" takes security free of any adverse claim (*STA*, s. 70). "Protected purchaser" means a purchaser (which includes a pledgee/secured creditor) of a certificated or uncertificated security or of an interest in the security, who
    - (i) gives value;
    - (ii) does not have notice of any adverse claim to the security; and
    - (iii) obtains control of the security (*STA*, s. 1(1)).
  - (b) A purchaser other than a secured creditor takes security free of the security interest if the purchaser
    - (i) gives value;
    - (ii) does not know that the transaction breaches the security agreement; and
    - (iii) obtains control of the security (*PPSA*, s. 28(6)).
  - (c) No action based on adverse claim may be brought against a person acquiring a security entitlement for value and without notice of the adverse claim (*STA*, s. 96).

The *PPSA* also establishes a set of complex conflict of law rules dealing with investment property in different jurisdictions. It is important that these conflict of law rules also be reviewed with the priority rules set out above in order to determine what priority a secured creditor has over certain investment property.

4.1.9 Bank Act security priority

Where the priority dispute is between security governed by the *PPSA* and security granted under s. 427 of the *Bank Act*, the *PPSA* priority rules do not apply, and it is necessary to establish priority by reference to common-law principles.

Section 427 security ranks behind the rights of a conditional sale vendor because s. 427 security operates by transferring the debtor's title to the bank. Under a conditional sale contract, title in the purchased goods is retained by the vendor until payment in full by the debtor. If the debtor does not have title, the debtor has no title to transfer to the bank.

In priority disputes between *Bank Act* security and security interests that are subject to the *PPSA* not involving conditional sale contracts, two recent decisions from the Supreme Court of Canada (SCC) have held that priority is determined by the party that acquired the security interest first in time. If the *PPSA* security interest was acquired first, the *Bank Act* security would attach to the title of the debtor but subject to the *PPSA* security interest. This reasoning is based on s. 428 of the *Bank Act*, which provides that the bank's title acquired pursuant to s. 427 has priority over all rights subsequently acquired "in, on or in respect of" the property of a debtor. If the *Bank Act* security was acquired first, the *PPSA* security interest could not attach since *PPSA* security only attaches to the interests of the debtor and such interests would have already been conveyed to the bank under s. 427. The SCC also held that this applies regardless of whether the *PPSA* security interest is registered under the *PPSA*: a *PPSA* security interest does not need not be registered to have priority over subsequent *Bank Act* security because registration is only relevant to competing priorities as between *PPSA* security interests.

4.2 Equipment leases

Prior to amendments to the *PPSA* that came into force on August 1, 2007, one of the most common priority issues in an insolvency was related to equipment leases and the characterization of these leases either as "true" leases (i.e., a rental arrangement) or "financing" leases, which in substance create a security interest.

Prior to the *PPSA* amendments, the *PPSA* applied to a lease that secures payment or performance of an obligation without regard to its form. The *PPSA* did not articulate the characteristics of a lease that secures payment or performance of an obligation for the purposes of application of the *Act*, and the case law was unfortunately not consistent on this matter. This resulted in considerable uncertainty and litigation regarding the issue of whether a particular equipment lease was a "true lease" or a "financing lease," the latter of which would be subject to the provisions of the *PPSA*.

As a result of the amendments to the *PPSA*, the *PPSA* now applies to leases of goods under a lease for a term of more than one year even though the lease may not secure payment or performance of an obligation (s. 2(a)). However, Part V of the *PPSA* (which governs rights and remedies) does not apply to true leases (s. 57.1). As a result, true leases with terms of one year or more are subject to the conflicts, registration, perfection, and priority provisions of the *PPSA*, but they are not subject to the rights and remedies provisions under Part V of the *PPSA*.

The definition of "leases for a term of more than one year" has a broad meaning. It applies not only to any true lease with an actual term of more than one year but also extends to any true lease with the potential of having a term exceeding one year, such as a lease for indefinite term or a lease for a term of less than one year but which is automatically renewable for one or more terms, the total of which may exceed one year. In addition, the definition covers an overholding lessee as permitted by the lessor. Therefore, even if the initial term plus any renewal thereof is less than one year but the lessee is entitled to retain uninterrupted or substantially uninterrupted possession of the leased goods for a continuous period of more than one year, with the consent of the lessor, such a lease will become subject to the *PPSA* after the lessee's possession exceeds one year.

There are two narrow exceptions. The *PPSA* will not apply to a true lease, even if it has a term of greater than one year, if

- the lessor is not regularly engaged in the business of leasing goods; or
- the leased goods are household furnishings or appliances that are subject to a lease of land and such goods are incidental to the use and enjoyment of the land.

The amendments to the *PPSA* do not mean that the distinction between true leases and financing leases will no longer be relevant. It will still be relevant in both the *PPSA* and non-*PPSA* contexts.

Under the *PPSA*, the distinction remains relevant in determining whether the enforcement provisions of Part V of the *PPSA* apply to a particular lease. Part V sets out various requirements, including the requirement to provide notices of disposition to the lessee and other interested parties and to account for any surplus. In the case of a true lease, the lessor's remedies will be governed by more lax common-law principles and the terms of the lease agreement. For example, unless the lease provides otherwise, a lessor is entitled to retain any surplus from the sale of the leased goods at the end of the true lease.

Outside of the *PPSA* context, the distinction between a true lease and financing lease will remain relevant. For example, s. 65.1(4) of the *BIA* and s. 11.3 of the *Companies' Creditors Arrangements Act* (*CCAA*) have been interpreted to provide that only a lessor under a true lease is entitled to continue to be paid when the lessee has filed for protection under the *BIA* or *CCAA*.

4.3 Execution creditors

An execution creditor's rights against the debtor's assets are subject to the rights of secured creditors with perfected security interests. The execution creditor may obtain priority if the execution process has been completely carried out, including the seizure and sale of assets by the sheriff and delivery of proceeds to the execution creditor, before the secured creditor enforces its security.

An execution creditor that has not completely carried out the execution process, including seizure, sale, and delivery of proceeds, will rank equally, or "*pari passu*," with other unsecured creditors.

In a priority dispute between an execution creditor and a secured creditor holding an unperfected security interest governed by the *PPSA*, the *PPSA* provides that the unperfected security interest is subordinate to the interest of the execution creditor if the sheriff has taken control of the collateral (s. 20(1)(a)(ii)).

5. Statutory liens and deemed trusts for Crown claims

5.1 General

In order to enhance the collection of certain kinds of statutory claims from the debtor, many federal and provincial statutes have created statutory liens and/or deemed trusts on the debtor's assets.

A statutory lien is a lien imposed by statute over the debtor's assets without the need for a consensual security agreement executed by the debtor.

A deemed trust is a trust created by statute in the debtor's assets in the amount required to be paid under the statute that is "deemed" to be held in trust by the debtor separate and apart from its other assets, whether or not the debtor actually segregates these assets.

5.2 PST clearance certificates

In addition to statutory liens and deemed trusts, some tax statutes, such as the *Retail Sales Tax Act*, require a secured creditor, receiver, or trustee-in-bankruptcy to remit any amounts owing by the debtor subject to the deemed trust, to the Minister of Finance, before any proceeds of security are distributed. Failure to do so

results in the secured creditor, receiver, or trustee liable for the amounts. Upon remittance, the secured creditor receives a certificate (commonly known as the provincial sales tax (PST) clearance certificate) from the Minister of Finance certifying that all amounts subject to the deemed trust have been paid or acceptable security has been given to the Minister in respect thereto (s. 22(5)).

Notwithstanding the introduction of the harmonized sales tax (HST) regime in Ontario effective July 1, 2010, PST certificates will still be issued in cases where proceeds are distributed after July 1, 2010, regardless of whether possession was taken before or after July 1, 2010.

5.3 Types of statutory liens and deemed trusts

Generally, statutory liens and/or deemed trusts relate to one of the following three categories:

- amounts owing by the debtor to the government authority, i.e., property taxes;
- amounts that are collected or withheld by the debtor on behalf of the government, such as HST, where applicable, or goods and services tax and retail sales tax, where not applicable, and employee source deductions (i.e., tax source deductions and Employment Insurance and Canada Pension Plan remittances, which are deducted from an employee's pay by the debtor/employer for remission to the relevant government authority); or
- amounts that are owed by the debtor to others, such as claims of employees for vacation pay.

The nature, scope, and priority of a statutory lien and deemed trust will vary significantly from statute to statute and will depend on the particular language of the statute in each case. Some statutes create statutory liens, some create deemed trusts, and others utilize both statutory lien and deemed trusts concepts. Some statutory liens require registration under the *PPSA* while others do not. Some deemed trusts and statutory charges have priority over pre-existing registered security (but only if the enabling legislation provides for such super-priority), and some do not. As a consequence, when reviewing the priorities over a debtor's assets, possible statutory claims against the debtor should also be reviewed to determine whether any of these claims may have priority over secured creditors with a perfected *PPSA* interest over the debtor's assets.

5.4 Effect of bankruptcy

5.4.1 Reversal of priorities for Crown claims

The relative priority of many statutory claims against secured creditors may be significantly affected by a bankruptcy of the debtor.

Pursuant to s. 86 of the *BIA*, the priority of a statutory lien and/or deemed trust may be reversed by a debtor's bankruptcy. Section 86 of the *BIA* provides that all claims of the federal and provincial Crown, including secured claims and all claims of a workers' compensation body, rank as unsecured claims in a bankruptcy or a *BIA* proposal, unless the claims are secured and have been registered in the manner provided for under s. 86 or 87 of the *BIA*. Furthermore, s. 67(2) invalidates statutory deemed trusts in the context of a *BIA* proposal or bankruptcy unless the deemed trust is a real trust under ordinary common-law principles.

As a consequence of s. 86, it may be beneficial for a secured creditor to initiate or encourage the bankruptcy of a debtor in order to reverse the priorities that are otherwise provided for under statute. This is what is commonly referred to as a "strategic bankruptcy"—that is, a bankruptcy where the main objective is to reverse the priorities that exist in a non-bankruptcy scenario.

A recent SCC decision has confirmed that an order lifting a *CCAA* stay to allow the debtor to make an assignment in bankruptcy in order to reverse priorities was within the authority of the *CCAA* judge. The SCC held that the priority provisions of the *BIA* should apply to the distribution of proceeds of liquidation and that the order lifting the stay to allow for a bankruptcy to reverse priorities is appropriate in that it advances the underlying purpose of the *CCAA* because it fosters a harmonious transition from reorganization under the *CCAA* to liquidation under the *BIA* (*Century Services Inc. v. Canada (Attorney General)*.

5.4.2 Exemption for employee source deductions

The most common statutory claims that are exempt from the application of ss. 86 and 67(2) are claims of the Canada Revenue Agency (CRA) for employee source deductions and claims of a provincial government for withheld but unremitted source deductions of a similar nature to those excluded for the benefit of the CRA (see ss. 67(3) and 86(3) of the *BIA*).

5.4.3 Securing Crown claims

Crown claims and workers' compensation claims are considered to be secured claims for the purposes of s. 86 in one of two ways.

First, a statutory claim can be secured by security in the same way as may be obtained by persons other than the Crown (s. 86(2)). The *BIA* does not expressly provide for any special priority to these claims, and therefore, it would appear that the priority of these claims would be governed by the same rules that would apply to similar forms of consensual security.

Second, a statutory claim may be secured pursuant to s. 87(1) by way of the security provided for under special federal or provincial legislation for the sole or principal purpose of securing a Crown or workers' compensation claims. Such security must be registered in the prescribed registration system prior to the earliest of four possible dates:

- the date a bankruptcy application is filed against the debtor;
- the date the debtor makes an assignment in bankruptcy;
- the date the debtor files a notice of intention to make a proposal under the *BIA*; and
- the date on which a proposal under the *BIA* is filed.

In a bankruptcy or *BIA* proposal, this security is subordinate to other security interests if the necessary steps to make other security interests effective against other creditors were taken before the registration of the Crown or workers' compensation interest (s. 87(2)(a)). This type of security is only valid in respect of the amounts owing to the Crown or workers' compensation board at the time the security was registered, plus any accrued interest thereon (s. 87(2)(b)).

Several Crown claims can be registered under provincial legislation, including claims for tax payable under the *Employer Health Tax Act*, the *Corporations Tax Act*, and the *Land Transfer Tax Act*. These claims may be registered against a debtor's interest in land, including the beneficial interest of an unregistered owner or any leasehold interests held by a debtor, by filing a notice in the required form in the appropriate land registry office.

These claims may also be registered by filing a financing statement against the debtor under the *PPSA*. By making such a filing, the Minister of Finance obtains a lien on any interest in personal property in Ontario then owned or thereafter acquired by the debtor.

Outside of a bankruptcy, the lien has priority over any perfected security interest registered after the registration and any encumbrance or other claim registered after, or that otherwise arises after, the financing statement is registered. The lien does not, however, have priority over a PMSI. The notice under the *PPSA* is valid for five years and may be renewed.

Outside of a bankruptcy, these claims secure all amounts from time to time owing by the taxpayer under the relevant statute while the notice remains registered.

6. Wage priority claims

Until recently, employees with claims for unpaid wages had no special priority for their wage claims except a limited preferred claim for certain unpaid wages in bankruptcy. However, where an employer is bankrupt or subject to a receivership, recent amendments to the *BIA* now give a priority charge to unpaid employee wage claims, which ranks in priority to almost all creditor claims, secured or unsecured.

Effective July 7, 2008 (the 2008 *BIA* Amendments), pursuant to ss. 81.3 (bankruptcy) and 81.4 (receivership) of the *BIA*, claims of a clerk, servant, travelling salesperson, labourer, or worker for unpaid wages, salaries, commissions, or compensation (including vacation pay but not including termination or severance pay) for services rendered in the six-month period prior to the bankruptcy or receivership, are secured for up to $2,000 (plus $1,000 of disbursements for travelling salespeople) by the employer's current assets. In a bankruptcy, the six-month period begins six months prior to the date of the "initial bankruptcy event" as defined in the *BIA* (which definition includes proceedings commenced under the *CCAA*) and ends on the date of bankruptcy. If the debtor first files under the *CCAA* or if the bankruptcy is involuntary and disputed, the total time period covered could be more than 6 months.

The statutory security created by ss. 81.3–81.4 is limited to the "current assets" of the employer. Recent amendments to the *BIA*, in force on September 18, 2009 (the 2009 *BIA* Amendments) introduce the definition of "current assets," which means cash, cash equivalents—including negotiable instruments and demand deposits—inventory or accounts receivable, and proceeds from dealing with those assets. In the case of a bankruptcy, the current assets subject to the statutory charge are those of the bankrupt at the date of the bankruptcy. In the case of a receivership, the current assets subject to the statutory charge are those current assets in the possession or control of the receiver.

A secured creditor has a preferred claim in bankruptcy to the extent its recovery is reduced by the priority charge for unpaid wage claims.

As a result of recent amendments to the *CCAA* effective September 18, 2009 (the 2009 *CCAA* Amendments), the foregoing wage priorities described above also now apply in *CCAA* proceedings, where these wage priority amounts must be paid or arrangements made for the payment thereof before a court can approve a *CCAA* plan or asset sale in a *CCAA* case.

6.1 Priority

The statutory charges granted under ss. 81.3–81.4 of the *BIA* have priority over all unsecured claims, all secured claims, including secured claims under the *PPSA*, regardless of whether those claims were made or were perfected before the wage claims arose, and most statutory liens and deemed trusts. They are subordinate only to very limited statutory claims such as those claims of unpaid suppliers under s. 81.1 of the *BIA* and, in a bankruptcy, claims of the CRA for unremitted source deductions. Although the charges were intended to also to be subordinate to CRA claims for unremitted source deductions in a receivership, due to differences in the language of the provisions between ss. 81.3–81.4 of the *BIA,* that priority is uncertain.

6.2 Transitional rules

There are complex transition rules in connection with the 2008 *BIA* Amendments, 2009 *BIA* Amendments, and the 2009 *CCAA* Amendments, and these should be reviewed carefully to determine whether a particular bankruptcy, receivership, or *CCAA* proceeding is subject to the old or new provisions.

7. Pension contribution claims

Effective July 7, 2008, where an employer is bankrupt or subject to receivership proceedings, unpaid pension plan contributions also benefit from a statutory priority charge by virtue of ss. 81.5–81.6 of the *BIA*.

Sections 81.5–81.6 provide a priority for unpaid regularly scheduled contributions to certain pension plans, prescribed by regulation, by creating a priority charge over all of the debtor employer's assets (i.e., the charge is not limited to current assets).

The statutory charge is limited to unpaid regularly scheduled contributions. It does not extend to special contributions and underfunded liabilities, which arise in defined benefit pension plans when the assets of the plan are insufficient to meet actuarial forecasts for what the plan's future liabilities will be.

A secured creditor has a preferred claim in bankruptcy to the extent its recovery is reduced by the priority charge for unpaid pension contributions.

The 2009 *CCAA* Amendments provide that the foregoing pension contribution priority also now applies in *CCAA* proceedings, where these amounts must be paid or arrangements made for the payment thereof before a court can approve a *CCAA* plan or asset sale in a *CCAA* case.

7.1 Priority

The statutory charges under ss. 81.5–81.6 of the *BIA* have priority over all unsecured claims, all secured claims, including secured claims under the *PPSA*, regardless of whether those claims were made or were perfected before the wage claims arose, and most statutory liens and deemed trusts. They are subordinate only to very limited statutory claims such as those claims of unpaid suppliers under s. 81.1 of the *BIA* and, in a bankruptcy, claims of the CRA for unremitted source deductions. Although the charges were intended to also be subordinate to CRA claims for unremitted source deductions in a receivership, due to differences in the language of the provisions between ss. 81.5–81.6 of the *BIA,* that priority is not clear.

7.2 Transitional rules

There are complex transition rules in connection with the 2008 *BIA* Amendments, 2009 *BIA* Amendments, and the 2009 *CCAA* Amendments, and these should be reviewed carefully to determine whether a particular bankruptcy, receivership, or *CCAA* proceeding is subject to the old or new provisions.

7.3 Underfunded pension deficiency claims

Sections 81.5–81.6 apply only to regular pension contribution payments, not to underfunded pension deficiency claims arising in a defined benefit pension plan. However, in a recent decision, the Ontario Court of Appeal, reversing the lower court decision, held that on the wind-up of a defined benefit pension plan, the *Pension Benefits Act* creates a deemed trust (akin to a statutory security interest) over the employer's assets for the amount necessary to fund the wind-up deficiency. It remains to be seen how the decision, which is very fact specific, may be applied or distinguished in other proceedings. Leave to appeal to the SCC has been sought.

8. Landlord priorities

8.1 Landlord's right of distress

A landlord has the right to seize and sell assets owned by the tenant located on the leased premises in order to satisfy any rental arrears owing by the tenant.

Subsection 31(2) of the *Commercial Tenancies Act* restricts the landlord's rights of distress to the assets

owned by the tenant that are located on the premises, even if the tenant's assets are subject to a security interest in favour of a secured creditor. The result is that where the tenant does not have title to the goods, the landlord's right of distress only applies to the extent of the debtor's equity in the assets located on the leased premises. Therefore, a landlord does not have a right to distrain on goods that are subject to conditional sale contracts, which reserve title in the seller, except to the extent of any equity in the goods held by the tenant. If the goods have been partly paid for, a landlord who wants the benefits of any of the tenant's equity will have to pay out the balance of the purchase price owing under the conditional sale contract. The same rule applies *vice versa*: if the conditional sale vendor wishes to seize the goods for its benefit, it will have to pay the landlord the value of any equity in those goods paid for by the tenant.

A similar result also arises where the secured creditor is a bank that holds security under s. 427 of the *Bank Act*. When a bank takes security under s. 427, it acquires legal title to the goods. Section 428 of the *Bank Act* provides that the bank's title acquired pursuant to s. 427 has priority over all rights subsequently acquired "in, on or in respect of" the property of a debtor. The landlord's right of distress has been held to be a right "in, on or in respect of" the property, and as a result, if the arrears of rent (and thus the right to distress) arises before the s. 427 security is taken, the bank's security under s. 427 will be subject to the landlord's distress rights, and therefore the landlord will have priority. Similarly, if the s. 427 security is taken by the bank before the arrears (and therefore before the right to distress arises), the bank's s. 427 security will have priority because the landlord's right of distress cannot attach to the tenant's assets once title has passed to the bank.

Unless there is a stay of proceedings in effect under a court receivership, the landlord's right of distress will supersede a receiver's rights to possession where there is no reservation of title. A secured creditor can protect itself from this risk in two ways. First, it can obtain a waiver of distress from the landlord at the time the security is taken. Second, it can terminate the landlord's right of distress by causing the debtor to become bankrupt.

The landlord may not distress on the trade fixtures of the tenant, even if removable.

8.2 Termination of leases

As an alternative to the landlord's right of distress, a landlord typically will have the right under its lease to terminate the lease for failure by its tenant to pay rent under a lease. It is important to note that the two remedies of distress and termination are alternative remedies. If the lease is terminated, the landlord has no right to the tenant's assets located on the premises following the termination. In most cases where there are rent arrears, the landlord usually prefers first to distress for the arrears of rent and then, if necessary, to terminate the lease on the basis of other defaults by the tenant under the lease. The landlord's rights of distress and termination are significantly affected by a bankruptcy of the tenant.

8.3 Effect of bankruptcy

8.3.1 General

A secured creditor may want to cause a debtor's bankruptcy not only to prevent a landlord's exercise of its rights of distress but also to prevent termination of the lease and preservation of the ability to assign the lease to a third party without the landlord's consent. This will occur in circumstances where the lease has terms favourable to the tenant, such as a below-market rent, and the landlord has reasonable prospects for re-letting the space on more favourable terms to the landlord.

8.3.2 Reversal of priority of landlord's right of distress

Upon the bankruptcy of the tenant, the landlord's right of distress against the goods of the tenant is replaced by a preferred claim under s. 136(1)(f) of the *BIA* for up to three months' arrears of rent and three months' accelerated rent (to the extent permitted under the lease), limited to the value of the tenant's goods located on the premises at the time of the bankruptcy.

If the landlord completes the distress prior to the tenant's bankruptcy, including receiving the proceeds of sale from the distrained goods, the landlord will be entitled to keep those proceeds, even if its distress was not conducted in compliance with the statute.

If the landlord's distress is not completed at the time of the bankruptcy, either because the goods have not been sold or the proceeds have not been paid to the landlord, the goods or the proceeds must be remitted to the trustee-in-bankruptcy or to the secured creditor with a prior secured claim to those goods or proceeds, in either case after deducting the landlord's costs of seizure (*BIA*, s. 73(4)).

8.3.3 Impact of bankruptcy on right to terminate the lease

The landlord's right to terminate the lease is also affected by a bankruptcy. Subsection 38(2) of the *Commercial Tenancies Act* provides that upon bankruptcy, the trustee-in-bankruptcy is entitled to possession of the

premises for a period of up to three months and has the right during that three-month occupation period to elect either to retain or disclaim the lease.

The trustee's statutory right of occupation in Ontario supersedes the landlord's right of termination. If the trustee disclaims the lease, the landlord is then free to take possession of the leased premises. If the trustee elects to retain the lease, the trustee is required to bring the lease back into good standing by paying all arrears of rent.

The trustee also has the right under s. 38(2) of the *Commercial Tenancies Act* to assign the lease to another party, thereby, obtaining some value for the estate. This statutory right of assignment applies even if the lease contains restrictions on the tenant's right to assign the lease without the landlord's consent. If the landlord refuses to consent to the assignment of the lease to the new tenant proposed by the trustee, the trustee has the right, subject to certain conditions, including the payment of all arrears of rent, to apply to the court for an order permitting the assignment of the lease without the landlord's consent.

9. Changing priorities

There are various ways in which the priorities set out in the *PPSA* and elsewhere can be altered. Some of the main ways that the priority of a creditor can be altered are set out below.

9.1 Priority, subordination, and inter-creditor agreements

Where there is more than one significant secured creditor of a debtor, the secured creditors may seek to confirm or alter the priorities otherwise attaching to their respective security under the *PPSA* and other applicable law by entering into an agreement between them that sets out the priorities between them, regardless of what priorities may otherwise attach to such security by virtue of the priority rules under the *PPSA*, other applicable statutes, or at common law. These types of agreements are typically referred to as priority agreements, subordination agreements, or inter-creditor agreements. The names are often used inter-changeably, although they are in fact each technically different. These agreements are important, not only because they alter the priorities otherwise accorded to the parties under the law, but also because they often contain restrictions against enforcement by the parties by requiring the consent of, or prior notice to, other parties prior to commencing any enforcement steps.

Typically, a "priority agreement" or "subordination agreement" will involve an arrangement in which the creditor parties agree that the security of one of the creditors has priority over the security of the others and that, conversely, the others' security is subordinated to the priority of the first.

An "inter-creditor agreement" is usually more complicated than a priority or subordination agreement. It can involve each creditor agreeing that their respective security rank equally (i.e., on a *pari passu* basis) so that the proceeds of any recovery are to be shared between them on a pro-rated basis. Alternatively, it can set out different ranks of priority between the creditor parties to the agreement over different categories of assets, which may be subject to caps or limits on the amount of the proceeds subject to the priority. An inter-creditor agreement can be quite simple; for example, creditor A has priority over the proceeds of all equipment collateral; and creditor B has priority over all inventory collateral; or it can be more complicated, such as creditor A has priority over the proceeds of all equipment collateral up to $X dollars; then creditor B has priority over proceeds of the equipment collateral up to the next $Y dollars, and so on.

The priorities and subordinations in the priority, subordination, and inter-creditor agreements can be in respect of security or debt and security.

Whether it is a priority, subordination, or inter-creditor agreement, the agreement will typically specify notice and/or consent requirements before demand and/or enforcement can proceed and set out how the proceeds of any realization are to be applied.

A priority, subordination, or inter-creditor agreement is simply a contractual agreement between the parties that a different order of priority applies between the parties than would otherwise occur under existing statutory or common-law rules. It is therefore common for these agreements to contain a provision that states that the priorities reflected in the agreement will continue to apply, regardless of the order of registration or perfection of the security held by the parties or any priorities otherwise afforded to the security under applicable statute or common law.

Because a priority, subordination, and inter-creditor agreement is only an agreement between the parties to it, those who are not parties to the agreement are not bound by the priorities set out in the agreement. Priority agreements typically provide that the agreements do not confer any rights on the debtor or any other person. This sometimes can lead to interesting priority issues. For example, if Creditor A has priority over Creditor B under the priority agreement but Creditor A is unperfected (and therefore is subordinate to a trustee-in-bankruptcy),

while Creditor B is perfected (and therefore has priority over the trustee-in-bankruptcy), who has priority over the debtor's assets? Creditor A can obtain priority because Creditor B would claim priority over the trustee under its security and then, pursuant to the terms of the priority agreement, would pay any proceeds of those assets over to Creditor A to the extent of the secured party's priority under the priority agreement. It is common in priority agreements to contain a provision that any proceeds received by a party from assets over which another party has priority under the agreement are to be held in trust for and promptly remitted to that other party.

9.2 Implied subordination

Even if there is no priority, subordination, or inter-creditor agreement, it is still possible for the priority of a secured creditor to be affected by operation of s. 38 of the *PPSA*, which provides that a secured party may, in the security agreement or otherwise, subordinate the secured party's security interest to any other security interest.

Implied subordinations have been found to arise in connection with the provision for permitted encumbrances in a loan or security agreement. This typically arises in the context of negative pledges contained in loan or security agreements under which the debtor covenants not to create or to permit encumbrances to exist against its assets except for certain exceptions, often referred to as "permitted encumbrances." If the security document permits the creation of permitted encumbrances without expressly stating that the provision of permitted encumbrances does not automatically grant priority to such permitted encumbrances unless otherwise provided by the law, an implied subordination could be found to have occurred. The most common type of permitted encumbrances for personal property is a PMSI. To address this risk, the loan and/security documentation should expressly provide an acknowledgement by the borrower and lender that nothing in the loan or security agreement, including the provision for any permitted encumbrances, is intended in any way to subordinate any of the security interests granted by the borrower to the creditor.

9.3 Correcting errors and re-perfecting security

As soon as a creditor discovers that a debtor who has granted security may be in financial difficulty, it is important for that creditor to commence a review of that security to confirm that the security was validly given and properly perfected or registered where required at the time the security was granted and that there have been no intervening events that require any amendments to the security or the registrations. If errors or deficiencies are discovered by the review, steps should be taken immediately to correct them by registering a financing change statement under the *PPSA* or by obtaining new security.

It may be possible for a creditor to correct an error or address the deficiency in its security and/or registrations and still be able to retain the same priority or at least some priority over other secured creditors and a trustee-in-bankruptcy. An unperfected security interest is subordinate to the interest of a trustee-in-bankruptcy, so at a minimum, any correction that results in an unperfected security interest becoming perfected will obtain priority over a trustee-in-bankruptcy. This could be beneficial if there is any residual value in the assets after secured creditors are satisfied.

The *PPSA* requires that on the occurrence of certain events (i.e., a change in the debtor's name), an amendment to a *PPSA* financing statement is required to be filed to continue the perfection of a security interest. As well, unless the financing statement was registered for a perpetual period, renewals must be filed in a timely manner under the *PPSA*. Accordingly, even if a security interest was properly registered at the time of the registration and was first in priority, circumstances may arise that could change this status. When the security interest becomes unperfected, it loses any priority it previously had over other perfected security interests. This situation can be rectified and the original priority reinstated by filing the required financing change statement (i.e., in the case of a debtor name change, by filing a financing change statement showing the new debtor name or, in the case of an expiry of the original registration, by filing a financing statement to record the security interest again).

Subsection 30(6) of the *PPSA* provides that once the required financing change statement is filed, or financing statement in the case of an expiry, the original security interest is deemed to have been continuously perfected from the date of the original registration, subject only to the interests of any parties who may have acquired rights in the collateral during the intervening period when the security was unperfected, such as other secured creditors of the debtor or purchasers of the collateral. In this case, the correcting financing change statement or financing statement will not be effective as against those intervening interests because at the time the intervening interests were acquired, the security interest was unperfected. In some cases, these rules can lead to complicated priority disputes because some of the rules requiring amendments to be filed are knowledge based; that is, the requirement to file arises within a certain time

period after the secured creditor obtains knowledge of an event (such as a debtor name change).

If the error or deficiency relates to the original *PPSA* financing statement, the secured creditor cannot obtain the benefit of the deemed continuous perfection under s. 30(6) since there was no perfection to begin with. The secured creditor should still immediately take steps to rectify the error or deficiency by filing a financing change statement or a new financing statement. If there is any possibility that the secured creditor could rely on the original financing statement, then it is recommended that a financing change statement be filed. The financing change statement will give the secured creditor a perfected security interest at least from the date of registration of the financing change statement. This procedure leaves it open for the secured creditor to claim that even though it may have contained an error or deficiency, its original filing was properly perfected. The secured creditor will argue that the error or deficiency was not materially misleading and therefore was cured by s. 46(4) of the *PPSA*.

Subsection 46(4) provides that a financing statement is not invalidated nor is its effect impaired by reason of an error or omission therein or in its execution or registration unless a reasonable person is likely to be misled materially by the error or omission. A significant issue in this regard will be whether the error would prevent a reasonable person from discovering the security interest under a *PPSA* search. Some secured creditors will both register a financing change statement and a new financing statement.

9.4 Perfection by repossession

For certain types of collateral, instead of filing a financing statement under the *PPSA*, a creditor may perfect its security interest by possession pursuant to s. 22 of the *PPSA*. The perfection possession rule under s. 30(6) of the *PPSA* referred to above only applies where the security interest is perfected at each stage by registration, not possession. As a result, if a security interest was originally perfected by registration and subsequently becomes unperfected, possession can perfect the security at the time of possession, but possession will not restore the secured party's original priority over other creditors.

9.5 The strategic bankruptcy

A secured creditor may bring an application for a bankruptcy order against a debtor in order to reverse the priorities that would result in a non-bankruptcy scenario since most Crown liens and deemed trusts are eliminated in a bankruptcy.

Before filing an application for a bankruptcy order, a secured creditor should first confirm that its security is in order (i.e., properly executed and proper collateral description); properly perfected under the *PPSA* because an unperfected security interest is subordinate in priority to a trustee-in-bankruptcy (*PPSA*, s. 20(1)(b)) or properly registered in accordance with the requirements under the applicable statute (i.e., *Bank Act*); and is free from challenge as a fraudulent conveyance, preference, or transfer at undervalue.

Additionally, the *BIA* gives workers a priority charge over current assets of a bankrupt employer for unpaid wages (up to $2,000 per claimant) and gives pension beneficiaries a priority charge over all assets of a bankrupt employer for unpaid regularly scheduled pension plan contributions (*BIA*, ss. 81.3-81.6). A secured creditor should therefore attempt to determine the status of outstanding wage claims and unpaid pension contributions before determining whether to petition a debtor into bankruptcy because the statutory charges for unpaid wages and pension contributions have priority over all secured claims except for CRA liens for unremitted source deductions and unpaid suppliers' proprietary claims on supplies.

10. Enforcing priority

10.1 Determination of priorities

The priority of a secured creditor to proceeds of its collateral will be subject to review by interested parties such as other creditors of the debtor, a trustee-in-bankruptcy, or a receiver. In some cases, the court will determine the priorities of security.

In order to determine the priority of a creditor's security, the creditor will be asked to provide a copy of its security documents, evidence of any registrations that have been made, and the particulars of the amount owing to it by the debtor. A secured creditor who is subject to the *PPSA* is required to provide such information under s. 18 of the *PPSA*. If the creditor is claiming a PMSI, the creditor will be required to provide evidence of when the property was delivered into the debtor's possession (or third party on debtor's behalf) and, in the case of a PMSI claimed over inventory, copies of any PMSI notices that were issued and proof of receipt thereof by the parties entitled to notice.

If there is a dispute as to priority and the parties are unable to resolve the dispute, a court determination of priority may be required.

Reviewing security and resolving priority issues takes time. In certain cases, the value of the assets will dissipate over time, or there may be a ready buyer who

wants to purchase the assets on an expedited basis. In these cases, in order to maximize the value of the assets, competing creditors can agree to allow the assets to be sold and the net proceeds of sale to be held in trust or in a third-party escrow pending agreement or settlement between the parties or an order of the court as to the priorities to the sale proceeds.

10.2 Judicial determination of priority

Where parties are unable to resolve a priority dispute, the court may be asked to adjudicate. In certain cases, the parties may already be subject to court proceedings, so there is a ready forum to hear the dispute.

In other cases where there are no existing legal proceedings (i.e., in the case of a private receivership), one of the parties to the dispute would need to commence a proceeding to ask the court to determine the priority in dispute. If the priority dispute relates to security that is governed by the *PPSA*, a party may make an application under s. 67(1)(c) of the *PPSA*, which permits the court to make any order necessary to determine questions of priority or entitlement in or to the collateral or its proceeds. The court may not have jurisdiction if the priority dispute is between a *PPSA* security interest and non-*PPSA* security.

Part II: Repair and Storage Liens Act

11. Introduction

In addition to the Crown statutory liens referred to above, there are several other types of liens that are created by statute that may give priority over properly perfected security interests under the *PPSA* or other consensual security interests or charges granted by a debtor to a creditor. One of these is a lien in favour of unpaid "repairers" and "storers" under the *Repair and Storage Liens Act* (*RSLA*).

12. Repairers and repairs

A "repairer" is defined under s. 1(1) of the *RSLA* as a person who makes a repair on the understanding that the person will be paid for the repair. A "repair" is defined in the same subsection as an expenditure of money on or the application of labour, skill, or materials to an article for the purpose of altering, improving, or restoring its properties or maintaining its condition. "Repair" includes the cost of transporting an article for the purpose of making a repair, the towing of an article, and the salvage of an article.

Whether a certain service or expenditure of moneys constitutes a "repair" for the purposes of the *RSLA* will depend on the facts of each case. For example, courts have held that software development and integration and the installation of a new locking system can be a "repair," while the installation of a new sound system in a car cannot.

13. Storers

A "storer" is defined in the *RSLA* as a person who receives an article for storage, or storage and repair, on the understanding that the person will be paid for the storage or storage and repair, as the case may be.

14. Articles

The *RSLA* applies only to "articles," which is defined to be tangible personal property other than fixtures. "Fixtures" is not defined in the *RSLA*. Repairers of fixtures may be entitled to a lien under the *Construction Lien Act*.

15. Overlap with the Consumer Protection Act, 2002

For repairs of "vehicles," as defined in the *Highway Traffic Act*, made pursuant to agreements for repairs entered into on or after July 30, 2005, a repairer must ensure that it is in compliance with the requirements of the *Consumer Protection Act, 2002* in order to have a valid claim for repairs.

16. The RSLA lien

16.1 Possessory liens

The *RSLA* creates two types of lien:

- the possessory lien; and
- the non-possessory lien.

The possessory lien entitles the repairer or storer to retain possession of the article until the lien amount has been paid.

16.2 Priority

A possessory lien under the *RSLA* has priority over the interests of all other persons in the article, including properly perfected security interests under the *PPSA* pursuant to s. 6 of the *RSLA* and s. 31 of the *PPSA*.

Section 6 of the *RSLA* provides that a possessory lien has priority over the interests of all other persons in the article. Section 31 of the *PPSA* provides that where a person in the ordinary course of business furnishes materials or services with respect to goods that are subject to a security interest governed by the *PPSA*, any lien that the person has in respect of the materials or services furnished has priority over a perfected security interest, unless the Act that creates the lien provides that such lien does not have such priority.

17. Non-possessory liens

17.1 Requirements to obtain a non-possessory lien

If the unpaid repairer or storer has given up possession of the article to the customer, it can still obtain a non-possessory lien in the article, pursuant to s. 7(1) of the *RSLA*. Subsection 7(1) provides that where an unpaid repairer or storer has given up possession of the article without having been paid in full, an unpaid repairer or storer who is entitled to a possessory lien under the *RSLA* may obtain a non-possessory lien against the article for the amount that remains unpaid.

In order to obtain a valid non-possessory lien under the *RSLA*, the unpaid repairer or storer must have

- a signed acknowledgment of the indebtedness pursuant to s. 7(5); and
- registered the lien claim as required under s. 10(1) of the *RSLA*.

The *RSLA* provides that a non-possessory lien is enforceable against third parties only if a claim for lien has been properly registered under the *PPSA* (ss. 9–10(1)). A non-possessory lien is registered by filing a Form 1C Financing Statement/Claim for Lien in paper form or electronically with the Ontario Ministry of Government Services in the same manner as a *PPSA* financing statement.

17.2 Priority

Subsection 7(3) of the *RSLA* provides that a non-possessory lien in an article has priority over the interest of any other person in the same article other than an unpaid repairer or storer who has a valid possessory lien in the article under the *RSLA*.

As between holders of a properly registered non-possessory lien claim and a validly perfected security interest under the *PPSA*, the non-possessory lien ranks in priority except in respect of any third party who has acquired rights against an article after the non-possessory lien arises but before the non-possessory lien was properly registered (*PPSA*, s. 10(1)).

17.3 Amount of lien

Unpaid repairers may only obtain liens for the unpaid principal amount of the repair and any reasonable costs and expenses associated with seizing and selling the article but not any interest on those amounts (*RSLA*, ss. 28(2)–(3)). Pursuant to s. 4(1)(b) of the *RSLA*, unpaid storers may include interest in their lien claim.

17.4 Bankruptcy

A properly obtained *RSLA* lien is treated as a secured claim in a bankruptcy, and therefore, its priority, like that of other secured claims, is not affected by a bankruptcy.

Part III: Enforcement of security

18. Introduction

The common law, the *PPSA*, *BIA*, and other applicable statutes govern the rights and obligations of a secured creditor and debtors. Generally, each step in the process of security enforcement is governed by rules of commercial reasonableness and reasonable notice of the secured creditor's intentions. If the secured creditor fails to meet the duties imposed upon it at any stage of the process, it may be liable to the debtor or others for damages.

Generally, there are six steps in the security enforcement process:

First, the loan and security documents of the secured creditor should be reviewed to ensure that the security has been properly granted and that the security interests have been properly registered or perfected in accordance with the *PPSA*, *Bank Act*, or other statute, as may be applicable, to give the secured creditor priority over the debtor's assets it intends to enforce.

Second, notwithstanding the provisions in a security agreement that may provide that demand is not required before a secured creditor can enforce its security, a secured creditor must demand repayment of its loans from the debtor before it can enforce its security against the assets of the debtor.

Third, pursuant to s. 244(1) of the *BIA*, if the debtor is insolvent and collateral granted to the secured creditor encompasses all or substantially all of the debtor's inventory, accounts receivable, or other property acquired for or used in relation to a business carried on by the debtor, the secured creditor must give 10 days' notice of its intention to enforce its security in a form prescribed by the *BIA*.

Fourth, the secured creditor must review the various remedies available to it to enforce its security and to take possession and control of the collateral. The secured creditor may obtain possession and control of the debtor's collateral directly; through a bailiff, agent, or privately appointed receiver; or through a court-appointed receiver and/or manager. Each of these persons is subject to certain statutory duties while in possession of the collateral.

Fifth, before selling or otherwise disposing of or foreclosing on the collateral subject to its security, the secured creditor must allow others an opportunity to redeem the indebtedness owing by the debtor to the secured creditor by providing written notice to the debtor, other secured creditors, and others with an interest in the collateral.

Lastly, in the disposition of the assets subject to its security, the secured creditor, its agents, or any receiver appointed by it must act in good faith and in a commercially reasonable manner.

In considering which remedy to use in the enforcement of its security, the secured creditor will consider a number of factors, including

- the nature and location of the collateral;
- the estimated realizable value of the collateral;
- whether any opposition from the debtor or any other creditor or interested person is anticipated;
- whether the court's assistance is required (to settle priority or value disputes or to provide a stay of proceeding);
- whether the business should continue to operate; and
- what costs and risks may be involved in continuing to operate the business and in the seizure and sale of the debtor's assets.

19. Making demand for repayment of the loan

19.1 The demand and s. 244 notice

19.1.1 The common-law requirement for reasonable notice

Whether the indebtedness is payable on demand or pursuant to a term loan, the first step to enforcing security is for the secured creditor to demand payment from the debtor. This is because the common law requires that reasonable notice be provided to the debtor to pay the indebtedness owed to the secured creditor before the secured creditor is entitled to proceed with enforcement of its rights. This right of the debtor to reasonable notice is independent of the loan or security agreement and therefore is required regardless of whether the loan or security agreement requires that demand be made or contains any waiver of demand or notice. The principle behind reasonable notice is to give the debtor an opportunity to cure the default, redeem the loans, or initiate a restructuring of its debts.

19.1.2 The s. 244 BIA requirement for notice

If the debtor is insolvent and the collateral granted to the secured creditor encompasses all or substantially all of the debtor's inventory, accounts receivable, or other property used in relation to a business carried on by the debtor, s. 244(1) of the *BIA* requires that the secured creditor must give 10 days' notice to the debtor of its intention to enforce its security in a form prescribed by the regulations (s. 244 notice). If there is any chance that the debtor is insolvent or that the collateral covered by the secured creditor's security constitutes all or substantially all of the inventory, accounts receivables, or other property of the insolvent person, a s. 244 notice should be sent. The consequences of failing to give the notice could be material if the debtor ceases operations as a result of an improper enforcement.

When the s. 244 notice is served on the debtor, the secured creditor is prohibited from taking any further steps in the enforcement of its security for the 10-day notice period. There is some issue about whether issuing notices of a secured creditor's intention to sell the property of the debtor subject to its security pursuant to the *PPSA* or any other applicable statute constitutes a "step" in the enforcement of its security. The general practice for secured creditors is to refrain from issuing such notices during this 10-day notice period.

Similar to the common-law requirement for reasonable notice, the s. 244 notice overrides any provision in loan and security agreements that may authorize the secured party to enforce its security and/or appoint a receiver immediately following default without notice of any kind to the debtor.

19.1.3 Exemptions from s. 244 notice

In certain circumstances, the *BIA* provides that secured creditors may enforce their security without waiting the 10 days. These exemptions include the following:

- The debtor has filed a proposal under the *BIA* that does not include that particular secured party.
- The class of secured creditors to whom a proposal is made has voted against a proposal.
- A receiver has been appointed by the court or another creditor.
- The debtor has consented to the earlier enforcement of the security but only after the s. 244 notice has been delivered to the debtor (ss. 244(3)–(4)).

Notice is also not required if the debtor is bankrupt. The requirement under s. 244(1) only applies to an insolvent person, which is defined in the *BIA* to expressly exclude a bankrupt. Clearly, if the debtor is bankrupt, the rationale for giving notice has become moot.

19.1.4 Contractual notice periods or other pre-conditions to enforcement

In addition to the common-law and statutory notice periods, the loan agreement, security documents, or inter-creditor agreement (if applicable) may also contain additional contractual rights of notice or conditions before the secured creditor is entitled to exercise its rights of enforcement. For example, if the indebtedness arises pursuant to a term loan and maturity has not yet occurred, the secured creditor will have to establish that an event of default has occurred under the loan agreement before being entitled to demand payment of the term loan.

Loan and security agreements may also give the debtor certain rights to "cure" defaults under the loan and/or security agreements after notice of default has been given by the lender. If the secured creditor intends to rely on these defaults, it must first wait until the curative periods have expired before demand can be made.

Sometimes the secured creditor's conduct can affect its entitlement to demand. For example, a secured creditor may be found to have impliedly agreed not to demand payment in the particular circumstances during the course of negotiations or discussions with the debtor leading up to the demand. In order to avoid any unintended consequences, it is recommended that a secured creditor who is negotiating with a debtor in these circumstances make it clear that the secured creditor is reserving all of its right and remedies, notwithstanding any negotiations or discussions; that any delay from proceeding with any such rights and remedies during such negotiations or discussions does not constitute a waiver of those rights; and that those rights and remedies are expressly reserved.

19.2 Reasonable notice

The 10-day notice period under s. 244(1) of the *BIA* appears to be an attempt to codify the common-law requirement for reasonable notice. In most cases, compliance with the requirements under s. 244(1) of the *BIA* will be sufficient to satisfy the common-law "reasonable notice obligation" with respect to insolvent debtors. In these cases, the secured creditor would concurrently deliver the demand with the s. 244 notice so that both notice periods run simultaneously.

However, s. 244(1) does not expressly override the common-law requirement for reasonable notice. As a consequence, if the debtor is not insolvent or if other special circumstances exist, a secured creditor may be required to provide more than the 10 days prescribed by s. 244(1).

What is sufficient reasonable notice will depend on the particulars facts in each case. Generally, reasonable notice is for a short period. In some cases, the common-law requirement for reasonable notice may even be less than the statutory 10-day period required by the *BIA*; for example, where the secured creditor has a justifiable concern about the dishonesty of the debtor or the collateral being dissipated.

Because the requirement for reasonable notice is dependent on the particular facts of each case, it is important for the secured creditor to review the circumstances prior to demanding and enforcing its debt and security against the debtor to determine whether the circumstances warrant a longer notice than the 10-day period required under s. 244(1) of the *BIA*.

19.3 Interim receivers

19.3.1 General

In certain cases, a secured creditor may seek to abridge the 10-day notice period required under s. 244 by seeking the appointment of an interim receiver under s. 47(1) of the *BIA*.

19.3.2 Pre-conditions to appointment

In order for the court to appoint an interim receiver, the court must be satisfied of all the following:

- The debtor is an insolvent person as defined in the *BIA*.
- A s. 244 notice has been or is about to be sent to the insolvent debtor (s. 47(1)).
- The appointment of the interim receiver is necessary for the protection of
  - the debtor's estate; or
  - the interests of the creditor who sent or is about to send the s. 244 notice (s. 47(3)).

19.3.3 Powers of the interim receiver

Interim receivers can be granted broad powers similar to those of a receiver appointed under the *Courts of Justice Act* (*CJA*). Interim receivers can be authorized to take possession of a debtor's assets and can be granted extensive rights and powers to investigate, locate, preserve, protect, and seize assets. The 2009 *BIA* Amendments now limit the length of time that an interim receiver may be appointed; in most cases, the limit is 30 days.

The court may appoint an interim receiver of all or any part of the property to which the s. 244 notice relates (*BIA*, s. 47(1)).

As the court considers advisable, the interim receiver may be empowered by the court to take possession or

control of the property or exercise such control of the property (s. 47(2)).

Prior to the 2009 *BIA* Amendments, the appointment of interim receivers was very common, because the *BIA* is a federal statute and, accordingly, an interim receiver appointed under the *BIA* had full authority across the country as compared to receivers appointed under provincial statute, which unless recognized by courts in another province, had no authority in those other jurisdictions. In addition, Quebec did not recognize receivers appointed under any other provincial law. Thus, creditors would often seek to appoint an interim receiver where the debtor had assets in multiple jurisdictions across Canada. However, despite being called "interim," the typical duration of an interim receivership was not short. The prevalence of interim receiverships is expected to decline as a result of the ability of the court to now appoint a receiver under the newly amended s. 243 of the *BIA* and because of the new limitations on interim receiverships under the *BIA*.

19.4 Section 243 receivers

Recent amendments to s. 243 of the *BIA* now provide for the court to appoint a receiver in respect of an insolvent person or bankrupt, with national authority, if it considers it just and convenient to do so.

19.4.1 Powers of s. 243 receivers

The powers of the s. 243 receiver are similar to the powers of a receiver appointed under the *CJA*. The s. 243 receiver may take possession of all or substantially all of the inventory, accounts receivable, or other property of an insolvent person or bankrupt that was acquired for or used in the course of that person's business; the receiver may exercise control over that property that the court considers advisable and take any other action that the court requires.

Because the only requirements for the appointment of a s. 243 receiver are that (a) the debtor be an "insolvent person" or bankrupt, and (b) the appointment is, in the view of the court, just and convenient, it is expected that s. 243 receivers will replace interim receivers in many situations where interim receivers would have been appointed prior to the 2009 *BIA* Amendments.

20. Taking possession

A security agreement typically contains a right of seizure and sale in favour of the secured creditor upon default by the debtor. Even if the agreement does not expressly provide for this remedy (as long as it is not expressly excluded), the right of seizure and sale is also granted to the secured creditor under statute. Typically, security agreements will provide that the secured creditor has, in addition to the listed rights and remedies, all remedies otherwise available to it under the law. Clause 62(a) of the *PPSA* provides that a secured party has, unless otherwise agreed in the security agreement, the right to take possession of the collateral by any means permitted by law and to dispose of the collateral in accordance with s. 63 of the *PPSA*.

A secured creditor can obtain possession of collateral subject to its security in various ways. For example, the collateral can be seized

- by the secured creditor directly;
- by a bailiff or agent appointed by the secured creditor; or
- through a receiver or receiver-manager appointed privately by the secured creditor under its security agreement (if so permitted by the security agreement) or by the court.

20.1 Self-help remedies

A secured creditor can also simply seize the collateral subject to its security itself. Typically, this "self-help" mechanism is used where the security is only over specific collateral (i.e., specific equipment). The secured creditor simply obtains possession of the collateral and sells it. This self-help remedy only works where the debtor is co-operative and does not seek to resist seizure of the collateral by the secured creditor.

Even if a secured creditor exercises the self-help remedy, it is still subject to various statutory duties, such as the duty to act in a commercially reasonable manner in respect of its possession and sale of the debtor's assets under the *PPSA* (s. 17) and *BIA* (s. 247(b)). In certain cases, a secured creditor acting by itself may also be considered to be a "receiver" for the purposes of the *BIA* and therefore subject to certain reporting and other obligations.

20.2 Bailiff or agent

Instead of seizing the collateral itself, a secured creditor may chose to appoint an agent, such as a bailiff or an accounting firm that provides insolvency and receivership services, to assist it in seizing and realizing upon all or part of the collateral charged by the security agreement.

20.3 Interim order for possession

Where a debtor is not co-operative and resists seizure of the collateral by the secured creditor or its agent, the secured creditor may obtain the court's assistance by way of a motion pursuant to s. 104 of the *CJA* and R. 44 of the *Rules of Civil Procedure* for an interim order for recovery

of possession. The motion is usually brought on notice to the debtor, but in certain circumstances, such as where the collateral is perishable or rapidly depreciating in value or where damage is likely to occur, the secured party may be able to obtain the order on an *ex parte* basis, without notice to the debtor. Because the interim order for possession is an interlocutory order, the court may require the secured creditor to pay into court or post a bond for an amount up to twice the value of the collateral.

20.4 Receivership

Typically, where the collateral comprises more than just specific pieces of collateral, such as all or substantially all of the assets of a debtor, a secured creditor will choose to enforce its security by either appointing a receiver or receiver-manager pursuant to the terms of the security agreement or seeking the court's appointment of an interim receiver, s. 243 receiver, or receiver-manager. The receiver is required to be a licensed trustee-in-bankruptcy. A receiver does not carry on the business; a receiver-manager does.

21. Foreclosure

As an alternative to disposing of the assets subject to the secured creditor's security, a secured creditor may choose to "foreclose" against the assets of the debtor—that is, to take the assets in full satisfaction of the indebtedness owed to it by the debtor.

Section 65 of the *PPSA* sets out the procedure for accomplishing a foreclosure against the debtor's assets. Subsection 65(2) of the *PPSA* states that the secured party must first give 30 days' notice of the proposed foreclosure to all those persons who would otherwise be entitled to receive a notice of sale under s. 63 of the *PPSA*. If no objection is made within that 30-day notice period, s. 65(6) provides that the secured party is deemed to have irrevocably elected to accept the collateral in full satisfaction of the obligation secured. This means that after the foreclosure takes place, the secured creditor has no residual right left to sue the debtor for any part of the indebtedness owed to it that was secured by the collateral.

If a person has properly objected to the retention of the collateral within the 30-day notice period and has provided proof of his or her interest in the collateral in accordance with s. 65(4), the secured party cannot retain the collateral and must proceed to sell it in accordance with s. 63 of the *PPSA*.

A secured creditor's right to foreclose against "consumer goods" (as defined in s. 1 of the *PPSA*) is limited by s. 65(1). "Consumer goods" are goods that are used or acquired for use primarily for personal, family, or household purposes. Subsection 65(1) provides that the creditor may not foreclose where the debtor has paid at least 60% of the indebtedness and has not agreed to any modification or renouncement of his or her rights under Part V. In those circumstances, the creditor must dispose of the collateral in accordance with s. 63.

22. Receivership

22.1 Private receiverships

22.1.1 Powers

A secured creditor is only able to appoint a receiver or receiver-manager if its security agreement contains the right to do so. A privately appointed receiver has the rights assigned to it in its appointment letter. Those rights are dependent on the rights granted by the debtor to the secured creditor in the security agreement under which the appointment is made. A privately appointed receiver takes its instructions from the secured creditor who appoints it.

22.1.2 Appointment letter

The process for the appointment of a receiver is simple. A secured creditor can appoint a private receiver by way of an appointment letter. That appointment letter will typically

- state that default(s) has (have) occurred under the security agreement;
- appoint the receiver under the security agreement to exercise all or only certain of the rights contained under the security agreement;
- set out over which assets of the debtor the receiver is being appointed (even though the secured creditor's security may charge all of the debtor's assets, the appointment letter may not necessarily apply to all of those assets);
- set out whether the receiver is to carry on the debtor's business or take possession of all or certain of the debtor's assets; and
- contain an acceptance by the receiver of the appointment signed by the receiver.

22.1.3 Indemnity of receiver

In most cases, a privately appointed receiver will not accept an appointment without an indemnity from the secured creditor, indemnifying the receiver against all costs and liabilities incurred by it while acting as receiver, save and except for negligence and misconduct. This indemnity can be contained in the appointment letter itself or, more typically, is set out in a separate document to preserve confidentiality since the receiver, as evidence

of its appointment, often provides the appointment letter to third parties.

22.1.4 Duties of a secured creditor or receiver under the PPSA while in possession

(a) Reasonable care

Once possession has been obtained, the secured creditor (which for the purposes of the duties under the *PPSA* includes its agent or privately appointed receiver) is subject to the duties of care under the *PPSA*. For example, s. 17(1) of the *PPSA* provides that the secured creditor must use "reasonable care" in the custody and preservation of collateral in its possession.

The secured party is entitled to deduct its reasonable expenses of realization from the amounts collected.

Failure to comply with any of the obligations under s. 17 will render the secured creditor liable for any loss or damage caused by such failure (ss. 17(3) and (5)).

(b) No contracting out/waiver

Pursuant to s. 59(5), the debtor cannot waive the provisions of ss. 17 and 63–66 of the *PPSA*.

(c) Commercially reasonable manner

In connection with the disposition of the collateral by the secured creditor, the secured creditor also has duties imposed on it by s. 63 of the *PPSA*. The debtor cannot waive the duties imposed by s. 63.

Pursuant to s. 63(2), a secured creditor may dispose of the collateral by public sale, private sale, lease, or otherwise so long as every aspect of the disposition is "commercially reasonable." Although security agreements may contain agreements by the debtor and secured creditor as to what will constitute a commercially reasonable disposition by the secured creditor, a court is not bound by such agreement.

The *PPSA* does not define commercial reasonableness, so reference to the case law must be made to determine

- how the courts have interpreted the standards having regard to the facts; and
- the particular circumstances in each case.

Generally, the courts will look to the following factors:

- Did the secured creditor act in good faith, based on a subjective standard?
- Was reasonable care exercised by the secured creditor, based on an objective standard?
- Was the purchase price close to the fair market value of the collateral, as established by independent appraisal evidence?

To establish that fair market value was obtained for the collateral, a creditor should obtain at least two independent appraisals of the collateral. If the appraisals are materially different in terms of valuation, a third appraisal should be obtained.

The secured creditor should also ensure that the collateral is properly marketed and advertised in appropriate trade or industry publications and newspapers to obtain the best possible price for the collateral.

(d) Requirement to undertake reasonable repairs

A secured creditor may be required to undertake reasonable repairs to the collateral if such repairs will enhance the value of the collateral on disposition. Subsection 63(1) of the *PPSA* provides that a secured creditor may dispose of any of the collateral in its possession either before or after any commercially reasonable repair, processing, or preparation for disposition. The case law suggests that failure to undertake repairs before disposition that would have resulted in a substantially higher sale price may result in a determination that the sale was not a commercially reasonable sale.

(e) Requirement to give notice of disposition of collateral

(i) Requirement to give notice

Before a secured creditor is entitled to sell the collateral, it must first give notice of the intended disposition of the collateral (commonly referred to as a "*PPSA* notice of disposition") to the debtor and other interested parties set out in the *PPSA* in order to give the debtor and others entitled to notice one last opportunity to redeem the indebtedness secured by the collateral before the collateral is sold by the secured creditor.

(ii) Who is entitled to receive notice

Subsection 63(4) of the *PPSA* identifies those who are entitled to notice from the secured party, being

- the debtor;
- any owner of the collateral;
- any person who owes payment or performance of the obligation secured, including guarantors;
- any person who has a perfected security interest in the collateral under the *PPSA;* and
- every person with an interest in the collateral who has delivered a written notice to the secured party of his or her interest.

(iii) Notice period and content of notice

The notice must be given not less than 15 days prior to disposition of the collateral. The notice of disposition can be served on the debtor personally or by registered mail (ss. 68(1)–(2)). Pursuant to s. 68(4) of the *PPSA*, if the notice is sent by registered mail, the recipient is deemed to have received the notice 10 days following the mailing, resulting in a 25-day notice period.

Subsection 63(5) of the *PPSA* sets out what information must be contained in the notice, including the amount required to pay out the secured creditor and redeem the collateral.

(iv) Waivers and exemptions from notice

The debtor cannot contract out of its statutory right to receive notice and opportunity to redeem (s. 59(5)). However, s. 63(7) of the *PPSA* sets out certain situations where a notice of disposition is not required to be delivered. For example, notice is not required where the collateral is perishable or will decline "speedily in value" or if a receiver is disposing of the collateral in the course of carrying on the debtor's business. In addition, s. 63(7)(f) provides that notice may be dispensed with if every person entitled to receive a notice under s. 63(4), including the debtor, consents in writing to the immediate disposition of the collateral.

(v) Special notice required for fixtures and accessions

If the secured creditor needs to remove fixtures from real property or accessions from other property before sale or foreclosure, the secured creditor must satisfy the special notice and other requirements under the *PPSA*.

Pursuant to s. 34(5) of the *PPSA*, a secured creditor must provide at least 10 days' written notice of its intention to remove a "fixture" from real property. A "fixture" is not defined in the *PPSA*, and reference to case law would be required to determine whether specific collateral constitutes a fixture for the purposes of s. 34(5).

The notice of removal of fixtures is to be provided to each person who appears on the records of the proper land registry office to have an interest in the real property. The content of the notice is specified under s. 34(5).

The secured creditor must reimburse any encumbrancer or owner of the real property (other than the debtor) for the cost of repairing any physical injury caused by removal and may be required to give "adequate security" for the secured creditor's reimbursement obligation (ss. 34(3)–(4)). The obligation to reimburse does not include any diminution in value of the real property caused by the absence of the fixture nor the cost of any replacement (s. 34(3)). Any person with an interest in the real property can retain the fixture by paying the secured creditor the indebtedness secured by the security interest (s. 34(7)).

Similarly, if any of the collateral constitutes an accession (as defined in s. 1(1)), s. 35(6) of the *PPSA* requires at least 10 days' notice of the secured creditor's intention to remove an accession.

The secured creditor's rights and obligations regarding removal and reimbursement for the cost of repairing any physical injury, as well as the contents of the required notice are similar to those relating to fixtures under s. 34 (see ss. 35(4) and (8)).

(vi) Consequences of non-compliance with notice requirements

If a secured creditor sells the assets of the debtor without providing notice in accordance with the *PPSA*, the debtor or anyone else with an interest in the collateral may hold the secured creditor liable for any damages or loss suffered by that person as a consequence of the non-compliance (s. 67(2)). In spite of any non-compliance, a *bona fide* purchaser for value will still obtain clear title to the collateral. Subsection 63(10) of the *PPSA* provides that a

- purchaser for value of the assets in a public sale without knowledge of the defect in the sale and without collusion with the secured creditor, other bidders, or the person conducting the sale; and
- purchaser in good faith for value in the case of a disposition other than by public sale

obtain the assets free and clear of the secured party's security interest, all subordinate security interests, and the debtor's interest.

(f) Delay of disposition

A secured creditor is not obligated to delay disposition of a debtor's assets until market conditions improve. Subsection 63(3) of the *PPSA* provides that a secured creditor may delay disposition of all or part of the collateral for such period of time as is "commercially reasonable." Although there may be circumstances when an immediate sale of security could be commercially unreasonable (such as when the secured creditor has not taken sufficient time to properly market the collateral for sale), the courts have not required secured creditors to delay disposition of collateral until poor market conditions improve and instead have given precedence to a secured creditor's right to be repaid immediately.

(g) Purchase by secured creditor

Under the *PPSA*, a secured creditor can only purchase the collateral itself at a public sale, unless the court orders otherwise (s. 63(8)). This restriction helps to ensure the most value can be obtained for the collateral.

(h) Duty to carry on the debtor's business

There is no obligation at common law or under the *PPSA* that requires a secured creditor to continue to operate an insolvent business. It would also not be commercially reasonable to force a secured creditor to assume the liabilities that arise in carrying on a debtor's business.

22.1.5 Duties under the BIA

In addition to the *PPSA*, the *BIA* also sets out certain statutory duties for secured creditors and receivers, both privately appointed and court appointed.

(a) Definition of "receiver" under the BIA

A "receiver" is defined in s. 243(2) of the *BIA* to be any person who has been appointed to take, or has taken, possession or control pursuant to a security agreement or order of a court of all or substantially all of an insolvent person or bankrupt's inventory, accounts receivable, or other property used in the debtor's business. The definition of receiver contained in the *BIA* is so broad that it includes a secured creditor or its agent who takes possession or control of such property; however, pursuant to the newly added s. 243(4), only a licensed trustee-in-bankruptcy may be appointed as a receiver.

(b) Duty to act honestly, in good faith, and in a commercially reasonable manner

Paragraph 247(a) of the *BIA* imposes a general duty of good faith on a receiver, requiring that a receiver "act honestly and in good faith."

Paragraph 247(b) of the *BIA* requires that a receiver deal with the property of the insolvent person or the bankrupt in a "commercially reasonable manner." The standard of "commercial reasonableness" is the same standard imposed on secured creditors and receivers under the *PPSA* but is now coupled with an overriding obligation to also act in "good faith."

(c) Reporting obligations under the BIA

(i) General obligation to give notice

A receiver's accountability to other creditors, the debtor, and the Superintendent of Bankruptcy is highlighted by the requirements under the *BIA* to provide notice to those interested persons of the receiver's appointment and information relating to the administration of the receivership.

As soon as possible and no later than 10 days after its appointment, the *BIA* requires a receiver to report its appointment to the Superintendent of Bankruptcy. If the debtor is bankrupt, the receiver must also send a notice to the trustee-in-bankruptcy. If the debtor is not bankrupt, the receiver must also send a notice of its appointment to the insolvent person and to all creditors of the insolvent person that the receiver can identify after reasonable diligence (s. 245(1)).

After the initial notice, a receiver continues to have ongoing obligations to provide notice to any additional creditor of the debtor of whom it becomes aware at any point during the receivership (s. 245(2)). A receiver can obtain some assistance in this task from the insolvent debtor, who is required under s. 245(3) of the *BIA* to provide the receiver with the names and addresses of all creditors upon receipt of the receiver's notice of appointment.

(ii) Receiver reports

Immediately after taking control or possession of an insolvent debtor's assets, a receiver is required to prepare a statement or report in the prescribed form setting out the name and amount owing to each creditor, a list of the property in the possession or under the control of the receiver and the book value of each item, and the receiver's intended plan of action during the receivership. A copy of this initial statement is to be provided by the receiver to the Superintendent of Bankruptcy, the insolvent person (or trustee in the case of bankruptcy), and any creditor of the insolvent person/bankrupt who requests a copy at any time up to six months after the end of the receivership (*BIA*, s. 246(1); *Bankruptcy and Insolvency General Rules* (*BIA Rules*), s. 125).

At least once every six months after the preparation of the initial report, a receiver is required to prepare and send a copy to the same persons entitled to the initial report, an interim report setting out an interim statement of receipts and disbursements, all property that still remains under the receiver's possession or control, and information about the anticipated completion of the receivership (*BIA*, s. 246(2); *BIA Rules*, s. 126)).

Upon completion of its duties as receiver, a receiver must prepare a final report and statement of accounts setting out the final statement of receipts and disbursements and details concerning the distribution of proceeds (*BIA Rules*, s. 127; *BIA*, s. 246(3)). Copies are to be sent to the same persons entitled to receive the initial and interim reports.

Within 6 months after a copy of the statement of accounts is provided to the Superintendent of Bankruptcy, any person entitled to a copy of the final

statement of accounts may apply to the court for review of the statement of account (s. 248(2)). The court may require a receiver to submit the statement of accounts for review, and the court may adjust, as it deems proper, the fees and charges of the receiver set out in such statement of accounts. Court-appointed receivers are exempted from this requirement pursuant to s. 243(3), but the typical receivership appointment order will almost always contain a duty to submit its account to the court for review before its discharge.

22.1.6 Court directions

Because they are officers of the court, court-appointed receivers can easily obtain the directions and advice of the court with respect to certain controversial actions proposed to be taken by the receiver. Even though privately appointed, a private receiver is able to obtain the benefit of the court's advice and directions pursuant to s. 67 of the *PPSA*. That section provides that a receiver may apply for directions regarding the exercise of the receiver's rights or the discharge of the receiver's obligations under Part V, s. 17, 34(3), or 35(4) of the *PPSA*.

In addition, secured creditors and privately appointed receivers may protect themselves by seeking the court's advice and directions with respect to the fulfillment of their duties under the *BIA* pursuant to s. 248(1) of the *BIA*.

22.1.7 Review powers of the court

Pursuant to s. 248(1) of the *BIA,* the Superintendent of Bankruptcy, insolvent person (or trustee in the case of bankruptcy), receiver, or creditor may, on an application to the court, require a review of the actions of a secured creditor, receiver, or insolvent person to determine if the receiver or insolvent person has satisfied its duties under ss. 244–247 of the *BIA* (s. 248(1)). Note that the court's powers of review extends to secured creditors even if they do not qualify as receivers under s. 243(2) of the *BIA*.

If the court is satisfied that the secured creditor, receiver, or insolvent debtor is not complying with the duties under ss. 244–247, the court may make an order

- directing that the duty be carried out; or
- restraining the secured creditor or receiver, as applicable, from taking any steps to realize or otherwise deal with the property of the insolvent person until the receiver or secured creditor complies with the relevant duty.

22.2 Court-receiverships

22.2.1 When are court-appointed receivers appropriate

In certain cases, even though a secured creditor has the contractual power to appoint a private receiver, it may be more appropriate or effective in the circumstances for the secured creditor to seek the appointment of a court-appointed receiver. A court appointment of a receiver may be considered to be advantageous in the following circumstances:

- The debtor has assets located outside of Canada: Foreign courts are much more likely to recognize the authority of a court-appointed receiver than a privately appointed receiver. Note that a receiver appointed under s. 101 of the *CJA* is appointed under provincial statute and, therefore, does not have authority in other provinces unless recognized by the relevant court in each province. Quebec courts will not recognize the authority of court-appointed receivers appointed under provincial statute. A receiver or interim receiver appointed under the *BIA* has national authority.
- There is a benefit to obtaining a stay of proceedings: A stay will restrain the exercise of a landlord's right of distress or its right to terminate a lease. The stay of proceedings would also prevent creditors from exercising remedies unless with leave of the court and would also prevent other parties from terminating agreements and contracts with the debtor. Generally, to be granted leave, the party seeking leave will need to establish that it is being uniquely prejudiced by the stay and/or there will be no material prejudice to the debtor or its stakeholders as a result of lifting the stay.
- The court's supervision is beneficial to resolve disputes between different parties as to priority, value of the assets, and/or the appropriate path of realization: Since every step of the realization is court-supervised, a court receiver will provide a forum for court resolution of these types of disputes.
- The operation of the debtor's business may expose a receiver to certain liabilities: A court appointment may insulate the receiver from liabilities, such as environmental and/or labour-related issues.
- A quick sale of the debtor's assets is necessary: A court receivership will usually avoid having to comply with statutory notice provisions.
- The debtor and secured creditor dispute whether there has been an event of default entitling the secured creditor to appoint a receiver.

22.2.2 The appointment and types of court receivers

A secured creditor can seek the appointment by the court of a receiver under s. 101 of the *CJA* if it is "just or

convenient" to do so; an interim receiver pursuant to s. 47(1) of the *BIA*; or, since the 2009 *BIA* Amendments, a receiver under s. 243 of the *BIA*. For the appointment of a *CJA* receiver, the court must conclude that an order to appoint is just or convenient in light of the interests of all affected parties, such as where the property is at risk or where a privately appointed receiver is unable to enforce its security because the debtor refuses to surrender possession of its property to the secured creditor or where the security agreement does not provide the privately appointed receiver with adequate powers in the circumstances. Even when a secured creditor is already in possession or there is a right of appointment of a receiver under the security agreement, a court may still exercise its discretion to appoint a receiver where the court is satisfied that the court's supervision and/or assistance is necessary to preserve the value of the property.

22.2.3 Powers of a court-appointed receiver

(a) General

A court-appointed receiver is an officer of the court. It derives its powers solely from the court's order and takes its directions and instructions from the court and not the creditor who sought its appointment.

(b) Standard template receivership order

The powers given to a court-appointed receiver are normally quite broad. To standardize and scale back the scope of such orders, the Commercial List Users' Committee of the Ontario Superior Court of Justice has developed a Standard Template Receivership Order. Counsel for the applicant seeking the court's appointment of a receiver is expected to provide the court with a black-lined version of the form of receivership appointment order being requested to show what changes are being requested that deviate from the Standard Template Receivership Order.

The Standard Template Receivership Order includes the following powers of a court-appointed receiver:

- receive, preserve, protect, and maintain control of the debtor's assets;
- manage, operate, and carry on the business of the debtor with powers to enter into any agreements or cease to perform any contracts of the debtor;
- engage consultants, experts, counsel, and other persons;
- purchase or lease equipment, inventories, supplies, or other assets;
- settle, extend, or compromise any indebtedness owing to the debtor;
- initiate, prosecute, and continue the prosecution of proceedings and settle or compromise any such proceedings;
- market any or all of the debtor's assets, including advertise and solicit offers in respect thereof;
- sell, convey, transfer, lease, or assign any of the debtor's assets out of the ordinary course of business, with or without court approval depending on the purchase price; and
- convey any of the debtor's assets to purchasers, free and clear of any liens or encumbrances.

22.3 Personal liabilities of receivers

22.3.1 General

The standard appointment order for a court-appointed receiver will almost always contain a first ranking court-ordered "receiver's charge" over the debtor's assets to secure the fees, expenses, and liabilities incurred by the receiver during the court-ordered administration of the receivership. This receiver's charge will typically take precedence over existing security interests over the debtor's assets. Notwithstanding the receiver's charge, a court-appointed receiver, like a privately appointed receiver, will normally also require an indemnity from the creditor who sought its appointment to protect itself in the event that the assets subject to the receiver's charge are not sufficient to cover its potential liabilities, since it is the creditor who appoints the receiver and accordingly it is the creditor who ensures that the receiver's fees get paid. Such an indemnity will typically exclude any liability incurred by the receiver as a result of the receiver's gross negligence or wilful misconduct.

It is through these indemnities that receivers expose secured creditors to the risks and liabilities that may be incurred by a receiver. The two most common areas of concern for receivers are in the areas of labour and employment law and environmental law.

22.3.2 Labour issues and successor employer liabilities

(a) General

If a trustee-in-bankruptcy or receiver carries on the business of a debtor or bankrupt and seeks the assistance of any of the employees of the debtor or bankrupt, the trustee or receiver may be at risk of being found to be a successor employer for the purposes of the various employment-related legislation. The monetary consequences of a finding of successorship can be significant. Successor employer obligations can render trustees and receivers liable for such obligations as vacation pay, termination and severance obligations, and

perhaps most significantly, pension plan obligations, all of which can add up to be in the millions of dollars.

(b) Successor employer liabilities for non-unionized businesses

In Ontario, the *Employment Standards Act, 2000* (*ESA*) governs the employment relationship between employers and non-unionized employees. The definition of "employer" in the *ESA* includes a "receiver" and "trustee." If the trustee or receiver sells the business, the buyer of the business would be a successor employer and would assume those obligations. The concern arises when the trustee or receiver cannot find a buyer for the business. The trustee or receiver does not want to be considered to be a successor employer during the period that it operated the debtor's business.

The Employment Standards Branch has, for the most part, alleviated this concern by clarifying its policy in connection with the treatment of trustees and receivers under the *ESA*. The branch has stated that a trustee or receiver-manager who continues the business of a debtor with a view to seeking a going-concern sale will not be considered by the branch to be a successor employer in the event that no sale is completed and the business is ultimately liquidated, as long as the time period that the business is being operated by the trustee or receiver is reasonably short in length. The longer employees are retained and the trustee or receiver operates the business before the decision is made to liquidate, the higher the risk that the branch may find that the business was not being operated with a view to selling the business.

Employees who are retained by the trustee or receiver are generally retained on the basis of "term and task" letters that expressly set out the terms of short-term employment and the limited liability of the trustee and receiver.

(c) Successor employer issues for unionized businesses

In Ontario, the *Labour Relations Act, 1995* (*LRA*) governs labour relations where there is a unionized workforce. Under s. 69 of the *LRA*, any person to whom a business is "sold" by an employer is bound by any collective agreement between the employer and its employees. The definition of "sells" for the purpose of the section "includes leases, transfers and any other manner of disposition." The issue for trustees and receivers is whether the assumption of control of a business by a receiver can be considered a sale within the definition under the *LRA*.

Being found to be a "successor employer" where there is a collective agreement can have significant consequences to the receiver and the administration of a receivership. As a successor employer, a trustee or receiver will be personally responsible for complying with the collective agreement while it is operating the business, which could include having to compensate employees for the debtor's breaches of the collective agreement that arose prior to the receiver's appointment. Further, a receiver could be bound to honour generous termination and plant closure rights in a collective agreement.

Historically, relying on standard language in security agreements that provide that privately appointed receivers carrying on the business of a debtor do so as agent for the debtor and not as agent for the creditor, the Ontario Labour Relations Board (OLRB) and the courts have found that privately appointed receivers carrying on the business of a debtor do so as agent for the debtor and not as agent for the creditor. This interpretation served to effectively insulate privately appointed receivers from any claim that there had been a "transfer" of the business for the purposes of the *LRA*. However, the OLRB eventually found that substance prevailed over form and rejected the historical distinction between privately appointed and court-appointed receivers, finding instead that privately appointed receivers can be successor employers if they assume real and substantial control of a business.

By way of contrast, court-appointed receivers were historically seen not to be agents of the debtor but rather independent court officers and, accordingly, principals. However, court-appointed receivers have historically been insulated from liability by the court appointment order, which typically provided that no transfer of the business has taken place as a result of the appointment of a receiver and that the receiver is not a successor employer. This, combined with a requirement under s. 215 of the *BIA* for leave to be granted by the court in order for any proceedings to be commenced against a court-appointed receiver (for example by the OLRB), meant that court-appointed receivers could effectively be insulated from successor-employer liabilities. Recent court decisions have challenged the effectiveness of these procedures. These decisions found that the bankruptcy court that appointed the interim receiver does not have jurisdiction under the *BIA* to declare that an interim receiver is not a successor employer. Instead, the OLRB has the exclusive jurisdiction to decide the issue of whether someone is a successor employer. Further, the courts have found that a collective agreement does not terminate for all purposes on a bankruptcy and can bind a successor employer, which may include a receiver that takes over the business of the debtor. Lastly, the courts have found that the applicable standard for granting leave under s. 215 of the *BIA* to permit the union to seek

a declaration that a receiver is a successor employer is a relatively low standard. If the union is able to establish a *prima facie* case that is not frivolous or vexatious, leave should be granted. The courts have also noted that if Parliament wanted to protect receivers from being found successor employers it needed to do so expressly, through clear statutory language.

The effect of these decisions has been a general "chill" on court receiverships in circumstances where the debtor is subject to a collective agreement.

(d) Statutory protections

Because of concerns that existing provisions in the *BIA* intended to protect receivers and trustees-in-bankruptcy were not sufficient to adequately protect receivers and trustees from these kinds of employment-related liabilities, the 2009 *BIA* Amendments amended s. 14.06(1.2) to explicitly provide that, notwithstanding any federal or provincial law to the contrary, a "trustee" is not personally liable in respect of any liability, including successor-employer liability, that is in respect of employees or former employees, including pension plan obligations. The amended s. 14.06(1.1) of the *BIA* provides that for the purpose of this statutory protection, a "trustee" includes an interim receiver, a receiver appointed under s. 243(2), or any other person who has lawfully taken possession or control of the property of an insolvent person or bankrupt used to carry on the business of that insolvent person or bankrupt.

These amendments were intended by Parliament to address the residual issues over whether the previous provisions of the *BIA* were adequate to protect receivers from personal liability for employment-related liabilities and are generally considered by insolvency professionals to do so. However, since these amendments have only recently been proclaimed in force, these new provisions have not been tested before the courts. It is hoped that the 2009 *BIA* Amendments will revive the use of the receivership mechanism.

The statutory protections under the *BIA*, as amended by the 2009 *BIA* Amendments, are not absolute. Receivers continue to be personally liable for any liabilities that arise following their appointment, and accordingly great care must be taken with respect to decisions made that could create new liabilities, including with respect to labour and employment and environmental issues.

Finally, there are complex transition rules in connection with the 2009 *BIA* Amendments, and these should be reviewed carefully to determine whether the 2009 *BIA* Amendments apply to a particular trustee-in-bankruptcy or receiver.

22.3.3 Environmental issues

(a) General

A receiver and trustee-in-bankruptcy may encounter environmental issues arising from certain of the real property owned by the debtor or bankrupt during the course of the administration of a receivership or bankruptcy. Under the *Environmental Protection Act* (*EPA*), the receiver and trustee could be liable for environmental discharges and spills and other environmental conditions. The *EPA* imposes a broad range of liabilities on non-owners of the property. Under the *EPA*, liability is imposed on all "persons" who permit or control the source of pollution, regardless of when the pollution may have started. Therefore, by virtue of being in possession, a receiver or trustee may be ordered to repair damage due to discharges or spills that occurred during its possession of the property.

If a receiver or trustee takes possession of property that is contaminated, the receiver or trustee could become responsible for cleaning up the property even if the cost of doing so exceeds the value of the property.

In an effort to shield receivers and trustees from personal liability for environmental claims, the *BIA* was amended in 1997 to provide some protection for "trustees" in respect of environmental matters (ss. 14.06(1)–(6)).

(b) Protections from personal liability

Subsection 14.06(2) provides that a trustee is not personally liable for

- any environmental condition that arose or environmental damage that occurred before the date of the trustee's appointment; or
- environmental conditions or environmental damage that arose or occurred after the date of the trustee's appointment unless as a result of the trustee's gross negligence or wilful misconduct.

The *BIA* does not release the trustee of its obligations to make any report or disclosure required under federal or provincial legislation (s. 14.06(3)).

(c) Compliance with environmental remediation orders

Under s. 14.06(4) of the *BIA,* where an order is made requiring an environmental condition or damage on real property owned by a debtor to be remedied, the trustee has the following four options:

(1) comply with the order within 10 days of the order or, if the order existed prior to the trustee's appointment, within 10 days of its appointment (s. 14.06(4)(a)(i));

(2) on notice to the person who issued the order, abandon, dispose of, or otherwise release any interest in any real property affected by the condition or damage within 10 days of the order or, if the order existed prior to the trustee's appointment, within 10 days of its appointment (s. 14.06(4)(a)(ii));

(3) apply for a stay of the order for the purpose of contesting the order (s. 14.06(b)(i)); or

(4) apply for a stay of the order for the purpose of allowing the trustee to assess the economic viability of complying with the order (s. 14.06(b)(ii)).

If the trustee exercises options (1) or (2) above, the trustee will not be personally liable for failure to comply with the order or the costs that are or would be incurred by any person in carrying out the terms of the order. If the trustee exercises options (3) or (4) above, the trustee will not incur personal liability during the period of the stay granted. The trustee will also incur no personal liability if it had abandoned, renounced, or divested any interests in the real property affected by the environmental condition or damage before the order was made (s. 14.06(c)).

(d) Priority charge for remediation costs

Where the government has to remedy an environmental condition or environmental damage, s. 14.06(7) of the *BIA* provides that the cost of remedying the environmental condition or damage constitutes a first charge over the real property and any real property of the debtor that is contiguous to that property and that is related to the activity that caused the condition or damage. Receivers, like anyone else, are responsible for preventing the escape or discharge of pollutants from assets while such assets are in their control or possession.

22.3.4 Standard template receivership order — protections for receivership liabilities

In addition to setting out the powers of the receiver, the Standard Template Receivership Order also provides certain protections for the court-appointed receiver to insulate the receiver from personal liability for liabilities arising during the course of its administration of the receivership. For example, the Standard Template Receivership Order provides the following protections:

- No proceeding or enforcement process can be commenced or continued against the receiver without leave of the court.
- The receiver is not liable for any employee-related liabilities, including wages, severance pay, termination pay, vacation pay, and pension or benefit amounts, other than such amounts as the receiver may specifically agree or the court orders.
- The receiver is not required to occupy or to take control, care, charge, possession, or management of any of the real property of the debtor that might be environmentally contaminated. The receiver is not deemed to be in possession of any property within the meaning of any environmental legislation, unless it is actually in possession.
- The receiver shall incur no liability, save and except for any gross negligence or obligation as a result of its appointment or carrying out the provisions of the receivership appointment order or wilful misconduct on its part.

The Standard Template Receivership Order also expressly provides that nothing in the order shall derogate from the protections given to the receiver by s. 14.06 of the *BIA* or by any other applicable legislation.

22.4 Obligations and duties of court-appointed receivers

Privately appointed and court-appointed receivers are subject to the same statutory duties under s. 247 of the *BIA*.

Even though the creditor who sought its appointment may indemnify it, a court-appointed receiver is an officer of the court and, as a result, has a fiduciary duty not only to the creditor that sought the appointment but also to all creditors of the debtor's estate and to the debtor. A court-appointed receiver has a duty to act in the best interests of the creditors generally.

23. Enforcement of other types of security

In addition to *PPSA* security, a creditor may seek to enforce other types of security that it holds, such as *Bank Act* security or mortgages against real property.

The enforcement of these types of security is governed by the same principles of commercial reasonableness and reasonable notice that govern the enforcement of *PPSA* security.

23.1 Enforcement of Bank Act security

23.1.1 Power to sell

Subsection 428(7) of the *Bank Act* sets out the bank's power of sale remedy. That section provides that in the event of non-payment of any debt, liability, loan, or advance, the bank is allowed to sell the collateral, subject to its s. 427 security at auction, and to apply the proceeds of sale against the borrower's indebtedness.

23.1.2 Notice requirements

Subsection 428(8) of the *Bank Act* sets out the notice requirements, which include a requirement for at least 10 days' notice (at least a 30-day notice in the case of forest

products) to the debtor and publication of the notice in one or more newspapers.

23.1.3 Standard of care

As with secured creditors selling collateral under the *PPSA*, banks are also subject to certain minimum standards of care when enforcing their s. 427 security. These are set out in ss. 428(10)–(11) of the *Bank Act*.

Subsection 428(10) provides that "the bank shall act honestly and in good faith" and shall deal with the property in a timely and appropriate manner.

Similar to the *PPSA*, the obligation to act honestly and in good faith under s. 428(10) does not require a bank to realize the "true market value" of the goods subject to its security. The *Bank Act* contemplates that the bank could dispose of the debtor's assets by way of a "forced sale" or public auction even if such method does not yield as high a recovery as might be obtained under more ideal circumstances. A bank is still required to take into consideration any unique characteristics of the property and to deal with the property appropriately in order to maximize recovery.

23.1.4 Right to appoint receiver, etc.

The *Bank Act* permits banks to enter into agreements with the debtor that may provide for the appointment by the bank of monitors, receivers, and receiver-managers to assist the bank in its enforcement of its *Bank Act* security (s. 427(3)).

23.2 Enforcement of Mortgages Act security

A secured creditor may have both personal property and real property security, so it may attempt to concurrently pursue its remedies under both kinds of security.

Subsection 7(1) of the *Land Registration Reform Act* specifically provides that certain provisions of the *Mortgages Act* dealing with the enforcement powers of mortgages are deemed to be included in a charge, unless expressly excluded or varied.

The same principles of commercial reasonableness and reasonable notice apply to enforcement under the *Mortgages Act*. The same six-step process described above for *PPSA* security generally also applies to mortgage enforcement: first, review the security to ensure it is valid, enforceable, and properly registered in priority to all other interests in the real property; second, demand payment; third, if applicable, provide notice under s. 244 of the *BIA*; fourth, choose a remedy; fifth, provide notice of sale; and sixth, complete a commercially reasonable disposition.

23.2.1 Demands

Demand on the mortgagor prior to enforcement is generally required under most loan agreements and most guarantees (which may be secured by a collateral mortgage) that require payment of all outstanding amounts under the mortgage forthwith "after demand." Even if there is no express requirement for notice in the loan or mortgage documents, the common-law doctrine of reasonable notice would apply to require reasonable notice be given to the mortgagor before enforcement of the mortgagee's remedies.

23.2.2 The requirement for a s. 244 notice

If the real property constitutes all or substantially all of the assets or "other property" of the mortgagor, the mortgagee must provide the mortgagor with a s. 244 notice before enforcing on the mortgage security. As with the enforcement of *PPSA* security, whether additional notice over and above the 10-day notice period under the s. 244 notice is required depends on the facts of each case.

In addition, if the demand states a time for payment, s. 42 of the *Mortgages Act* prohibits the mortgagee from commencing any "further proceedings" during the demand period.

23.2.3 Selection of the appropriate realization remedy: power of sale, judicial sale, or foreclosure

The following is a summary of the available remedies and issues concerning mortgage enforcement.

(a) Obtaining possession

A mortgagee may take possession of the mortgaged property

- privately;
- by court order; or
- by a receiver
  - appointed pursuant to the provisions contained in the mortgage; or
  - appointed by the court.

(b) Power of sale and foreclosure remedies

Once in possession, a mortgagee may either

- sell the mortgaged property under power of sale or by judicial sale; or
- obtain title to the mortgaged property by means of
  - a foreclosure action; or
  - accepting a quit claim deed to the mortgaged property.

(c) Comparison of the power of sale, judicial sale, and foreclosure remedies

A comparison of the differences between power of sale, judicial sale, and foreclosure remedies available to a mortgagee is set out below.

(i) Effect

Upon a sale pursuant to a private power of sale, the mortgaged property is conveyed to a purchaser free and clear of the interest of the mortgagor and any other person having an interest in the mortgaged property subsequent in priority to the mortgagee. A judicial sale has essentially the same result as a private sale.

In a foreclosure action, the mortgagee will be the owner of the mortgaged property subject only to any prior encumbrances. The mortgagor and any other persons having an interest in the mortgaged property subsequent to the mortgagee will lose their interest in the mortgaged property as a consequence of the foreclosure.

(ii) Notice periods and other procedures

In a power of sale situation, the mortgagor generally has between 35 and 45 days to pay the moneys due under the mortgage after the issuance of the notice of sale, failing which the mortgagee can exercise its power of sale.

In a judicial sale or foreclosure procedure, a lengthy time period is required before the payment must be made, and then still the mortgagor has a further 60-day redemption period.

The procedure for a foreclosure and judicial sale is extremely technical and can take a considerable period of time and expense to complete. As a result, in most circumstances, mortgagees will realize on mortgaged security by selling the mortgaged lands under power of sale proceedings.

The procedures for the foreclosure or judicial sale of mortgaged property are contained in the *Rules of Civil Procedure*.

Foreclosure proceedings should be considered only in situations when the value of the property is less than the mortgage debt and the mortgagee is prepared to hold on to the mortgaged property in the hopes that it will appreciate in value.

Because of the costs and delay associated with implementing a judicial sale, a judicial sale is best used in situations where there are legal issues relating to the mortgage or title to the mortgaged property that could benefit from the court's assistance or where there are contentious disputes about the value of the mortgaged property.

(iii) Cost

A notice of sale is a relatively standard form, easy, and therefore, inexpensive to produce.

In a judicial sale or foreclosure, the procedure is court-supervised and is, therefore, usually a more expensive process than the exercise of a private power of sale.

(iv) Service

A notice of sale may be served by personal service or registered mail.

A foreclosure action or a judicial sale action is commenced by the issuance of a statement of claim by the mortgagee. Once issued, a statement of claim must be personally served on the defendants.

(v) Deficiency after sale

If the debt to the mortgagee has not been fully satisfied from the proceeds of sale under the private power of sale, the mortgagee is entitled to sue the mortgagor, and any guarantors thereof, to recover any shortfall or deficiency in the debt that remains. The mortgagee has the same right after judicial sale.

Upon foreclosure, the mortgagee takes the real property in satisfaction of the debt secured by the mortgage and, therefore, gives up any right to sue the mortgagor or any guarantor for any deficiency that may exist after it subsequently sells the property.

(vi) Finality

If a purchaser has bought under a power of sale in "professed compliance" with the provisions of the *Mortgages Act*, the purchaser's title should be immune from challenge from the mortgagor or any other interested person who has suffered damages, but the mortgagor and other interested persons retain its rights to sue the mortgagee for non-compliance with the *Mortgages Act* (s. 36).

On the other hand, the court retains the discretion to allow a mortgagor to redeem the mortgage after a foreclosure has taken place and, in certain circumstances, even after a subsequent sale by the mortgagor who has foreclosed to a third-party purchaser.

(vii) Land transfer tax

In exercising a power of sale or in a judicial sale, land transfer tax is not payable by a mortgagee because there is no transfer of title from the mortgagor to the mortgagee.

However, land transfer tax is payable by a mortgagee when it takes title by final order of foreclosure or by

quitclaim since there is a legal transfer of title from the mortgagor to the mortgagee.

(viii) Court approval

One of the primary advantages of a judicial sale is that the court supervises every step of the process, including the sale of the property and the terms. The most common risk that a mortgagee under a private power of sale faces is to be sued by the mortgagor, a subsequent mortgagee, or a guarantor for improvident sale—that the property was sold for at less than fair value. Under a private power of sale, the mortgagee does not have the benefit of the court's supervision and approval of the sale.

In a judicial sale, the court is asked to approve the terms of the sale, including the purchase price to be paid for the property, so judicial sale is best used where the benefits of getting the court's approval outweighs the costs of a court-supervised sale process, such as in circumstances where the value of the property is a major source of contention with the mortgagor and/or subsequent mortgagees or guarantors.

23.2.4 Notice of sale

The technical requirements of a private power of sale are detailed in the Real Estate section of the Examination Materials. One significant point to highlight in the context of security enforcement is s. 41 of the *Mortgages Act*, which provides that the notice requirements set out under Part III of the *Mortgages Act* do not "apply to a mortgage given by a corporation to secure bonds or debentures." There is conflicting authority on whether this exemption applies to a mortgage given under a single debenture security issued to a creditor. Unless it is absolutely clear that the exemption applies, the general practice is for the mortgagee to comply with the notice requirements under Part III of the *Mortgages Act*.

23.2.5 Standard of care

The standards imposed on a mortgagee while enforcing its mortgage security are similar to those that exist in connection with other forms of security enforcement.

The mortgagee is subject to a subjective standard of good faith and an objective standard of reasonable care in the sale of real property. The standard of reasonable care requires a mortgagee to take all reasonable steps to carry out the sale under conditions that would produce the best possible price in the circumstances.

23.2.6 Receivership of the property

(a) Privately appointed receiver

Many mortgages entitle the mortgagee to appoint a receiver or a receiver-manager of the real property charged by the mortgage. The mortgaged property may include both real property and the mortgagor's business assets charged under a floating charge. In lieu of taking possession of the mortgaged property itself and thus becoming a mortgagee-in-possession, the mortgagee may appoint a receiver or receiver-manager of the charged property, in the same way a receiver or receiver-manager would be appointed over personal property assets.

Under the common law, a receiver-in-possession is deemed to be subject to dual agencies. While in possession of the property, including the carrying on of the mortgagor's business, the receiver is deemed to be an agent of the mortgagor because the mortgage or debenture under which the receiver is appointed typically states that this is the case. In selling the mortgaged property, the receiver is deemed to be an agent of the mortgagee, who exercises the mortgagee's power of sale contained in the mortgage or debenture under which the receiver was appointed.

(b) Court-appointed receiver

A court has the discretion to appoint a receiver when it is "just or convenient" to do so pursuant to s. 101 of the *CJA*.

(c) Sale by receiver

In Ontario, it is common for a privately appointed receiver to sell the mortgaged property pursuant to the power of sale provisions contained in the mortgage. In so doing, the receiver would be subject to the same standard of care as the mortgagee pursuing the power of sale.

In Ontario, a sale by a court-appointed receiver is not a mortgage sale, and therefore, a court-appointed receiver is not required to comply with the notice requirements under Part III of the *Mortgages Act*. Instead, dispositions by a court-appointed receiver will be subject to the court's review and approval, including the marketing and solicitation process. In addition, the receiver will typically obtain expert appraisals of the property that are filed with the court to support the reasonableness of the sale price obtained.

The court is not bound to approve the receiver's recommendations with respect to a proposed sale of the mortgaged assets. Instead, the court considers whether the receiver has made sufficient efforts to get the best price for the property in the circumstances, keeping in mind the interests of all parties and the integrity of the sale process.

Chapter 29
Aboriginal business law

General legal principles apply with respect to Aboriginal peoples. However, there are some significant differences of which practitioners should take note. The most significant is related to the limited Indian exemption from taxation and seizure contained in the *Indian Act* (*Act*).

This chapter focuses primarily on the impact and application of the exemption from taxation and seizure. Because the exemption is based upon the *Act*, we will use the terminology used in this *Act*. Moreover, since the legislation only applies to registered Indians defined under the *Act*, unless specifically mentioned, the discussion in this chapter does not apply to Inuit, Métis, and non-status Indians.

1. Aboriginal taxation issues

Many people mistakenly believe that Indians are exempt from paying tax in Canada. In fact, the only recognized special tax treatment received by Indians and bands in Ontario is a result of s. 87 of the *Act*, which states:

> **87.—(1)** Notwithstanding any other Act of Parliament or any Act of the legislature of a province, but subject to section 83 and section 5 of the *First Nations Fiscal and Statistical Management Act*, the following property is exempt from taxation, namely:
>
> (a) the interest of an Indian or a band in reserve lands or surrendered lands; and
>
> (b) the personal property of an Indian or a band situated on a reserve.
>
> **—(2)** No Indian or band is subject to taxation in respect of the ownership, occupation, possession or use of any property mentioned in paragraph 1(a) or (b) or is otherwise subject to taxation in respect of any such property.

1.1 Elements of the Indian Act exemption

The s. 87 exemption applies if all of the following are met:

- The claimant is an Indian or a band (a corporation does not qualify for the s. 87 exemption).
- The amount in issue is a "tax."
- The property giving rise to the tax is either
  - an interest in reserve or surrendered land; or
  - personal property situated on a reserve.

The most controversial aspect of s. 87 and the most heavily litigated is the definition of "situated on a reserve." Canadian courts have increasingly limited this phrase to the extent that it is now a very restricted exemption. The following areas have been found to qualify for a tax exemption if found to be "situated on-reserve": income tax (employment income, business income, investment income), commodity and transaction tax (Goods and Services Tax (GST)/Harmonized Sales Tax (HST)), and excise tax.

1.2 Income tax — employment income

Paragraph 81(1)(a) of the federal *Income Tax Act* (*ITA*) confirms the provisions of s. 87 of the *Act* and excludes from a taxpayer's income any amount that is declared to be exempt from income tax by any other enactment of Parliament, other than international income tax treaties or conventions.

In 1994, the Supreme Court of Canada considered the tax-exempt status of unemployment insurance benefits. In *Williams v. Canada*, the court held that one must look at "connecting factors" to determine if the income is located on-reserve. Justice Gonthier suggested the proper approach was to identify potentially relevant connecting factors and analyze the factors to determine the weight to be given in light of the purpose of the exemption and the nature of the taxation of that property.

The connecting factors considered by the court in *Williams* were the

- residence of the debtor;
- residence of the person receiving the benefits;
- place the benefits are paid; and
- location of the employment income that gave rise to the qualification for the benefits.

The court also confirmed that ss. 87 and 89–90 of the *Act* were intended to preserve the property interests of Indians on reserve lands and not a general economic benefit upon Indians, particularly if the Indian chooses to enter the "economic mainstream" outside of the reserve.

Since *Williams*, courts have had numerous opportunities to address the connecting factors test mandated by the Supreme Court. Connecting factors considered to date include

- the residence of employer and employee;
- the place the benefits are paid;
- the location of work;

- whether the employment is aimed at improving the general conditions of Indians other than through a commercial enterprise;
- whether the residence of the employer is closely connected with a reserve, if not on it;
- whether the funds appropriated were for the benefit of Indians; and
- whether the location of the employment is intimately connected with a reserve.

1.3 Section 90 — deeming provision

In order for income to be exempt from taxation for an Indian, it must be "situated on a reserve." By virtue of s. 90 of the *Act*, it is possible for property located off-reserve to be deemed on-reserve for reasons of exemption from taxation and seizure. Paragraph 90(1)(b) states:

> For the purposes of sections 87 and 89, personal property that was ... (b) given to Indians or to a band under a treaty or agreement between a band and Her Majesty ... shall be deemed always to be situated on a reserve.

The argument is that the Indian or band is paid from moneys that were given under an agreement with the Crown and is therefore deemed to be situated on reserve and exempt from tax. Recently, courts have rejected this argument, reading into the provision a requirement that the property (funds) be provided by the Crown pursuant to a treaty obligation and not simply a comprehensive funding agreement.

1.4 Income tax — business income

Business income from an unincorporated proprietorship will be considered according to the same test as employment income found in *Williams*. Courts will look at "connecting factors" to determine if the business and therefore its income are located on-reserve. The following factors have been considered:

- location of the customers (debtors) of the business;
- business owner's residence;
- place where the business owner's income was paid;
- locations where the business owner engaged in the "income earning process";
- location of the head office of the business;
- location where decisions affecting the business were made;
- type of business and the nature of the work;
- the degree to which the business was in the commercial mainstream;
- location of a fixed place of business and the location of the books and records; and
- whether the business income was "integral to community life on the reserve."

While different factors are given significantly differing weights by the courts, it appears that the more that an Indian or band enters the "commercial mainstream," or more accurately, the non-Aboriginal commercial community, the more likely the income will be taxed. While this restriction is not contained in the *Act*, it appears to be a new barrier to successfully claiming s. 87 tax provisions.

1.5 Income tax — investment and interest income

The Federal Court of Appeal has adopted an equally restrictive interpretation of "property situated on-reserve" in relation to investment income.

In *Recalma v. Canada*, the appellants invested their money in bankers' acceptances and mutual funds, through deposit at a branch of the Bank of Montreal located on the Squamish Indian Reserve in British Columbia. The court found that while the dealer in the securities (the local branch of the Bank of Montreal) was on a reserve, the issuers of the securities were not; the corporations that offered the bankers' acceptances and the managers of the mutual funds in question were located in cities far removed from any reserve. Similarly, the main income-generating activity of the issuers was found to be situated in towns and cities across Canada and around the world, not on reserves.

In *Sero v. Canada*, the Federal Court of Appeal rejected the applicant's claim for tax exemption of interest income earned on a bank account held at the Royal Bank on the Six Nations Reserve in Ontario. Although the account was on-reserve, the court held that the interest was earned in the commercial mainstream of the Royal Bank off-reserve and that it was not, therefore, tax-exempt.

1.6 Federal goods and services tax (GST) and Harmonized Sales Tax (HST)

On July 1, 2010, Ontario adopted the HST, which is administered by the Canada Revenue Agency (CRA). HST applies to the purchase of goods and services in Ontario. However, because of s. 87 of the *Act*, there is a limited exemption from HST for Indians with respect to "personal property situated on-reserve."

The policy of the CRA contained in GST/HST Technical Information Bulletin B-039R3 provides the federal government's position on the application of HST to status Indians, Indian bands, and "band-empowered entities." The Information Bulletin basically conforms with the *Act*'s tax exemption as currently interpreted by Canadian courts and also extends the HST exemption to

tribal councils and to "band-empowered entities," which include corporations, boards, councils, associations, societies, or other organizations that are "owned or controlled by a band, a tribal council, or a group of bands other than a tribal council."

In a note to Information Bulletin B-039R3, the CRA states:

> Goods acquired by Indians and Indian bands off a reserve in Ontario without being delivered to a reserve will generally be subject to the HST as of July 1, 2010. However, the Government of Ontario has announced that, effective September 1, 2010, point-of-sale relief equal to the 8% provincial part of the HST will be provided on eligible purchases by qualifying First Nation purchasers.

This statement by Ontario is consistent with its former practice granting Provincial Sales Tax (PST) exemption to most purchases of retail goods off reserve by registered Indians—notwithstanding current law that indicates purchases must be made on reserve in order to qualify for the *Act*'s tax exemption.

1.7 First Nations goods and services tax (FNGST)

The *First Nations Goods and Services Tax Act* came into effect on June 19, 2003, as part of the *Budget Implementation Act, 2003*. This statute recognizes the authority of certain First Nations, specified on a schedule, to enact taxing by-laws in their territory equivalent to the federal GST. It then permits those First Nations to enter into agreements with Canada to enforce and collect the tax and to share the tax revenues with the First Nation. Status Indians in the participating communities would not have to pay the GST because of their tax exemption under the *Act*, but they would not be exempt from the equivalent FNGST. Currently no First Nations in Ontario are listed on the schedule.

2. Insolvency

Provincial laws of general application in relation to seizure and garnishment, and federal bankruptcy and insolvency rules apply generally to Aboriginal people. Section 89 of the *Act* applies to registered Indians or bands with property located on reserve. Section 89 states:

> **89.—(1)** Subject to this *Act*, the real and personal property of an Indian or a band situated on a reserve is not subject to charge, pledge, mortgage, attachment, levy, seizure, distress or execution in favour or at the instance of any person other than an Indian or a band.
>
> **—(1.1)** Notwithstanding subsection (1), a leasehold interest in designated lands is subject to charge, pledge, mortgage, attachment, levy, seizure, distress and execution.
>
> **—(2)** A person who sells to a band or a member of a band a chattel under an agreement whereby the right of property or right of possession thereto remains wholly or in part in the seller may exercise his rights under the agreement notwithstanding that the chattel is situated on a reserve.

As a result of this section, real and personal property owned by an Indian is protected from execution and seizure and cannot be mortgaged or used as security. A creditor may not go onto a reserve and seize the assets of an Indian to satisfy a judgment, unless (a) the creditor is another Indian or band, (b) the property is the subject of a conditional sales agreement in favour of the creditor, or (c) the property is a leasehold interest on designated lands on a reserve. A recent decision of the Manitoba Court of Appeal in *Tribal Wi-Chi-Way-Win Capital Corp. v. Stevenson*, held that a creditor may seize an Indian's personal property where the debtor previously waived the s. 89 protection as part of a promissory note.

2.1 The "paramount location" test

Obviously there is no difficulty in determining what real property is situated on-reserve for the purposes of exemption from seizure and attachment. It is the location of personal property that has raised questions as to the test to apply for "situated on a reserve."

The Supreme Court of Canada in *Mitchell v. Peguis Indian Band* stated that the "paramount location" test should be applied to determine the location or *situs* of personal property for the purposes of s. 89. According to this principle, one must determine the location of property according to the pattern of the property's use and safekeeping. Therefore, the fact that a piece of property is temporarily off-reserve will not necessarily expose it to risk of seizure or tax. The court in *Peguis* said that as long as there remains a "discernable nexus between the property concerned and the occupancy of the reserve," it will not lose its reserve *situs*.

The paramount location has been applied, for example, so that a school bus, which had been used for years to transport children from the reserve to an off-reserve school, could not be seized by creditors while off-reserve pursuant to s. 89(1) of the *Act* because its paramount location was on the reserve.

2.2 Criminal seizure

The s. 89 exemption from seizure does not apply where evidence is seized on-reserve as part of a criminal process. If the seizure is related to a criminal investigation or prosecution, but not for the purpose of obtaining evidence, s. 89 applies. Therefore, statutory provisions allowing seizure for the purposes of holding security in the event of conviction or further punishing a

defendant in the event of conviction cannot be enforced if the s. 89 exemption applies. In *Douglas v. R.*, the chief of a First Nation was charged with resisting arrest when he tried to prevent a police officer from seizing a band member's truck. The truck had been used during allegedly illegal fishing activities. The relevant fisheries laws did not permit the seizure of the truck as evidence; however, it did permit seizure as a punishment in the event of conviction and permitted the sale of the truck by Ministry officials. The court held that s. 89 protected the right of the chief to resist seizure of the truck.

The same exemption has been applied to the seizure of cash during a police search of premises. If the cash is not used for evidentiary purposes, it is exempt from seizure and must be returned.

2.3 Garnishment

The same test that is applied to determine whether various income is situated on-reserve (as per *Williams*) is used to determine whether such property is situated on-reserve in order to claim an exemption from seizure. In other words, if the income is exempt from taxation, it is also exempt from garnishment. With respect to bank accounts, if the bank where the deposit is held is located on-reserve, it is "situated on a reserve" for the purposes of s. 89. Thus non-Indian creditors may only seize property whose paramount location is off-reserve.

2.4 Seizure by another Indian or band

Since s. 89(1) permits other Indians or bands to seize or execute against the property of another Indian or band on-reserve, the s. 89 protection against seizure does not apply.

However, there are still limitations against seizure of real property on-reserve because non-members cannot hold (real) property on a reserve—even if they are registered Indians. Moreover, under s. 29 there is an absolute restriction on seizure of reserve lands under legal process, regardless of the status of the creditor.

Courts have not yet conclusively addressed the question as to whether an Indian may enter into the purchase or assignment of a debt owed by another Indian, thereby allowing the assignee/purchaser to execute upon the property of the Indian on-reserve.

2.5 Business planning

Although s. 89 may appear to be a benefit to Indians, it can also be a disadvantage. Because the section makes it difficult for an Indian or a First Nation to pledge security for debts, banks and other lending institutions can be reluctant to provide loans. This is a problem for Indians living on-reserve and can even follow Indians off-reserve, since their personal property can always be removed to a reserve for protection from creditors.

Subsection 4(2) of the *Act* makes it possible to have s. 89 waived in respect of certain transactions; however, it is the policy of the Department of Indian Affairs and Northern Development (also known as Indian and Northern Affairs Canada) to refuse any such requests.

Indians may also avoid the application of s. 89 by the exemption sections contained in that section. For example, if a sale is made whereby the right of possession or property remains with the vendor, the property can be seized. Likewise, if the sale is made by way of a conditional sales agreement, the asset can be repossessed.

In order to finance the construction of homes on reserve, banks have also allowed the First Nation to guarantee payment of loans. The First Nation usually requires the member to transfer his or her interest in the land to the band as security for repayment of the loan. In 2007, the federal government established the First Nations Market Housing Fund to facilitate and broaden the range of housing options for residents of First Nations communities.

Other creative solutions may also be available to the practitioner and should be considered in light of the restrictions of the *Act*.

2.6 Bankruptcy

There is little case law dealing with the interaction between the Indian protection from seizure and bankruptcy laws. However, the case of *Seguin v. Pelletier* demonstrates some of the issues that arise. In that case, Pelletier owed Seguin $23,000 when he declared bankruptcy. The trustee-in-bankruptcy (a non-Indian) could not seize Pelletier's property on-reserve, so it was assigned to Seguin, another Indian. The court held that as an assignee, Seguin could not acquire any greater rights to the property than the trustee/assignor. However, when Pelletier later applied to be discharged from bankruptcy, the court ordered the discharge to be conditional upon payment of $10,800 to the trustee-in-bankruptcy.

3. Business vehicles

Just as non-Aboriginal people can enter into a variety of arrangements to best suit their individual business needs, so too can Aboriginal people. However, because of the unique position of First Nations in relation to reserve lands, taxation, and exemptions from seizure, there are additional considerations that the practitioner must be aware of when advising a First Nation (band) or a registered Indian.

3.1 Sole proprietorships

Sole proprietors operating a business on their own maintain their Indian status under the *Act* and, therefore, derive benefits associated with tax exemption where property or income is found to be situated on-reserve. Thus, purchases of goods and services on the reserve by sole proprietors will be exempt from HST. In order to ensure that business income attributed to the owner is tax-free, sole proprietors should maximize the "connecting factors" to the reserve, such as

- the location of the business office;
- the location of the business records;
- the location of the administration of the business and where contract and business transactions are entered into;
- the location where employees report to work and are paid;
- the location where inventory and equipment is ordered and maintained;
- the location where physical activities of work are carried out;
- the location where work product is delivered;
- the identity of the customer (non-Aboriginal or Aboriginal);
- the benefit to the reserve community; and
- whether the business is in the "commercial mainstream" (i.e., competing with non-Indians off-reserve).

3.2 Partnerships

Since a partnership has no separate legal identity, for most purposes the same considerations apply as for sole proprietorships. To optimize tax exemptions, the partnership should also maximize the "connecting factors" to the reserve. Where it can be shown that a partnership is located on a reserve, any of its income allocated to an Indian or a band would be exempt from tax under s. 87 of the *Act*. Where any of the partners are non-Aboriginal, their share of the profit would, of course, be subject to tax. Purchases by a partnership with a non-Aboriginal partner would also be subject to sales tax unless purchased separately by the Indian partner.

3.3 Joint ventures

A joint venture arises from an agreement whereby individuals agree to invest their individual property to carry out a specific project, whereupon revenues will be shared. Expenses and profits are usually shared *pro rata*.

Generally, the comments above regarding partnerships also apply to joint ventures. If the joint venture can establish that it is located on-reserve according to the above connecting factors, any individual participants who are Indians or bands would be exempt from taxation.

CRA policy in regards to joint ventures involving Indians is that the determination of *situs* "must be made by applying the permanent establishment test to each person engaged in the joint venture. As a result, the income of certain joint ventures may be considered to be earned on the reserve and the income of others earned off-reserve, even though the income is from the same joint venture."

3.4 Corporations

As corporations have been held by courts as incapable of having "Indian" status under the *Act*, there is no issue as to whether a corporation, residing on or off-reserve, is exempt from tax under s. 87 of the *Act*. However, there are at least two other exemptions from taxation available to Aboriginal corporations.

In *Gull Bay Development Corporation v. R.*, the court held that the corporation was exempt from corporate income tax because the corporation had been incorporated exclusively for social and welfare purposes and thereby fell within the exemption for non-profit corporations contained in s. 149.1(1) of the *ITA*.

As well, in certain circumstances, a corporation where a First Nation owns at least 90% of the share capital, may be exempt from taxation under s. 149(1)(d.5). The section exempts from taxation the income of any corporation that is at least 90% owned by one or more municipalities in Canada.

The CRA's position is that it will consider a First Nation to be equivalent to a municipality under s.149(1)(d.5) if the First Nation demonstrates that it performs functions and provides services in a manner generally exhibited by a government. Examples of such activities would be if the First Nation has been involved in negotiations for land settlements with Canada or if the band provides community, health, safety, and education services to its members. The CRA has also said that First Nations that have enacted significant by-laws under ss. 81 and 83 of the *Act* will qualify for the s. 149(1)(d.5) exemption.

Chapter 30

Corporate reorganizations under the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act

1. The case for restructuring

1.1 General

When a company is in financial distress, a restructuring of a company's financial affairs will usually preserve as much as possible the going-concern value of the business, such as the goodwill of the company and the jobs of the employees, and may preserve the equity of the shareholders. As a result, a restructuring of a company's financial affairs will generally result in a better recovery for the company's stakeholders as a whole, as compared to a liquidation of the company's assets by way of a bankruptcy, receivership, or voluntary winding-up of the business. There is also a public and societal interest in maintaining the *status quo* and minimizing the social disruption and unemployment that occurs when a business fails.

Although as a general matter, restructurings can be more advantageous to the insolvent company's stakeholders as a whole, they will not always support a restructuring over a liquidation. In some cases, the stakeholders may determine that the ultimate proposal or plan being offered by the company does not favourably compare to estimated recoveries in a liquidation scenario. In addition, the stakeholders will also consider the prospects of a successful restructuring and the long-term viability of the restructured business.

A company can achieve a restructuring of its financial affairs in many ways, including the following:

- Negotiate a restructuring of its debts with its creditors by way of agreements with the company's key stakeholders.
- Downsize its business and operations by closing locations and reducing its workforce.
- Wind down or sell non-core or money losing parts of its business so that it can focus on the core or financially viable parts of the business.
- Seek additional financing, in the form of debt and/or equity financing.
- Do any one or more of the above through the use of formal insolvency proceedings under the *Bankruptcy and Insolvency Act* (*BIA*) or the *Companies' Creditors Arrangement Act* (*CCAA*).

This chapter will review how a financially distressed company may restructure using the statutory mechanisms available under the *BIA* and the *CCAA*. In November 2005, the federal government passed *An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts*, S.C. 2005, c. 47 (Chapter 47) (formerly Bill C-55), which introduced substantial amendments to the *BIA* and the *CCAA*.

In December 2007, the federal government passed *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and Chapter 47 of the Statutes of Canada, 2005* (Chapter 36) (formerly Bill C-12).

Both Chapter 47 and Chapter 36 were proclaimed into force (with the exception of a few provisions rendered moot, presumably deemed unnecessary, or intended to coordinate the inter-government flow of information) on September 18, 2009. These *Acts* significantly amended both the *BIA* and the *CCAA*.

1.2 The impact on stakeholders of a restructuring

1.2.1 Secured creditors

If possible, it is always preferable to have the secured creditors on side for a restructuring at the commencement of the restructuring process given that secured creditors often hold veto positions. Due to their security, secured creditors will almost always receive a better recovery in a liquidation than ordinary unsecured creditors of the insolvent debtor. In many cases secured creditors will not necessarily recover their full indebtedness from the insolvent debtor in a liquidation. In this situation, secured creditors will weigh their possible recoveries in a liquidation scenario against their possible recoveries under a restructuring. Where the estimated recoveries are higher if the company is allowed to restructure, secured creditors may decide that their interests would be better served by a restructuring of the company as a going concern.

1.2.2 Trade creditors

For trade creditors, the value of continuing future supplies to a going-concern business is typically higher than the recovery, if any, that the trade creditor would

receive in a liquidation as an unsecured creditor. It is usually in the trade creditors' interest to support a viable restructuring if there are reasonable prospects for future business from the restructured debtor.

1.2.3 Landlords

The position of landlords will depend on the facts and nature of the business in each case. If there are leased premises upon which a material part of the company's significant operations are conducted (such as manufacturing facilities or retail operations), then the landlords will have significant leverage in the implementation of any restructuring that may involve some renegotiation of the lease terms. As with trade creditors, depending on the market conditions, a landlord may prefer continuing a lease with a restructured tenant rather than chasing its preferred claim in a bankruptcy scenario and having to find a new tenant for the leased premises.

1.2.4 Regulatory agencies

Many businesses operate under regulatory supervision (such as airlines, publicly traded companies, and telecommunication companies). Other companies will have significant environmental issues that will need to be addressed in any restructuring. In addition, some regulatory authorities, such as pension regulators, will have a significant voice in the restructuring if there are significant regulatory issues that need to be addressed. Any successful restructuring will often be dependent on the co-operation of the applicable regulatory authorities to the going-forward business plan of the restructured business.

1.2.5 Shareholders

Shareholders will often lose their entire investment in a liquidation. As a result, shareholders will almost always favour a restructuring over a liquidation, provided of course that there are reasonable prospects for a successful restructuring. Depending on the particular circumstances, shareholders may be able to preserve some or a substantial portion of their equity if there is a successful restructuring.

1.2.6 Employees/unions

For employees of an insolvent debtor, restructuring is almost always preferred because it will preserve jobs, even if at a reduced level, for employees.

In unionized settings, unions are becoming more and more critical to the restructuring process. Typically, significant concessions are requested of unions as part of the restructuring plan. In addition, during the restructuring process, the operation of the normal union grievance and other processes are often stayed. In certain cases, the importance of maintaining union principles may outweigh any gains that might be obtained by the union in a restructuring.

1.3 Key considerations prior to a restructuring

Before commencing formal restructuring proceedings, there are a number of important considerations that will have an impact on the company's ability to successfully restructure. These factors include the following:

- Timing considerations: It can take several months to several years for a formal restructuring to be implemented. During this time, the viability of the company remains uncertain. Some customers of the debtor company may even refuse to deal with the company while under formal restructuring proceedings. As a result, it is important for the restructuring proceedings to be completed as soon as possible to minimize disruption to, and uncertainty in, the business.
- Cost/funding considerations*:* Formal restructurings under the *BIA* or *CCAA* can be expensive, particularly so in a *CCAA* case, which is an entirely court-supervised process. In addition to the day-to-day operating costs of the company, there will be an additional layer of professional costs. These include legal and accounting fees, trustee/monitor's fees, and other related expenses. Accordingly, it is essential for the debtor either to have a "war chest" available for these anticipated costs or to obtain debtor-in-possession (DIP) financing from a DIP lender. The statutory authority for DIP financing can be found under s. 11.2 of the *CCAA* and s. 50.6 of the *BIA*.
- DIP financing: This typically involves giving the DIP lender a first priority charge over the assets of the debtor ahead of most pre-existing secured creditors. Because of this, DIP financing will not be approved by the court unless the application for such DIP financing was on notice to the company's existing secured creditors likely to be affected by the charge. In addition, s. 11.2 of the *CCAA* and s. 50.6 of the *BIA* mandate factors that the court must consider in granting an order for such financing.
- Viability of proposal or plan: The company must conduct a realistic analysis of the likelihood that it can obtain the support of enough creditors to satisfy the double majority creditor approval threshold required under the *BIA* or *CCAA*.
- Feasibility of a successful restructuring: The company needs to review and consider whether the company, once restructured, is capable of being financially viable.
- Communications plan: In order to minimize business disruption and loss of goodwill during the formal restructuring process, consideration should be given to the timing, extent, and manner of

disclosure of information to the company's key stakeholders, employees, customers, and other interested persons.

2. Typical compromises or arrangements under BIA proposals or CCAA plans

In the *BIA* proposal process, the debtor company makes a "proposal" to its creditors, which contains proposed compromises of the pre-filing liabilities of the debtor company. In *CCAA* proceedings, the debtor company files a "plan of compromise or arrangement" (commonly referred to as the "plan") with the court, which also contains proposed compromises of the debtor company's pre-filing liabilities.

The nature of the compromises of indebtedness under a *BIA* proposal or a *CCAA* plan can take a variety of different forms. Some of the most common ways of compromising debt include the following:

- Cents on the dollar: a percentage reduction of each affected creditor's claim indicated in the proposal/plan (often referred to as a "cents on the dollar" compromise, i.e., creditors will receive a certain percentage of the face amount of their provable claims). This payment can be made in one lump sum on implementation of the proposal/plan or in payments staggered over time.
- Basket compromise: a lump-sum payment to be divided equally among all unsecured creditors with provable claims (often referred to as a "basket" compromise) to be paid on implementation of the proposal/plan or in staggered payments.
- Debt conversion: a conversion of all or some portion of the creditor claims into equity of the restructured company. The equity could take a variety of forms and attributes (i.e., voting or non-voting, preferred or common, etc.) and will result in a dilution or elimination of the existing equity. Typically, there are a certain number of shares set aside for distribution to the creditors, and each creditor will obtain a *pro rata* share of such shares based on the provable amount of its claim. This form of compromise provides creditors with an ability "to share in the potential upside" of the restructured business and its future profitability.

A compromise can contain one or more of the foregoing forms. Where the payments or equity to be paid under the proposed compromise are not being distributed immediately on implementation of the proposal or plan, the proposal or plan may provide that the obligations to make such payments and distributions are guaranteed or being funded by a related party, subject of course to that guarantor's or funder's ability to make the payments or distributions when due. If there is a default in any of the payments provided for in a proposal or in any of its other terms, the court can annul the proposal under s. 63 of the *BIA*, and the debtor will become automatically bankrupt. If there is a default in any of the payments provided for in a plan or any of its other terms, there is no automatic bankruptcy, and the debtor may present a new plan to its creditors. However, the practical result of a failed plan may be the lifting of the stay and a bankruptcy or the appointment of a receiver over the debtor's assets if another plan is not viable.

3. Private compromises and informal restructurings

3.1 Generally

Before commencing formal proceedings, a company will typically have attempted some form of informal restructuring or private compromise with its creditors and other key stakeholders. There are two primary reasons for this. First, private compromises are typically just that, and therefore any negative consequences from disclosure of the company's financial problems and impact on goodwill can be avoided. Second, this process is much less expensive than formal proceedings.

Informal restructurings work best and are usually achievable under limited circumstances. Because of the logistical difficulty of dealing with the varied and numerous interests of a large number of stakeholders, informal restructurings generally involve only a few key stakeholders.

3.2 Key weaknesses

The key weaknesses of informal restructurings are as follows:

- Informal restructurings do not have any mechanism to force key stakeholders to come to the table or to make a decision on a timely basis.
- The key stakeholders may not fully appreciate the urgency of the situation.
- Informal restructurings do not have the benefit of a statutory or court-ordered stay of proceedings against the company, and thus the company's creditors are not at law restricted from terminating their agreements with or supply to the debtor or enforcing their other rights against the debtor or its assets.
- A private compromise does not bind or affect non-consenting creditors, including those unknown creditors, such as holders of contingent or unliquidated claims.

4. Proposals under the BIA

4.1 Introduction

Part III of the *BIA* contains the proposal provisions of the *BIA*. Part III is divided into two divisions. Division I sets out the provisions relating to general (non-consumer) proposals, and Division II sets out the provisions

governing consumer proposals. Consumer proposals apply to proposals by consumer debtors who are defined under s. 66.11 of the *BIA* to be individuals who are bankrupt or insolvent and whose aggregate debts, excluding any mortgage debt on their principal residence, are less than $250,000.

The following discussion will review only the general (non-consumer) proposal provisions of the *BIA*.

4.2 Who may make a proposal

A proposal under the *BIA* may be made by an insolvent person or bankrupt or any receiver (as defined in s. 243(2) of the *BIA*), liquidator, or trustee-in-bankruptcy of that person.

An "insolvent person" is defined in s. 2 of the *BIA* as:

> a person who is not bankrupt and who resides, carries on business or has property in Canada, whose liabilities to creditors provable as claims under this Act amount to one thousand dollars, and
>
> (a) who is for any reason unable to meet his obligations as they generally become due,
>
> (b) who has ceased paying his current obligations in the ordinary course of business as they generally become due, or
>
> (c) the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due.

It has been held in the context of a *CCAA* application, that it is sufficient that the debtor company be "in proximity" to insolvency. It is not clear whether this test applies in the context of proposals under the *BIA*.

The *BIA* defines a "person" broadly to include partnerships, corporations, and unincorporated associations. "Person" does not include banks, insurance companies, trust companies, loan companies, or railway companies since such entities are excluded from the definition of "corporation" under the *BIA*. The insolvency of these types of organizations are governed by different statutes such as the *Winding-Up and Restructuring Act*.

4.3 Equal treatment of creditors and secret deals

A proposal under the *BIA* must treat all creditors in each class equally because the same proposal must be made to all creditors in the same class (ss. 50(1.2)–(1.3)). Secret deals with only certain creditors in a class are not permitted.

4.4 Commencing the proposal process

The debtor filing one of the following with the Official Receiver in the debtor's locality can commence the proposal process:

- a "notice of intention" to make a proposal pursuant to s. 50.4(1) of the *BIA*; or
- a proposal to its creditors pursuant to s. 62(1) of the *BIA*.

It is rare that a debtor would be in a position to file a definitive proposal immediately, so more frequently, the proposal process under the *BIA* is commenced by the filing of the notice of intention to make a proposal (commonly referred to as an "NOI").

4.4.1 Requirements of a notice of intention

Pursuant to s. 50.4(1) of the *BIA*, an NOI must state the following:

- the debtor's intention to make a proposal;
- the name and address of the licensed trustee who has consented in writing to act as trustee under the proposal (the proposal trustee); and
- the names of the creditors with claims amounting to $250 or more and the amounts of their claims as known or shown on the debtor's books.

4.4.2 Notice to creditors

Pursuant to s. 50.4(6) of the *BIA*, the proposal trustee must send a copy of the NOI to every known creditor of the debtor company within 5 days after the NOI is filed.

4.4.3 Requirement to file cash flow statement and related reports

Once the NOI is filed, the debtor has 10 days in which to prepare and file a projected cash flow statement with the Official Receiver pursuant to s. 50.4(2)(a) of the *BIA*. The cash flow statement is required to be signed by both the debtor and the proposal trustee.

With the cash flow statement, the debtor must also file a report, prepared and signed by the trustee, in the prescribed form on the reasonableness of the cash flow statement (s. 50.4(2)(b)).

Upon a request made to the proposal trustee, creditors may obtain a copy of the debtor's cash flow statement (s. 50.4(3)). If the court is satisfied that release of the cash flow statement would unduly prejudice the debtor and non-release would not unduly prejudice the creditor or creditors seeking disclosure, the court may order that the cash flow statement not be released to some or all of the creditors (s. 50.4(4)).

Although the proposal trustee is required to provide a reasonableness report on the cash flow statement, the trustee is not liable for any loss or damage to any person who relied on the cash flow statement as long as the proposal trustee acted in "good faith" and took "reasonable care" in reviewing the cash flow statement (s. 50.4(5)).

Immediately after ascertaining a material adverse change in the debtor's projected cash flow or financial circumstances, the proposal trustee must file a report with the Official Receiver on the state of the debtor's business and financial affairs containing the prescribed information and is also required to send a report about the material adverse change to creditors without delay (ss. 50.4(7)(b)–(c)).

If the filing of a proposal commenced the *BIA* process, the cash flow statement and related reports must be filed with the Official Receiver at the same time that the proposal is filed (s. 50(6)).

4.4.4 Consequences of failure to file cash flow statement and related reports

There is no authority under the *BIA* for the court to extend the 10-day period given to file the cash flow statement and related reports required to be filed under s. 50.4(2). If they are not filed within 10 days of the NOI, s. 50.4(8) of the *BIA* provides that the debtor is deemed to have made an assignment in bankruptcy.

4.5 The role and obligations of proposal trustee

In addition to providing a reasonableness report on the cash flow statement, where an NOI has been filed, the proposal trustee shall advise the debtor and participate in the preparation and negotiation of the proposal (s. 50.5).

The proposal trustee is to monitor the debtor's business and financial affairs (s. 50.4(7)(a)). In order to accomplish this, the proposal trustee is entitled to access the debtor's books and records and other financial documents.

For the purposes of the court hearing to approve a proposal after it has been accepted by the creditors, the proposal trustee is required to prepare a report to the creditors that sets out the debtor's liabilities; the realizable value of the debtor's assets; the conduct of the debtor that should be subject to censure; the causes of the debtor's insolvency; and whether, in the proposal trustee's opinion, the proposal is an advantageous one for creditors (*BIA*, s. 58(d); *Bankruptcy and Insolvency General Rules* (*Bankruptcy Rules*), Form 40).

Subsections 14.06(1.2) and (2)–(8) of the *BIA* set out certain protections from personal liability for a proposal trustee in respect of labour and environmental matters.

The creditors may appoint up to five inspectors of the estate to assist and instruct the trustee, pursuant to s. 56 of the *BIA*.

4.6 Timelines for filing proposal

4.6.1 Initial 30-day period

If the *BIA* process was commenced with an NOI, the debtor has 30 days to file a proposal with the Official Receiver. The debtor may request extensions of the 30-day initial period by application to the court. If the debtor fails to file a proposal within the initial 30-day period as may be extended by the court from time to time, the debtor will be deemed by s. 50.4(8) of the *BIA* to have made an assignment in bankruptcy.

4.6.2 Extensions

The debtor's ability to obtain extensions of the initial 30-day period is subject to the following:

- No individual extension can be for more than 45 days at a time (s. 50.4(9)).
- The aggregate of all extensions cannot exceed 5 months, for a total of 6 months including the initial 30-day period under the NOI (s. 50.4(9)).
- In respect of each application for an extension, the court is satisfied of all of the following:
  - The debtor has acted, and is acting, in "good faith" and with "due diligence."
  - The debtor would likely be able to make a viable proposal if the extension sought were granted.
  - No creditor would be materially prejudiced if the extension being sought were granted (ss. 50.4(9)(a)–(c)).

4.6.3 Termination of time period for filing proposal

Pursuant to s. 50.4(11) of the *BIA,* at any time after the filing of the NOI, the trustee, an interim receiver appointed under s. 47.1, if any, or a creditor may seek to terminate the time that a debtor has for making a proposal by making an application to the court. A court will terminate the time that a debtor has to file a proposal if the applicant trustee, interim receiver, or creditor, as the case may be, can establish any of the following:

- The debtor has not acted, or is not acting, in "good faith" and with "due diligence."
- The debtor will not likely be able to make a "viable" proposal before the expiration of the period in question.

- The debtor will not likely be able to make a proposal, before the expiration of the period in question, that will be accepted by creditors.
- The creditors as a whole would be materially prejudiced by the court allowing a continuation of the period for filing the proposal.

4.7 Automatic stay of proceedings

4.7.1 General

Once a NOI or a proposal has been filed, the *BIA* imposes a comprehensive stay of proceedings under ss. 69(1) (in respect of a NOI filing) and 69.1 (in respect of a proposal filing) of the *BIA*. These sections contain a general prohibition against any creditor exercising remedies against the debtor or the debtor's assets or the commencement or continuation of any actions, execution, or other proceeding against the debtor in respect of a claim provable in bankruptcy. The stay is automatic. No court order is required, and nothing more needs to be done by the debtor to trigger the commencement of the stay other than the filing of the NOI or a proposal. The stay continues until it expires pursuant to the terms of the *BIA* or until the court terminates it.

4.7.2 Application of stay to secured creditors

Once the stay is in effect, all remedies and proceedings against the debtor for the recovery of claims are prohibited from proceeding or continuing against the debtor, including secured creditors who are stayed from enforcing their security (ss. 69(1) and 69.1).

The automatic stay invoked by filing a NOI or proposal under the *BIA* does not apply to a secured creditor (i) who gave notice of its intention to enforce its security under s. 244 of the *BIA* more than 10 days before the NOI or the proposal, as applicable, was filed; (ii) who has taken possession of the debtor's assets for the purposes of realization before the NOI or proposal, as applicable, was filed; or (iii) whose debtor has consented to the enforcement of the secured creditor's security (ss. 69(2) and 69.1(2)).

If the proposal that is filed is not made to secured creditors or to all secured creditors, those to whom the proposal is not made are no longer subject to the stay (s. 69.1(5)).

4.7.3 Lifting of stay by creditors

A creditor may seek a lifting of the stay by application to the court for a declaration that the stay is no longer effective against it. The court may grant a creditor's application to lift the stay if the court is satisfied that the creditor is likely to be "materially prejudiced" by the continued operation of the stay or that it is equitable on other grounds to make such a declaration (s. 69.4).

4.7.4 Application of stay against the Crown

The *BIA* stay also applies to the federal and provincial Crowns, who are generally stayed from pursuing collection remedies, such as issuing demands (known as third-party demands) on persons who owe the debtor money to pay the indebted amounts to the Crown (instead of to the debtor) to satisfy amounts the debtor owes to the Crown in respect of income tax, Canada Pension Plan contributions, *Employment Insurance Act* premiums, and payments under similar provincial legislation (ss. 69(1)(c)–(d) and 69.1(1)(c)–(d)). This stay lasts until it expires pursuant to the terms of s. 69(1) or 69.1(1), as applicable, or earlier if the debtor defaults in the payment of any such amounts due post-filing or a secured creditor becomes entitled under its security to seize the amount due to the debtor from a third person (ss. 69(3) and 69.1(3)).

4.7.5 Application of stay to regulatory bodies

Subsection 69.6(2) provides an exception to the automatic stay of proceedings with respect to "regulatory bodies." Pursuant to this provision, no stay under s. 69 or 69.1 affects a regulatory body's investigation of the debtor company or a proceeding in respect of the debtor before the regulatory body. The sole exception is the enforcement of a payment ordered by that regulatory body. "Regulatory body" is defined in s. 69.6(1) as a person or body that has powers, duties, or functions relating to the enforcement or administration of a federal or provincial Act. Pursuant to s. 69.6(3), the court may order that subsection (2) does not apply if it is satisfied that (i) a viable proposal cannot be reached if the provision were to apply, and (ii) it is not contrary to the public interest that the regulatory body is affected by the stay.

4.7.6 Application of stay to claims against directors

In order to provide some protection to directors of the debtor and to entice them to stay on as directors of the company during a *BIA* proposal, the *BIA* also contains a stay of proceedings in respect of claims against directors of the debtor company. Pursuant to s. 69.31 of the *BIA*, upon the filing of a NOI or a proposal, as applicable, creditors are stayed from commencing or continuing any action against directors of the company for any claims arising before the filing of the NOI or the proposal.

The stay of proceedings against directors only applies to claims against directors in their capacity as directors. The

stay does not apply to contractual obligations of the directors, such as guarantees, or to actions in which injunctive relief is sought against the directors in relation to the debtor company (s. 69.31(2)).

Pursuant to s. 69.31(3), where all of the directors have resigned or have been removed by the shareholders, any person who manages the business and affairs of the company is deemed to be a director for the purpose of the stay provisions.

4.7.7 Stay against termination of agreements with debtor

(a) General

While the debtor is putting together its proposal, it is important that it be allowed to continue its business without interruption of the supply of critical goods, services, or licences. In the case of suppliers, franchisors, licensors, and landlords, a formal restructuring proceeding will usually trigger a default and corresponding right of termination under their supply, franchise, licence, and lease agreements with the debtor.

Section 65.1 of the *BIA* provides that where a NOI or a proposal has been filed in respect of a debtor, no person may terminate or amend any agreement (including a security agreement) with the debtor or claim any accelerated payment or forfeiture of the term under any agreement (including a security agreement) with the debtor, by reason only of either of the following:

- The debtor is insolvent.
- The NOI or proposal has been filed.

The debtor cannot contract out of these statutory protections. Like the stay under s. 69, the stay under s. 65.1 is automatic upon the filing of a NOI or proposal.

(b) Payment for goods and services

Although persons who supply goods and services to the debtor are prevented from terminating the supply of goods and services after the filing of a NOI or proposal under s. 65.1, the debtor must pay for these goods or services, and the person supplying such goods or services does not have to rely on the debtor's credit for payment.

Paragraph 65.1(4)(a) of the *BIA* provides that persons are entitled to require immediate payment or other valuable consideration for goods, services, or the use of leased or licensed property that is provided to the debtor after the NOI or proposal is filed. Similarly, no creditor of the debtor can be required to make further advances of money or credit to the debtor after the filing of the NOI or proposal (s. 65.1(4)(b)). These exceptions from the stay under s. 65.1 are significant because they mean that suppliers cannot be prevented from terminating their service or supply arrangements with the debtor if they do not receive immediate payment for those goods or services.

Immediate payment can take the form of cash on delivery. Alternatively, due to practical difficulties of implementing a cash on delivery payment method, other alternatives can also be used, such as cash in advance payments, letters of credit arrangements, or trust arrangements supervised by the proposal trustee.

(c) Eligible financial contracts

Pursuant to s. 65.1(7) of the *BIA*, the stay against termination of agreements under s. 65.1 of the *BIA* does not apply to "eligible financial contracts" (EFCs) as defined under the *Eligible Financial Contract General Rules (Bankruptcy and Insolvency Act)*, made under the *BIA*. EFCs are defined to include derivatives agreements based on or referenced to interest rates, currencies, commodities, credit, or guarantee obligations.

EFC's are exempt from the stay because of a broader policy concern to protect confidence in public financial and derivatives markets. As a result, EFCs may be terminated after the filing of an NOI or proposal, and the setting-off of obligations in accordance with such agreements is expressly permitted by s. 65.1(9) of the *BIA*.

As a result of amendments proclaimed into force in November 2007, the realization of financial collateral that secures an obligation under an EFC may be dealt with or realized upon despite the stay of proceedings. These amendments also provide that no court order may be made that would prevent a secured creditor from realizing on such financial collateral or that would have the effect of subordinating financial collateral.

The amendments to the *BIA* proclaimed into force in July 2008 give a super-priority charge over the debtor's assets in favour of unpaid wages and pension plan contributions. There are no corresponding provisions that specifically afford the above protections to EFCs against these new priorities. As a result, these amendments may conflict with the policy considerations underlying the protection given to EFCs.

(d) Aircraft objects

Under s. 65.1(4)(c) of the *BIA*, which came into force in order to allow Canada to meet its commitments under the *Convention on International Interests in Mobile Equipment* (*Cape Town Convention*), the stay does not prevent the lessor of an "aircraft object" from taking possession of such "aircraft object" in certain circumstances. "Aircraft objects" is defined as including airframes, aircraft engines, and helicopters. The term

"airframes" would seem to include most airplanes, with the exception of those used in military, customs, or police services.

4.8 Claims against directors

Subsection 50(13) of the *BIA* provides that certain pre-filing claims against directors of a debtor company can be compromised under a proposal. However, the proposal cannot compromise claims such as contractual claims or claims based on misrepresentations made to creditors or wrongful or oppressive conduct of the directors (s. 50(14)). While this has generally been considered to be a rather wide exception, the recent decision of the Ontario Superior Court of Justice in *Re Allen-Vanguard Corp.* with respect to a similar provision under the *CCAA* appears to have interpreted the exception more narrowly to prevent the release of claims based on misrepresentations or oppressive conduct arising out of pre-filing actions by directors taken in the name of the debtor company. As a result, it will be interesting to see how future decisions will interpret the scope of the release of pre-filing claims against directors.

Under s. 50(15) of the *BIA*, the court has the discretion to declare that a certain claim against directors shall not be compromised if the court is satisfied that the compromise would not be just and equitable in the circumstances.

4.9 Disclaimer of commercial leases

Section 65.2 of the *BIA* sets out the debtor's right to disclaim some or all of the debtor's commercial leases of real property. For debtors with significant lease obligations, this right can be of significant value.

The debtor can exercise this right by giving the landlord 30 days' notice of the debtor's disclaimer. If a landlord wishes to challenge the disclaimer by the debtor, it has to make an application to the court within 15 days of receiving the notice from the debtor to request that the disclaimer by the debtor be reviewed. The court will disallow the disclaimer unless the debtor can satisfy the court that the debtor would not be able to make a viable proposal without the disclaimer of that lease and any other leases that the debtor has disclaimed (s. 65.2(3)).

The amount of a landlord's claim for a disclaimed lease is determined by s. 65.2(4) of the *BIA*. Paragraph 65.2(4)(a) provides that the landlord of a disclaimed lease has no claim for accelerated rent. Paragraph 65.2(4)(b) provides that any proposal must either provide that the landlord can claim for actual losses resulting from the disclaimer or for an amount calculated in accordance with s. 65.2(4)(b).

4.10 Classification of creditors

Proposals under the *BIA* must be made to the unsecured creditors of the debtor and may be made to secured creditors, organized in classes in each case (s. 50(1.2)). Although the *BIA* permits more than one class of unsecured creditors, they will typically form one class.

If a proposal is made to secured creditors, it does not need to be made to all secured creditors as long as the proposal is made to all secured creditors in the same class (s. 50(1.3)).

Subsection 50(1.4) of the *BIA* sets out how secured creditors can be divided into classes based on a "commonality of interest" among other secured creditors. Commonality of interest is established by taking into account factors such as the nature of the debts giving rise to the claims, the nature and priority of the security in respect of the claims, the remedies available, and the extent to which the claims would be recoverable upon the exercise of those remedies.

If the required double majority of secured creditors in a class vote in favour of the proposal, the proposal is binding on all secured creditors in that class (s. 62(2)(b)).

While the *BIA* sets out a "commonality of interest" test for classifying secured creditors, it does not provide any guidelines as to how to classify unsecured creditors into classes. Generally, the courts have applied the "commonality of interest" guidelines set out for secured creditors under s. 50(1.4) to unsecured creditors who seek to classify themselves as a separate class of unsecured creditors. Subsection 65.2(5) provides that landlords of the debtor may be classified as a separate class or part of the same class with other unsecured creditors.

4.11 Creditors' meetings

4.11.1 Proposal trustee's duties and obligations

Once the proposal has been filed with the Official Receiver, the proposal trustee must call a meeting of the affected creditors within 21 days of the filing of the proposal. At least 10 days before the meeting, the proposal trustee must send to all known creditors and the Official Receiver a copy of the proposal, together with a statement of the debtor's assets and liabilities, a list of creditors with claims over $250, notice of the date and time for one or more creditors' meeting(s) to consider the proposal, and a proof of claim, proxy, and voting letter (i.e., letter indicating vote accepting or refusing proposal) for the creditor to complete and file with the proposal trustee (s. 51(1)).

4.11.2 Administration of the creditors' meetings

(a) Provable claims

In order to vote at creditors' meetings, each creditor must complete and return a proof of claim form to the proposal trustee before the time scheduled for the meeting, as required by s. 109 of the *BIA*.

(b) Review of debtor's financial affairs by proposal trustee

The meeting commences with a review by the proposal trustee of the proposal and its report to creditors. Creditors are then given an opportunity to question the proposal trustee and the debtor about the proposal, the proposal trustee's reports, and all relevant matters pertaining to the debtor's financial affairs.

(c) Adjournment of creditors' meetings

Upon an ordinary resolution of the creditors, creditors' meetings may be adjourned by the Official Receiver or its nominee in order to permit further appraisals or investigation of the company's affairs or assets, including examination under oath of the officers of the debtor (s. 52).

4.12 Required creditor approval

Pursuant to s. 54(2)(d) of the *BIA*, a proposal is deemed to have been accepted by the creditors, if the proposal is accepted by a double majority in each class of creditors:

- a numeric majority of voting creditors in each class with proven claims; and
- a two-thirds majority in value (dollar amount) of the proven claims in each class.

Creditors in each class of creditors vote separately. Creditors who are related to the corporation as defined in ss. 4(2)–(3) of the *BIA* are entitled to vote their provable claim but only against the proposal, not in favour of the proposal (s. 54(3)). Creditors having equity claims may not vote unless the court orders otherwise (s.54.1).

If the unsecured creditors (or any class of unsecured creditors, if there is more than one class) do not accept the proposal by the necessary double majority, then the proposal will be deemed refused by its creditors and the company is deemed to be automatically bankrupt (s. 57(a)).

If the unsecured creditors have approved the proposal, but any class of secured creditors rejects the proposal, the proposal will be deemed to have been accepted by unsecured creditors, but secured creditors of the rejecting class will become free to enforce their security immediately, and there is no automatic bankruptcy. Secured creditors to whom a proposal was not made are free to enforce their security upon the filing of a proposal that was not made to members of that secured class.

4.13 Revisions or amendments to a proposal

Creditors of any class and the debtor may agree to revise or amend the proposal as it applies to such class at the creditors' meetings prior to votes being taken. This will sometimes happen if it becomes clear to the debtor that the proposal as originally drafted is unacceptable to the unsecured creditors. At the meetings, the creditors would then vote on the amended or modified proposal (s. 54(1)).

4.14 Court approval

Once the necessary double majority of creditors has approved the proposal, the proposal must then be approved by the court. The proposal trustee must, within five days after the creditors have accepted the proposal, arrange an appointment with the court for a court hearing to approve the proposal (s. 58(a)). Notice to all creditors of the court hearing must be provided at least 15 days before the court hearing (s. 58(b)).

In connection with the court approval hearing, the proposal trustee is required to prepare and submit a report to the court, which sets out the debtor's liabilities, the realizable value of the debtor's assets, the conduct of the debtor that should be subject to censure, the causes of the debtor's insolvency, and whether, in the proposal trustee's opinion, the proposal is an advantageous one for creditors (*BIA*, s. 58(d); *Bankruptcy Rules*, Form 40). This report must also be delivered by the proposal trustee to the Official Receiver at least 10 days before the date of the hearing (s. 58(c)) and filed with the court two days before the date of the hearing. The court on reviewing the proposal trustee's report and hearing submissions of the proposal trustee, debtor, and any creditors opposing the approval of the proposal may approve or refuse to approve the proposal.

Pursuant to s. 59(2), a court must refuse to approve a proposal if

- the court is of the opinion that the terms of the proposal are unreasonable or not calculated to benefit the general body of creditors;

and may refuse to approve a proposal if

- it is established that the debtor has committed any of the bankruptcy offences set out in ss. 198–200 of the *BIA* (such as making a fraudulent disposition of property (s. 198(1)(a)), failing to comply with duties (s. 198(2)), failing to disclose the fact of being an undischarged bankrupt (s. 199), and failing to keep proper books of accounts (s. 200(1))).

If the court refuses to approve the proposal, the debtor is deemed thereupon to have made an assignment in bankruptcy, the Official Receiver shall issue a certificate of assignment, and the trustee will proceed to a first meeting of creditors as in an ordinary bankruptcy (s. 61(2)).

4.15 Required statutory terms that must be included in a proposal

The *BIA* requires that certain terms must be included in a proposal. If these terms are not included in a proposal, the court cannot approve the proposal. These terms include the following:

- payment of preferred claims under s. 136 of the *BIA* in priority to claims of ordinary unsecured creditors (s. 60(1));
- payment in full to the Canada Revenue Agency (CRA) or any province, within six months of approval, of amounts that may be the subject of a demand under s. 224(1.2) of the *Income Tax Act* (*ITA*), *Employment Insurance Act*, Canada Pension Plan, or similar provincial legislation (i.e., generally employee source deductions) that were owing at the time of the filing of the NOI or the proposal, if no NOI was filed (s. 60(1.1));
- payment to employees of the wages and commissions up to $2,000 and disbursements of travelling salespersons up to $1,000 for which they have a preferred claim under s. 136(1)(d) of the *BIA* incurred prior to the filing of an NOI or the proposal and payment to employees of wages, salaries, commissions, or compensation for services rendered in the ordinary course of business, and to travelling salespersons for disbursements after the proposal proceeding is commenced and before the proposal is approved by the court (the court must be satisfied that the debtor can and will make these payments (s. 60(1.3)); and
- payment of unpaid current service contributions and defined benefit contributions, unless the relevant parties have entered into an agreement approved by the relevant pension regulator, respecting the payment of those amounts (s. 60(1.6)) (the court must be satisfied that the debtor can and will make these payments (s. 60(1.5)).

In addition, the court cannot approve a proposal if there are any arrears in remittances to the CRA or a province relating to source deductions arising from the period after the filing of the NOI or the proposal, as applicable (s. 60(1.2)). Further, the proposal must provide that all claims that are not equity claims must be paid in full before any equity claims are paid (s. 60(1.7)).

Currently, Parliament is considering certain legislative amendments regarding unfunded pension plan liabilities to the *BIA* that would require a proposal to provide for special payments to the extent that such payments have become due and have not been remitted and any amount required to liquidate any additional unfunded liability or solvency deficiency as determined at the time of bankruptcy (Bill C-331). In addition, Bill C-25 would amend the *BIA* proposal provisions to require payment of amounts equal to the sum of all amounts that would be required to be paid by the debtor in respect of a prescribed pension plan if it was regulated by the *Pooled Registered Pension Plans Act*. These Bills are in the first reading stage. If these Bills receive Royal Assent, they may significantly impact a company's ability to restructure if it has large, unfunded pension deficiencies.

4.16 Effect of an approved proposal

4.16.1 Binding on all creditors in the class

The proposal, once accepted by its creditors and approved by the court, will bind all classes of creditors that approved the proposal, even those creditors in the class that filed a proof of claim or did not vote in favour of the proposal and regardless of whether they attended the creditors' meeting or voted in person or by proxy (s. 62(2)). Even unknown or undisclosed creditors in the unsecured classes that approved the proposal are generally bound by the proposal.

Pursuant to s. 4.1 of the *BIA*, the provisions of the *BIA* bind both the federal and provincial Crowns.

4.16.2 Release of pre-filing claims

Once a proposal has obtained the approval of the requisite creditors and the court, with certain limited exceptions, all provable claims that arose before the date of the NOI or the proposal, whichever came first, for the creditors in each class that approved the proposal are released in exchange for the compromise offered to each creditor under the proposal.

4.16.3 Claims not released in a proposal

Certain claims cannot be released by a proposal unless the proposal explicitly compromises the claim and the creditor in relation to the claim assents. These are the same claims that cannot be released by a discharge in bankruptcy. These include claims set out in s. 178(1) of the *BIA* such as claims arising out of fraud or misappropriation, or liability for obtaining property by false pretences or fraudulent misrepresentation (s. 62(2.1)).

4.16.4 Undisclosed creditors

If an unsecured creditor with a provable claim did not receive any dividend under the proposal because the claim was not disclosed to the proposal trustee, that creditor may recover the amount of the dividend that it would have been entitled to receive had it been given proper notice from the restructured debtor.

4.17 Annulment of an approved proposal

Pursuant to s. 63(1) of the *BIA,* the court can annul a proposal if any of the following occurs:

- The debtor fails to honour the terms of the proposal.
- The court believes the proposal cannot continue without "injustice" or "undue delay."
- The court finds that the approval of the court was obtained by fraud.

In addition, the trustee or any creditor may request the proposal be annulled if the debtor has been convicted of any offence under the *BIA* (s. 63(3)).

On an annulment of a proposal, the debtor is immediately deemed to be bankrupt (s. 63(4)).

4.18 Advantages/disadvantages

4.18.1 Advantages

The main advantages of a *BIA* proposal are as follows:

- A proposal can bind all creditors in the classes that accepted the proposal, even members of the class who did not accept the proposal. This is a significant advantage over private compromises/informal negotiations where a person's approval is required to bind him or her.
- The cost to initiate the process (by filing an NOI) is a relatively simple and inexpensive process.
- The implementation costs generally are less than a formal restructuring under the *CCAA*.

4.18.2 Disadvantages

The main disadvantages of a *BIA* proposal are as follows:

- All creditors in a class need to be treated equally, so if a creditor has a veto position, no special arrangement can be made to that creditor in order to obtain its support for the proposal.
- Once the proposal process is initiated, the proposal has to be filed no later than six months after the filing of an NOI, or else the debtor is deemed to be automatically bankrupt.
- If the proposal is not approved by the required double majority of creditors or by the court, there is an automatic bankruptcy of the debtor.
- Generally, a restructuring under the *BIA* proposal mechanism is less flexible than a restructuring under the *CCAA*.

5. The CCAA

5.1 General

Historically, the *CCAA* was a short statute with only 22 sections, and as a consequence, much of the nature and scope of the *CCAA* has been determined by case law. Many of the *CCAA* amendments that were recently proclaimed into force codify existing practice.

The courts have generally held that the *CCAA* should be interpreted liberally to give meaning to its purpose, and the court has relied on its broad jurisdiction under s. 11 of the *CCAA* and its "inherent jurisdiction" to accommodate the restructuring purposes of the *CCAA*. Because of this, the *CCAA* has become the statute of choice for complex restructurings and for debtors who wish to have the maximum flexibility when it comes to restructuring their financial affairs.

However, the court's jurisdiction under the *CCAA* is not without limits. Some of the flexibility previously enjoyed by *CCAA* debtors has been curtailed under the current *CCAA* regime.

5.2 Who may use the CCAA

Pursuant to s. 3(1), the *CCAA* applies to a "debtor company" or affiliated debtor companies, where the total of claims against the debtor company or affiliated debtor companies exceeds five million dollars or any other amount that is prescribed. Only those companies that fall within the definition of "debtor company" in the *CCAA* can be restructured under the *CCAA*.

An application for permission to submit a plan of compromise or arrangement to the creditors of the debtor company can be made by

- the debtor company;
- a creditor; or
- a trustee-in-bankruptcy or liquidator of the debtor company.

The debtor company submits most plans. Plans submitted by a creditor are referred to as "creditor sponsored plans."

5.2.1 "Debtor company" and affiliated debtor companies defined

(a) "Debtor company"

Section 2 of the *CCAA* defines "debtor company" as:

> any company that
>
> (a) is bankrupt or insolvent,
>
> (b) has committed an act of bankruptcy within the meaning of the *Bankruptcy and Insolvency Act* or is deemed insolvent within the meaning of the *Winding-up and Restructuring Act*, whether or not proceedings

in respect of the company have been taken under either of those Acts,

(c) has made an authorized assignment or against which a bankruptcy order has been made under the *Bankruptcy and Insolvency Act*, or

(d) is in the course of being wound up under the *Winding-up and Restructuring Act* because the company is insolvent;

(b) "Company" defined

"Company" is defined under s. 2 of the *CCAA* to include only companies

- that are incorporated under federal legislation;
- that are incorporated under provincial legislation;
- with assets or doing business in Canada, wherever incorporated; or
- any income trust.

Thus, the *CCAA* is restricted only to incorporated companies and income trusts while *BIA* proposals can be filed by unincorporated organizations. Similar to the *BIA*, the *CCAA* cannot be used by banks, insurance companies, trust companies, loan companies, or railway companies since these organizations are expressly excluded from the definition of "company" under the *CCAA*.

(c) Insolvent or bankrupt

Like the *BIA*, the debtor company must be "insolvent" or bankrupt in order to utilize the *CCAA*. However, the test for insolvency under the *CCAA* is arguably broader than that under the *BIA*. In *Re Stelco Inc.*, it has been held that while it may be sufficient for *BIA* cases to require a stricter test of "ceasing to meet obligations generally as they come due" for insolvency, in *CCAA* cases the test should be given a "contextual and purposive interpretation." In that case, the court focused on whether there was a reasonably foreseeable expectation of a looming liquidity crisis that would result in the debtor having insufficient liquidity to survive without the benefit of the stay and other protections of the *CCAA*. The court held that companies "in proximity" of insolvency should be able to have access to the *CCAA*.

(d) Five million dollar debt threshold

Given that the debtor company and its affiliated debtor companies (who are seeking to restructure under the *CCAA*) must have aggregate creditor claims of more than five million dollars (or some other prescribed amount), this monetary threshold means that as a general matter, the *CCAA* is used only by corporate debtors with significant creditor claims.

5.2.2 Affiliated debtors

Subsection 3(2) of the *CCAA* stipulates which companies are affiliated, including if one company is a subsidiary of another or if two companies are subsidiaries of the same company or controlled by the same person.

5.3 Commencing the CCAA process

5.3.1 Jurisdiction

Pursuant to s. 9(1) of the *CCAA*, a *CCAA* proceeding is commenced in the province where the debtor company has its head office or chief place of business or, if the debtor company has no place of business in Canada, in any province in which any of its assets are situated. If a debtor company has a head office in one province and a chief place of business in another, the proceeding can be brought in either jurisdiction.

It is not uncommon for the debtor company or its creditors to favour proceeding in a jurisdiction other than where the head office or chief place of business may be located. In those situations, the debtor company may attempt to relocate its head office to the favoured jurisdiction. The ability to change may be restricted by corporate statutes requiring shareholder approval in order to effect a valid change of the company's head office. In addition, some courts have refused to take jurisdiction of a matter if most of the debtor company's assets are located in another province.

5.3.2 The initial application

In order to initiate a restructuring under the *CCAA*, the debtor company must make an application to the court under s. 11 of the *CCAA*. This application is made by way of a notice of application (see s. 10 of the *CCAA* and rr. 14.05 and 38 of the *Rules of Civil Procedure*) and is referred to as the "initial application." In Ontario, the initial application is made to the Superior Court of Justice. In Toronto, the application is made to the Commercial List.

The notice of application is typically supported by an affidavit from an officer of the debtor company. The affidavit will usually set out the history of the company, the nature of its business, assets and liabilities, the company's financial information, and the reasons for its insolvency.

The initial application must be accompanied by a projected cash flow statement, a report containing prescribed representations about preparations of the cash flow statement, and copies of all financial statements, audited and unaudited, prepared during the year prior to the application, or the most recent statement if none is available for the prior year (s. 10(2)).

5.3.3 The initial order — the Standard Form Template CCAA Order

The order that is made by the court on an initial application is commonly referred to as the "initial order."

The Commercial List Users' Committee of the Ontario Superior Court of Justice has developed a Standard Form Template *CCAA* Order. Counsel for the debtor company is expected to provide the court with a black-lined version of the form of initial order being requested to show what changes are being requested that deviate from the Standard Form Template *CCAA* Order.

Most applications under the *CCAA* are made with little or no notice. As a result of this, the Standard Form Template *CCAA* Order includes a "comeback clause," which allows creditors and other interested persons to "come back" to court if they wish to seek to amend or vary the terms of the initial order (see para. 51 of the Standard Form Template *CCAA* Order).

However, the *CCAA* now requires that where a charge is being sought in the initial order that relates to DIP financing (s. 11.2), administrative expenses (s. 11.52), or the indemnification of officers and directors (s. 11.51), notice must be given to secured creditors who are likely to be affected by the charge.

5.3.4 The role of the monitor

When a court makes the initial order, pursuant to s. 11.7(1) of the *CCAA*, the court must at the same time appoint a person (the monitor) to monitor the business and financial affairs of the company while the initial order remains in effect. The person appointed as monitor must be a "trustee" as defined in s. 2(1) of *BIA*.

Pursuant to s. 23(1)(a) of the *CCAA*, the monitor must, within 5 days of the initial order, post a copy of the initial order on its website, send notice to every known creditor of the debtor company with a claim of more than $1,000 advising them that the order is publicly available, and post a list of creditors on its website showing the names and addresses of the creditors and the estimated amount of their claims.

Pursuant to ss. 24 and 23(1)(d)(i) of the *CCAA*, the monitor is entitled to access the books and records of the debtor company and is required to file reports on the debtor company's business and financial affairs forthwith after ascertaining a material adverse change in the debtor company's projected cash flow or financial circumstances, shortly after the company's fiscal quarter-end and at such other times as the court may order. It is common practice for the monitor to file regular reports to the court.

Similar to a proposal trustee under the *BIA*, the monitor is not liable for loss or damage to any person who relies on its report, as long as the monitor acted in good faith and took reasonable care in its preparation of the reports (s. 23(2)).

Section 11.8 of the *CCAA* sets out certain statutory protections for the monitor from certain labour (s. 11.8(1)) and environmental liabilities (s. 11.8(3)), similar to those found under s. 14.06(1.2) and (2) of the *BIA* for a "trustee."

5.4 The court ordered stay of proceedings

5.4.1 Generally

Subsection 11.02(1) of the *CCAA* gives the court wide discretion to impose a stay of proceedings in favour of the debtor. It provides that the court may make an order "on any terms that it may impose" and effective for such period as the court "considers necessary" but not exceeding 30 days.

The stay that is granted in the initial order is usually one of the most significant parts of the initial order. Unlike the *BIA* stay, the *CCAA* stay is not automatic but is discretionary—part of the court's discretion under s. 11. Section 11 has been given a wide interpretation to ensure its effectiveness.

The Standard Form Template *CCAA* Order contains comprehensive stay provisions much like the stay provisions provided under the *BIA* upon the filing of an NOI or a proposal (such as prohibitions against proceedings against the debtor company and prohibition against secured creditors enforcing their security) (see for example paras. 14–17 of the Standard Form Template *CCAA* Order). Because the stay under the *CCAA* is by court order, it allows for the stay provisions to be tailored to fit the specific needs of the debtor.

In addition, s. 34(1) of the *CCAA* provides that no person may terminate or amend any agreement (including a security agreement) with the debtor, or claim any accelerated payment of forfeiture of the term under any agreement (including a security agreement) with the debtor by reason only that proceedings have been commenced under the *CCAA* or that the debtor company is insolvent.

Paragraph 11.02(1)(a) also expressly permits the court to stay all proceedings against the debtor company under the *BIA* or the *Winding-up and Restructuring Act*.

5.4.2 Duration of CCAA stay

Pursuant to s. 11.02(1) of the *CCAA*, the initial stay period cannot continue for more than 30 days. Prior to the expiry of the initial 30-day stay, the debtor company may

apply for extensions of the stay. Unlike the *BIA* process, there is no time limit for any extensions under the *CCAA*, and the court is permitted to grant such extensions for such period as the court deems necessary as long as the pre-conditions for granting or extending a stay are found to exist (s. 11.02(2)).

5.4.3 The test for granting and extending the CCAA stay

Pursuant to s. 11.02(3) of the *CCAA*, the court cannot make an initial order until satisfied that circumstances exist that make the order appropriate. On subsequent applications to extend the stay, the following three pre-conditions must be established on each such application:

- Circumstances exist that make the order appropriate.
- The debtor company has acted and is acting in good faith.
- The debtor company has acted and continues to act with due diligence.

The onus is on the applicant to establish that these three pre-conditions exist. When considering whether it is appropriate to grant or extend a stay order, courts will consider whether the plan has a reasonable chance of being accepted by the debtor's creditors.

5.4.4 Stay against claims against directors

Under s. 11.03 of the *CCAA*, initial orders can stay certain kinds of claims against directors (see para. 19 of the Standard Form Template *CCAA* Order).

5.4.5 Government claims

A stay order can be made under the *CCAA* against the federal and provincial Crowns to prevent the exercise of its rights to recover amounts that may be the subject of a demand under s. 224(1.2) of the *ITA*, similar provision under the Canada Pension Plan or *Employment Insurance Act*, or similar provincial legislation (s. 11.09(1)). Such stay is terminated upon the occurrence of one of the following events:

- the expiration of the stay order;
- failure to pay the Crown the amounts due under s. 224(1.2) of the *ITA* or similar provincial legislation while the stay is in effect;
- default by the debtor company under the plan;
- rejection of the plan by the creditors of the debtor company or the court;
- six months after the sanctioning of the plan by the court; and
- performance of the plan by the debtor company.

5.4.6 Immediate payment for goods and services

Similar to proposals under the *BIA*, stay orders made under s. 11 of the *CCAA* cannot prohibit a person from requiring immediate payment for goods or services provided after the order is made, nor can they require the creditor to further advance money or credit to the debtor company (s. 11.01).

5.4.7 Eligible financial contracts

The definition of EFCs set out in the *Eligible Financial Contract General Rules (CCAA)* is identical to that in the *Eligible Financial Contracts General Rules (BIA)*. Similar to s. 65.1(7) of the *BIA*, s. 34(7)(a) of the *CCAA* excludes EFCs from the stay provisions.

Subsections 34(8)–(9) also permit the setting-off of obligations and any dealing with financial collateral securing obligations under an EFC, and no order preventing such action is permitted. Subsection 34(11) expressly prohibits any order that would have the effect of subordinating financial collateral.

5.4.8 Guarantees and letters of credit

Pursuant to s. 11.04 of the *CCAA*, the court is also prohibited from staying proceedings against third parties liable under guarantees or letters of credit issued in respect of the debtor company.

5.4.9 Regulatory matters

Historically, government regulators affected by *CCAA* cases have insisted that the standard stay provisions in the initial order permit government regulators to continue to deal with matters affecting life, health, and safety issues.

The *CCAA* has now been amended to provide that no stay order under the *CCAA* may affect a regulatory body's investigation of the debtor company or a proceeding in respect of the debtor that is before the regulatory body (s. 11.1(2)). The sole exception is the enforcement of a payment ordered by that regulatory body. "Regulatory body" is defined in s. 11.1(1) as a person or body that has powers, duties, or functions relating to the enforcement or administration of a federal or provincial Act. Pursuant to s. 11.1(3), the court may order that subsection (2) does not apply if it is satisfied that (i) a viable compromise or arrangement cannot be reached if it were to apply, and (ii) it is not contrary to the public interest that the regulatory body is affected by the order. Accordingly, the Standard Form Template *CCAA* Order provides a "carve-out" from the stay provisions for actions, suits, or proceedings by a regulatory body permitted under s. 11.1 of the *CCAA* (see para. 15 of the Standard Form Template *CCAA* Order).

5.4.10 Aircraft objects

Similar to the *BIA*, in order to allow Canada to meet its commitments under the *Cape Town Convention*, s. 11.07 provides that no stay order may be made that has the effect of preventing a lessor who holds security over an aircraft object from taking possession of such equipment in certain circumstances.

5.4.11 Lifting of stay by creditors

Under the *CCAA*, stay orders to set aside or vary the initial order under the ordinary *Rules of Civil Procedure* can be lifted on application to the court by a creditor. There are no statutory provisions in the *CCAA* that set out the test that the court should apply in respect of applications to lift or vary the stay. The courts have generally considered the impact of the requested lift or variance on the debtor company's ability to restructure successfully and whether there is material prejudice to the creditor seeking to lift or vary the stay if the stay remains in place.

5.5 Court-ordered charges

In addition to the priority charge for DIP financing pursuant to s. 11.2 of the *CCAA*, the *CCAA* provides for additional court-ordered charges that may have priority over most other pre-existing security interests of creditors. These include an administrative charge for professional fees incurred by the monitor, its counsel, and the debtor's counsel (s. 11.52) and a directors' charge for post-filing liabilities that may be incurred by directors (s. 11.51). The exact nature and scope of these charges and their relative priority among the various court-ordered charges will be dependent on the circumstances of each case.

The court may also order a charge in favour of a critical supplier. Pursuant to s. 11.4 of the *CCAA*, the court may make an order declaring a person to be a critical supplier of the debtor company, if the court is satisfied the person is a supplier of goods or services that are critical to the continued operation of the debtor company. The critical supplier is required to continue to supply the goods or services on any terms consistent with the supply relationship or on terms the court considers appropriate. The court must grant the critical supplier a charge over the debtor's property equal to the value of the goods or services supplied and may order that the charge be in priority to any other secured creditor. In each case, the application for the charge must be on notice to secured creditors likely to be affected by the charge.

5.6 Compromises against directors

Pursuant to s. 5.1(1) of the *CCAA*, a plan may include a compromise of creditor's claims against the directors of the debtor company that arose before the initial application. Similar to the *BIA*, the compromise cannot include claims arising in connection with contractual rights (such as guarantees) or that are based on allegations of misrepresentations made by directors to creditors or wrongful or oppressive conduct of directors (s. 5.1(2)). While this has generally been considered to be a rather wide exception, the *Allen-Vanguard* decision appears to have interpreted this exception more narrowly to prevent the release of claims based on misrepresentations or oppressive conduct arising out of pre-filing actions by directors taken in the name of the debtor company. As a result, it will be interesting to see how future decisions will interpret the scope of the release of pre-filing claims against directors.

A court may refuse to allow a claim against a director to be compromised under a plan if the court is satisfied that the compromise would not be fair and reasonable in the circumstances (s. 5.1(3)).

5.7 Compromises against third parties

A controversial issue under the *CCAA* has been the scope of releases in plans of compromise or arrangement that release creditors' claims against third parties, i.e., independent parties that are not privy to the agreements between the debtor and its creditors, in exchange for compromising the debt. Recently, the Ontario Court of Appeal, in its decision with respect to the Canadian asset-backed commercial paper market, held that such releases are permissible in a plan as long as they are reasonably connected to the proposed restructuring. Many commentators have argued that this is too broad a test. The point at which third-party releases are "reasonably connected" to a restructuring will likely be the subject of much comment in future *CCAA* proceedings. Recent court decisions, including *Allen-Vanguard*, have also emphasized that third-party releases should generally be the exception rather than the rule.

5.8 Classification of creditors

A plan can be made to unsecured creditors, secured creditors, or any class of either (ss. 4–5). Unlike the *BIA*, a plan does not need to be made to unsecured creditors. A plan can be made to secured creditors or any class where it is shown that the assets of the debtor corporation are insufficient to generate any recovery for unsecured creditors.

Creditors may be placed into classes for voting purposes depending upon the nature of their claims in a manner similar to the "commonality of interest" test used under the *BIA*. Section 22.1 of the *CCAA* provides that creditors having equity claims must be in the same class unless otherwise ordered by the court.

Classification of creditors can be critical in determining whether the creditors will accept a plan. The more classes there are, the more creditors there will be who may hold an effective veto over the approval of the plan. Therefore, a debtor company would prefer to have as few classes as possible to minimize and dilute the leverage of its creditors. Creditors who oppose the plan would prefer the opposite. Courts have generally recognized the impact that classification can have, and have attempted to ensure that how creditors are classified does not give creditors any unfair leverage over the viability of the plan.

With some exceptions (such as for source deductions and other specified claims), claims of the federal and provincial Crowns and any statute respecting workers' compensation rank as unsecured claims in a *CCAA* plan pursuant to ss. 38–39.

5.9 Creditors' meetings

Sections 4–5 of the *CCAA* require the debtor company (or trustee-in-bankruptcy/liquidator of the debtor company or its creditors) to make an application to the court for an order permitting meetings of creditors to vote on a proposed plan of compromise or arrangement. Section 4 refers to compromises or arrangements with unsecured creditors or any class of them, and s. 5 refers to compromises or arrangements with secured creditors or any class of them. Typically, the plan is filed with the court at the time of the application for creditors' meetings.

Sections 4–5 are not mandatory. The court does not have to grant the order permitting creditors' meetings. If the court believes that the proposed plan is not in the best interests of creditors, it may refuse to order meetings of creditors.

5.10 Creditor approval

Pursuant to s. 6(1) of the *CCAA*, the required level of creditor approval is the same "double majority" test required for a *BIA* proposal:

- a numeric majority of voting creditors in each class who filed proofs of claim before the meetings; and
- a two-thirds majority in value (dollar amount) of the proven claims in each class.

Unlike a proposal under the *BIA*, which can proceed following the rejection by any class of secured creditors, under the *CCAA* every class of creditors to whom the plan is made must approve the plan by the required double majority in order for the plan to pass. As is also the case under the *BIA*, related creditors may vote against, but not for, a plan (s. 22(3)), and equity claimants may not vote, unless the court orders otherwise (s. 22.1).

However, if the required double majority of creditors in each class does not approve the plan, there is no automatic bankruptcy of the debtor company, even though the practical result may be the same. If the creditors do not approve the plan, the stay of proceedings will usually be terminated, and creditors will then be free to pursue their remedies against the debtor, including a bankruptcy and/or receivership of the debtor.

5.11 Court approval

5.11.1 Generally

Like a proposal under the *BIA*, once the requisite majority of creditors has approved the plan of compromise, the plan is then brought before the court for the court's approval or "sanction" pursuant to s. 6(1) of the *CCAA*.

Subsection 6(1) of the *CCAA* is discretionary. Even if the creditors have approved the plan, the court is not required to sanction the plan. Historically, s. 6 did not set out the basis on which the court may sanction or refuse to sanction a plan, so reference had to be made to case law. As a result of the *CCAA* amendments, there are certain requirements that a plan must meet before the court may sanction the plan (see ss. 6(3)–(8)). These requirements are similar to those in ss. 60(1.1)–(1.7) of the *BIA*. Over and above these provisions, it is anticipated that the common law will continue to apply.

5.11.2 The common-law test for court sanction

As a general rule, the courts have applied the following three tests for the court approval of a plan:

- There has been strict compliance with the statutory requirements.
- Nothing has been done or purports to be done by the debtor company that is not authorized by the *CCAA*.
- The terms of the plan are "fair and reasonable."

If these requirements are not satisfied, courts have refused to sanction a plan even after creditors had approved it.

(a) Terms of plan are authorized by the CCAA

Similar to the *BIA*, the *CCAA* requires that certain terms must be included in a plan of compromise or arrangement. If these terms are not included in a plan, the plan will not be sanctioned the court. These terms include the following:

- payment in full to the CRA, or any province, within six months after the court sanction, of source deductions owing by the debtor company (s. 6(3));

- payment to employees of the wages and commissions up to $2,000 and disbursements of travelling salespersons up to $1,000 for which they have a preferred claim under s. 136(1)(d) of the *BIA* (the court must be satisfied that the debtor can and will make these payments (s. 6(5)(a)(i)));
- payment to employees of wages, salaries, commissions, or compensation for services rendered in the ordinary course of business and to travelling salespersons for disbursements after the *CCAA* proceeding is commenced and before a plan is sanctioned by the court (s. 6(5)(a)(ii)); and
- payment of unpaid current service contributions and defined benefit contributions, unless the relevant parties have entered into an agreement approved by the relevant pension regulator respecting the payment of those amounts (s. 6(6)).

In addition, s. 6(4) of the *CCAA* provides that no plan can be sanctioned if the debtor company is in default of remitting source deductions to the CRA or any provincial Crown that became due after the initial application. Further, the plan must provide that all claims that are not equity claims must be paid in full before any equity claims are paid (s. 6(8)).

Currently, Parliament is considering certain legislative amendments to the *CCAA* regarding unpaid pension plan liabilities that would require a plan to provide for special payments to the extent that such payments have become due and have not been remitted and any amount required to liquidate any additional unfunded liability or solvency deficiency as determined at the time the *CCAA* proceeding was commenced. In addition, Bill C-25 would amend the *CCAA* to require payment of amounts equal to the sum of all amounts that would be required to be paid by the debtor in respect of a prescribed plan if it were regulated by the *Pooled Registered Pension Plans Act*. These Bills are in the first reading stage. If such Bills receive Royal Assent, they may significantly impact a company's ability to restructure if it has large, unfunded pension deficiencies.

(b) Fair and reasonable

The courts have considered the following factors in determining whether a plan is "fair and reasonable":

- comparison of what the plan offers to creditors versus what creditors would receive if the debtor company were liquidated instead of restructured (typically, the monitor would prepare and file with the court a liquidation analysis to this effect);
- whether other options or alternatives have been explored and rejected and the reasons therefor;
- whether the plan oppresses any creditors;
- whether the plan is unfair to the shareholders; and
- whether approval of the plan is in the public interest (in this regard, retention of jobs and economic capacity will be a critical factor).

5.12 Amendments or modifications to plan

Section 6 of the *CCAA* permits a plan to be altered or modified up until the time of voting at the creditors' meetings. When the court is asked to sanction the plan, it will consider the plan as so altered or modified.

The *CCAA* also permits alterations or modifications to the plan after creditors' meetings without having to hold further creditors' meetings as long as the court is of the opinion that no class of creditors or shareholders are "adversely affected" by the alteration or modification (s. 7).

5.13 Effect of a plan

Once the court sanctions the plan, it is binding on all creditors whose claims are compromised by the plan (s. 6(1)(a)). "Claims" generally have the same meaning as provable claims under s. 121 of the *BIA*.

In order to bar claims from being filed after a certain date, the debtor company typically obtains a claims bar order. There is no statutory provision in the *CCAA* for a claims bar order. The claims bar order is made pursuant to the court's inherent jurisdiction.

5.14 Binding on the Crown

Pursuant to s. 40 of the *CCAA*, the *CCAA* is binding on both the federal and provincial Crowns.

5.15 Recognition of international insolvency proceedings

To provide for a co-ordination of proceedings under the *CCAA* with foreign bankruptcy or insolvency proceedings, Part IV of the *CCAA* gives the court wide discretion to facilitate, approve, or implement arrangements under the foreign proceedings. The cross-border provisions found in Part IV of the *CCAA* are modeled on the *UNCITRAL Model Law on Cross-Border Insolvency*. The purpose of these provisions is to provide mechanisms for dealing with cases of cross-border insolvencies and to promote cooperation between the Canadian courts and the foreign courts, greater legal certainty for trade and investment, fair and efficient administration of cross-border insolvencies, protection of the interests of the stakeholders and maximization of value, and rescue of financially troubled businesses (s. 44).

The cross-border provisions under the *CCAA* permit the "foreign representative" of a proceeding in a foreign jurisdiction to apply to the Canadian courts to recognize such foreign proceeding and the orders made pursuant

thereto. To be eligible, the foreign proceeding must deal with "creditors' collective interests generally under any law relating to bankruptcy or insolvency in which a debtor company's business and financial affairs are subject to control or supervision by a foreign court for the purpose of reorganization" (s. 45(1)).

An application for recognition must be brought before the court by the foreign representative (s. 46(1)). A "foreign representative" is defined as a person or body who is authorized in the foreign proceeding to monitor or administer the debtor's property and affairs or to act as the representative in respect of the foreign proceeding (s. 45(1)).

The court must first determine the foreign representative's authority to act and the existence of the foreign proceeding in accordance with the provisions of the *CCAA* (s. 47(1)). Once the court has made these determinations, the court must then determine whether the foreign proceeding is a foreign main proceeding or a foreign non-main proceeding (s. 47(2)). This determination depends on where the debtor has its centre of its main interests (COMI). COMI is not defined in the *CCAA*, but it is presumed that a debtor's COMI is the location of the debtor's registered office, unless there is evidence to the contrary (s. 45(2)). In determining whether the presumption is rebutted, the court will assess the debtor's COMI based on a number of factors under the common law. These factors include the location of the debtor's corporate head offices, the location of management or nerve center, and the location perceived by the debtor's major creditors as its COMI.

If the foreign proceeding is recognized as a foreign main proceeding, the Canadian court is required to order a stay of proceedings against the debtor in Canada and a suspension of the debtor's rights to transfer or encumber its assets outside the ordinary course of business. The Canadian court can also grant any other relief it deems necessary in the circumstances (s. 48(1)). Such relief must be consistent with the *CCAA* and Canadian public policy (s. 48(2)).

By contrast, there is no automatic relief that follows from the recognition of a foreign non-main proceeding. The recognition of a proceeding as a foreign non-main proceeding gives the Canadian court discretion to make any order that it considers appropriate, including a stay of proceedings against the debtor and a suspension of the debtor's rights to sell or transfer its assets outside the ordinary course of business (s. 49).

Once the Canadian court recognizes a foreign proceeding, the Canadian court will cooperate with the foreign representative and the foreign court to the maximum extent possible. Such cooperation includes communicating with the foreign court in order to issue orders that will help coordinate the Canadian and foreign aspects of the proceedings (s. 52).

The utilization of Part IV of the *CCAA* is expected to increase over time as a result of the increasing complexity of multinational corporations and the broad impact of the global economic downturn in multiple jurisdictions.

5.16 Advantages/disadvantages

5.16.1 Advantages

The main advantages of pursuing a restructuring under the *CCAA* are as follows:

- There is increased flexibility and scope of the stay of proceedings compared to a formal restructuring under the *BIA*.
- The court has discretion to impose stays on creditors or grant further extensions to the debtor longer than the maximum six-month period permitted under the *BIA*.
- There may be less stigma resulting from a filing under the *CCAA* as opposed to a filing under the *BIA*.
- Unlike a *BIA* proposal, bankruptcy does not automatically result if the plan is rejected by the creditors or the court.

5.16.2 Disadvantages

The main disadvantages of pursuing a restructuring under the *CCAA* are as follows:

- There are increased legal and professional costs and longer delays to implement the restructuring because the proceedings are completely court supervised.
- There is greater uncertainty about the outcome of any proceedings before the court because of the level of discretion given to the court.
- There is potentially increased publicity, given the court proceedings.
- Smaller debtors may be unable to obtain relief under the *CCAA* because of the monetary threshold of five million dollars in creditor claims.
- Until recently, a plan under the *CCAA* must have provided for payment in full of GST (and accordingly HST) arrears. However, the Supreme Court of Canada recently overturned prior case law in *Century Services Inc. v. Attorney General of Canada on behalf of Her Majesty the Queen in Right of Canada*. Pursuant to the *Century Services* decision, the court held that GST (and accordingly HST) does not have priority in *CCAA* proceedings. As a result of this landmark decision, differential tax treatment will no longer be a disadvantage to pursuing *CCAA* proceedings over *BIA* proceedings.

5.17 Conversion of proceedings between the BIA and the CCAA

Section 11.6 of the *CCAA* provides that proceedings under the *BIA* may be continued under the *CCAA* as long as the debtor company has not filed a proposal. However, the reverse is not possible, since s. 66(2) of the *BIA* provides that proceedings commenced under the *CCAA* cannot be continued under the *BIA*. In spite of these provisions, it is possible to have concurrent proceedings under both the *CCAA* and *BIA*.

Chapter 31

The purchase and sale of a business

1. Introduction

The discussion in this chapter presumes that the purchase and sale transaction is done on an arm's length basis. Many of the considerations would not apply if the transaction were on a non-arm's length basis.

There are basically two methods used to purchase a business. The purchaser can

- acquire the underlying assets of that business; or
- purchase the shares of the corporation that owns the assets and operates the business.

In most cases, the choice as to whether the acquisition will be by way of assets or shares is a decision that is based on business considerations. The task of the lawyer is to advise the client as to the advantages and disadvantages of each method, including the various tax consequences. Tax consequences are extremely important because in many cases the structure of the transaction will be influenced by those considerations.

The contract law relating to offer, counter-offer, and acceptance will apply to any agreement of purchase and sale of a business or shares of a corporation. The law works on the assumption that a contract arises out of an offer and unequivocal acceptance whether there is one offer and acceptance or numerous offers and counter-offers and final acceptance.

At the outset of a proposed transaction, the lawyer should conduct the following searches:

- a search of the corporate records;
- security searches (*Personal Property Security Act* (*PPSA*), *Bank Act*, etc.); and
- lists of employees, benefit programs, leases, contracts, etc.

The lawyer's searches should also be updated prior to closing the transaction.

The existence of claims and encumbrances against the business may be one of the most influential factors in determining whether the sale is of assets or shares. Provisions in contracts granting important rights to the business that make the rights unassignable (or unassignable except with consent) or "change of control" clauses may also dictate the preferred way for the business to be transferred.

The lawyer should also consider preparing appropriate checklists at the outset of a transaction and reviewing the same checklists in the course of the transaction, immediately before and upon closing the transaction.

2. Letters of intent

In many transactions, the purchaser and the vendor will execute a letter of intent. Depending on the stage of negotiations, a letter of intent can be either binding or non-binding. The majority of letters of intent are drafted to be non-binding, and if the purpose of a letter of intent is merely to set forth the intention of the parties—and not to create a binding agreement—then the letter of intent should express that thought clearly.

A letter of intent is typically drafted in order to indicate an interest by a potential purchaser and to open negotiations, or to establish whether sufficient consensus can be reached on the fundamental terms of a transaction before the parties commence the expensive and time-consuming process of settling definitive documents.

3. The major decision: shares or assets

The following is a discussion of the general advantages and disadvantages of share purchase and asset purchase transactions.

3.1 Corporate considerations of assets versus shares

3.1.1 Choice of assets/liabilities

In an asset transaction, the purchaser is able to select only those assets that it wishes to purchase as well as only the accompanying liabilities. Remaining liabilities, particularly unknown liabilities, will, unless expressly assumed, remain the responsibility of the vendor. By contrast, in a share acquisition, by virtue of acquiring shares of a corporation, the purchaser acquires the corporation itself, with all of the underlying assets of that corporation together with all of its liabilities, both known and unknown. Typically, this is often referred to as buying the "skeletons in the closet" or buying the business "warts and all." Generally, a vendor prefers to sell the shares of a corporation to avoid being left with unwanted assets or liabilities and to take advantage of the $750,000 capital gains exemption, if available, under the federal *Income Tax Act* (*ITA*); a purchaser prefers to purchase assets to avoid unwanted assets and unknown liabilities and to obtain depreciable assets.

3.1.2 Simplicity

The documentation of a share transaction is often thought to be simpler because the only "assets" purchased are the shares themselves. All of the other assets and liabilities flow automatically by virtue of acquiring the shares. In an asset transaction, however, each asset must be conveyed in the appropriate manner. It would appear initially that the asset transaction is more complex. However, a number of investigations must be performed in a share purchase transaction, including a review of the minute books and other corporate records of the corporation, as well as a review of important contracts to ensure there are no change-of-control clauses (which might make such contracts terminable by the other party to the contract upon a share transfer) and a review of the title of the target to its assets. It is questionable whether, by the time the detailed review of a corporation's assets is complete for the purposes of a share transaction, there is really less complexity than in an asset transaction. In fact, there is often very little difference in the legal costs.

3.1.3 Bulk sales

In an asset transaction, the sale of assets may fall under the provisions of Ontario's *Bulk Sales Act* (*BSA*), which provides that unless there is compliance with this *Act*, a creditor can have the transaction set aside. The *BSA* is not relevant in a share transaction.

The 2011 Ontario budget amended s. 6 of the *Retail Sales Tax Act* (*RSTA*) dealing with clearance certificates that are required for sales under the *BSA*. These amendments now allow the Minister to withhold the issuance of a clearance certificate until certain tax debts (taxes, penalties, and interest) under the following listed Acts are paid or secured:

- *Alcohol and Gaming Regulation and Public Protection Act, 1996;*
- *Fuel Tax Act;*
- *Gasoline Tax Act;*
- *Race Tracks Tax Act;*
- *RSTA;* and
- *Tobacco Tax Act*.

Generally speaking, these changes apply to bulk sales carried out on or after July 1, 2011, but in any event do not apply to bulk sales completed under written agreements entered into on or before March 29, 2011 (2011 budget date). These *RSTA* amendments are to be effective until June 30, 2013, but may be extended.

3.1.4 Employees

While a share purchase transaction results in no change in the status of the employment relationship between employees and the corporation, an asset transaction results in more complications. Contracts for employment cannot automatically be assigned to the purchaser. There are a number of implications under the Ontario *Labour Relations Act, 1995* if employees are unionized. The Ontario *Employment Standards Act, 2000* (*ESA*) also deems continuous employment under many circumstances even where assets are purchased.

3.1.5 Third-party consents

Under some circumstances, a corporate vendor may own a number of assets that are not automatically transferred if the business is sold by way of an asset transaction. Frequently, the consent of a third party is required in order for the asset to be conveyed to the purchaser. If such assets exist and they are important, rather than proceed by way of an asset transaction, it may be necessary to proceed by way of a share purchase transaction so as to automatically acquire such assets without a transfer of title. Caution should nonetheless be exercised even in a share purchase transaction because some agreements (for example, a lease) may deem a change in control or ownership of the business to be the equivalent of an asset sale and to similarly require consent.

3.1.6 Corporate structure of the business

It is possible that a corporation operates in segregated divisions. If only some of the assets of a division or one of a number of divisions are being purchased, the purchaser will acquire assets, not shares. In a share purchase, the purchaser would acquire the entire corporation and, therefore, other non-division assets at the same time.

3.1.7 Pension and benefit plans

Where shares are transferred, there is no disturbance of existing plans. On an asset purchase transaction, where employees are offered continued employment, the establishment of new plans is often required.

3.2 Tax considerations of purchasing assets versus shares

3.2.1 General preferences

For various income tax reasons, a vendor generally prefers to sell shares while a purchaser prefers to buy assets. The parties' contrasting reasons for that preference are due, in large part, to the tax consequences flowing to each, depending on how the transaction is structured (i.e., either assets sale or shares sale).

Typically, a vendor wants to maximize the after-tax sale proceeds, and the purchaser wants to minimize cost or purchase price. A vendor is also concerned about the tax consequences arising in the year of sale. On the other hand, a purchaser is concerned about the tax consequences in the years following the year of sale when the purchaser may be permitted to make deductions associated with the costs of assets (i.e., minimize future income tax by maximizing future deductions from income). Since a vendor's tax issues are more immediate in comparison to the purchaser's, the vendor's preference is to structure a sale transaction as a sale of shares. Negotiation may result in a reduction of the share sale price to compensate the purchaser for the lost future deductions (sometimes referred to as lost tax shield) that would have been available in an asset purchase.

3.2.2 Vendor's preference — share sale

(a) Capital gain

A vendor is concerned about the immediate income tax consequences (i.e., in the year of sale) and prefers a share sale (if the shares are capital property to the vendor) as capital gains are taxed more favourably (i.e., currently only one-half of a capital gain realized is included in income for tax purposes). Realizing a capital gain is particularly important for an individual vendor since he or she may be entitled to claim and deduct up to the $750,000 capital gains exemption (for dispositions after March 19, 2007, and $500,000 for dispositions before March 20, 2007) arising on the sale or disposition of qualifying shares of a small business corporation (SBC) or of a family farm or fishing corporation. An SBC is a Canadian-controlled private corporation (CCPC), all or substantially all of whose fair market value (FMV) of its assets are used principally in carrying on an active business primarily in Canada, or is a holding corporation for this type of corporation, which holding corporation also meets these tests.

It should be noted that with respect to an SBC, there are additional conditions that the corporation must satisfy, both at the time the shareholder sells his or her shares (i.e., 90% of the FMV of the corporation's assets) and throughout the preceding 24-month period (i.e., a lesser, 50% FMV asset test), in connection with the use of its assets principally in an active business carried on in Canada. There are also other requirements associated with the ownership of these shares by the vendor in the same 24-month period prior to the sale of the shares that must be satisfied. Furthermore, where the shares being sold are shares of a holding company, the requirements for these holding company shares to qualify as shares of an SBC are even more strict.

Generally speaking, where a corporation sells assets, there is a greater possibility of ordinary income arising on the sale from

- the recapture of capital cost allowance (CCA) on the sale of depreciable property; and
- the profit realized on the sale of inventory (at an amount greater than its cost).

(b) One level of tax

When a shareholder sells shares in a company, the proceeds

- are paid directly to the shareholder; and therefore
- are only taxed at the shareholder level.

In an asset sale, there are two levels of taxation:

- to the corporation when it sells its assets (realizing income, recapture, and/or capital gains); and
- to the shareholders of the corporation when the corporation distributes the after-tax proceeds to the shareholders as a dividend and the shareholders pay tax on the dividend.

3.2.3 Purchaser's preference — asset purchase

To minimize the purchase price and also maximize the tax deductions from the purchase, a purchaser will take deductions to reduce its income in future years. Therefore a purchaser often prefers to structure the transaction as an asset purchase and take tax deductions against income in future years (i.e., by way of CCA on depreciable assets).

(a) Increased tax cost

In an asset purchase transaction, the purchaser is entitled to take tax deductions against income (in future years), by claiming

- CCA on depreciable assets;
- the cost of inventory sold; and
- part of the cost for eligible capital property

associated with the allocation of the purchase price to the appropriate asset (or class of asset(s)).

In a share purchase transaction, the full purchase price is added to the purchaser's adjusted cost base (ACB) of the purchased shares. Since shares are a type of non-depreciable property, there is no tax relief (i.e., no deductions are available in future years against the income of the purchaser) associated with the cost of the shares. Rather, a purchaser recoups its ACB on a subsequent disposition of the share(s). At the same time, by acquiring the shares, the purchaser will inherit the tax cost (i.e., ACB, undepreciated capital cost (UCC), or cumulative eligible capital (CEC)) of the non-depreciable

capital, depreciable capital, and eligible capital assets (respectively) of the corporation and can continue to claim deductions based on the existing "tax cost" of the assets inside the corporation.

3.2.4 Why preferences change

Although typically a vendor prefers to sell shares and a purchaser prefers to purchase assets, these preferences may change. Consequently, it is helpful to fully consider the tax consequences to each of the vendor and purchaser in any transaction.

(a) Vendor may prefer an asset sale

(i) Availability of losses

It is possible that a vendor has substantial non-capital or net capital loss carryforwards available that can be used against or to offset any income or capital gains arising from a sale of the assets of the business. In this case, a vendor may prefer to sell assets and shelter the income or capital gains with available losses.

(ii) Low tax rate

Subject to certain limitations, CCPCs enjoy a low rate of tax on active business income (ABI). Accordingly, where a corporation is entitled to the small business deduction (SBD), it would pay a lower rate of tax on

- recapture (income) of CCA; and
- eligible capital amounts

arising from the sale of depreciable capital property and eligible capital property, respectively.

(iii) Tax cost of assets exceeds purchase price of shares

It is possible that a corporation's tax cost for its assets is greater than the shareholder's ACB in the shares of this corporation. This situation may arise where the corporation recently acquired the assets. In this case, the overall tax arising from a corporation selling its assets may be less than the tax arising to the shareholder of the corporation selling shares in the corporation to a purchaser.

(iv) Sale of division

It is possible a vendor may only be downsizing its business or selling a division. In such a case, the sale of assets from that part of the business or the assets of the division may be preferable to a share sale.

(b) Purchaser may prefer a share purchase

(i) Availability of losses

A corporation may have substantial unused non-capital losses (operating losses) that are being carried forward and that might be used in later years to reduce the corporation's taxable income and therefore its income taxes. Care should be exercised to ensure the losses are capable of being used in later years.

In an asset purchase, the purchaser cannot benefit from these losses since they remain with the corporation (i.e., a taxpayer's losses cannot be bought and sold).

(ii) Deductions available

It should be noted that the class(es) of depreciable property and consequently the rate of CCA that applies may be determined by reference to the date on which the asset or property was acquired by the taxpayer. For example, buildings acquired before 1988 are included in Class 3 (5% CCA) whereas buildings acquired after 1987 are included in Class 1 (4% CCA). A purchaser of shares of a corporation that owned a building since before 1988 would retain the historical CCA classes and the higher rate of CCA claimable for the building in this case. The tax rules dealing with depreciable assets and classes may be subject to more frequent legislative amendment, and therefore, a purchaser needs to carefully consider the implications in structuring either a share or asset purchase.

(iii) Fair market value less than tax cost

Where a purchaser acquires assets, the purchaser's tax cost of each asset is the amount of the purchase price allocated to that asset. For example, assume that the FMV of

- intangible property or goodwill (cumulative eligible capital); or
- depreciable capital property

is less than the cumulative eligible capital account balance (i.e., the amount that remains to be deducted on a declining balance basis) or the UCC of these assets. In this case, a purchaser may prefer to purchase shares and have a higher ACB in the shares.

This may be the case notwithstanding the fact that the accrued losses (on the assets—those with a lower FMV than their tax cost) would be deemed realized as a result of the rules on an acquisition of control of the corporation (i.e., the inherent losses on the assets are "freed-up" and available after an acquisition of control). This deemed realization of the inherent losses on assets would increase the corporation's losses carried forward. While such losses now deemed to be realized are

available for carryforward to future years, they also remain subject to the limitations on use as specified in the *ITA*.

3.2.5 Other taxes

On the purchase of assets, a purchaser should consider the implications of other taxes applying, including land transfer tax (LTT) on real estate and the new Harmonized Sales Tax (HST) on the purchase of goods and services.

With respect to the HST, HST applies in Ontario effective July 1, 2010 (i.e., Ontario is now referred to as a "harmonized" or "participating" province). As of July 1, 2010, businesses that were registrants for the Goods and Services Tax (GST) (imposed under Part IX of the *Excise Tax Act* (*ETA*)) are now required to charge and collect the HST. HST registrants are agents of the federal government and responsible for charging HST on taxable supplies of goods and services in Ontario and other HST participating provinces or territories, remitting the HST to the Receiver General of Canada, and fulfilling certain reporting obligations. The HST is administered by the Canada Revenue Agency (CRA).

Generally speaking (and subject to certain transitional rules), HST applies in Ontario to amounts paid or payable for goods or services provided or supplied in Ontario after June 30, 2010, at a blended rate of 13% (i.e., the former GST of 5% plus the former Ontario Retail Sales Tax (RST) of 8%). (In certain cases, an HST registrant in Ontario that brings goods and services into Ontario (other than for the exclusive use in the course of its commercial activities) may be required to self-assess the provincial component of the HST on such goods and services.) Since the HST is a value-added tax and applicable to goods and services, it applies to a broader tax base than Ontario's former RST, which was generally applicable only to tangible personal property (TPP). However, it should be noted that HST does not to apply to certain items like groceries, prescription drugs, and medical devices. Businesses making taxable or zero-rated sales will be able to claim an input tax credit (ITC) for the HST paid on the business's purchases of assets.

Consequently, where a purchaser buys assets from a vendor who is a registrant for HST purposes, the vendor is required to charge (collect) HST on the purchase price allocable to the assets (i.e., goods) and remit the HST to the CRA. HST does not apply to any goodwill acquired as part of the assets purchased to carry on a business. Where the purchaser of assets intends to use the purchased assets in carrying on a business and is itself an HST registrant (i.e., will use the assets in a commercial activity and will charge and collect HST in the business activity), the purchaser of assets would be entitled to claim an ITC for the HST paid to the vendor for the assets used in carrying on a commercial activity (i.e., a business).

Since this represents a timing issue (i.e., purchaser pays HST on buying assets and then claims an ITC) associated with HST for the purchaser of assets, relief may be available under the *ETA*. Where a purchaser of assets acquires all or substantially all of the assets necessary to carry on a business or part of a business (i.e., sufficient assets of a business) from an HST registrant vendor, the vendor and purchaser (who must also be an HST registrant) can jointly elect (*ETA*, s. 167(1.1)) not to have HST payable on the purchase and sale of such assets. This joint election helps the purchaser, since HST does not have to be paid on the assets at the time of purchase (and the purchaser does not have to wait to claim back and receive an ITC for the HST paid). Similarly, the vendor does not have to collect and remit the HST.

These additional taxes (i.e., LTT and HST) do not arise in a share purchase.

4. Asset purchase considerations

4.1 Commercial considerations

Complexity arises from the fact that the purchaser can pick and choose the assets to be purchased and the liabilities to be assumed. Therefore, each type of asset and any liabilities must be specifically dealt with and any exceptions or exclusions must be addressed. The transfer considerations are more complex in an asset transaction since there are generally requirements to register documents; to obtain consents from interested parties such as lenders, landlords, contract counterparties, and regulatory authorities; and to give notices to customers, employees, tenants, and others.

At the outset, it is important to determine which assets are to be acquired by the purchaser and which are to be excluded. Generally, there is no advantage to either party if the purchaser acquires cash or similar assets (for example, short term deposits) other than petty cash amounts in branch offices. Similarly, a purchaser may not want to acquire assets that result from non-arm's length transactions between the vendor and other persons (for example, inter-company indebtedness within a related group of companies or rights and obligations under some contracts with non-arm's length parties). As well, a purchaser will not normally wish to retain and pay for "key man/person" life insurance on the vendor, even if the vendor is being retained as an employee or consultant.

4.2 Tax considerations

In the purchase and sale of assets, tax consideration must be given to the allocation of both

- the purchase price to the assets; and
- the consideration (i.e., money or property paid) among the assets of the business.

4.2.1 Allocating the purchase price

Allocating the purchase price is an important tax consideration. A vendor will be motivated to minimize any tax liability arising in the year of sale. Therefore, a vendor will wish to allocate the purchase price to assets that will give rise to either no income or income that will be taxed more favourably (i.e., at lower tax rates).

Typically, a vendor will prefer to allocate the purchase price to assets in the following order:

(1) non-depreciable capital property (such as land), since only one-half of any capital gain will be included in income;

(2) depreciable capital property whose disposition will give rise to little or no recapture of CCA;

(3) eligible capital property, since only three-quarters of the sales proceeds will be deducted from the CEC account balance and the excess amount (if any, and as adjusted) will give rise to a capital gain;

(4) depreciable capital property whose disposition will give rise to recapture of CCA; and

(5) inventory (and other assets), which give rise to a full income inclusion.

A purchaser will be motivated to minimize any tax liability after purchasing assets and will therefore want to allocate the purchase price to those assets for which there will be the maximum tax deductions available in the years following the year of sale. Typically, a purchaser will prefer to allocate the purchase price to assets in the following order:

(1) inventory;

(2) depreciable capital property, particularly in respect of classes that have a higher rate of CCA;

(3) eligible capital property;

(4) depreciable capital property in respect of classes that have a lower rate of CCA; and

(5) non-depreciable capital property.

Since the vendor and purchaser often have conflicting interests for tax reasons, allocation of the purchase price will likely require negotiation. Therefore, the CRA typically accepts the purchase price allocation agreed to by the parties, provided there is evidence the transaction has been negotiated at arm's length.

If the vendor and the purchaser do not have conflicting interests (where for example, one party is exempt from income tax) or the parties report the transaction on a different basis for tax purposes (are inconsistent in their tax reporting), the CRA may invoke s. 68 of the *ITA* and set aside the parties' otherwise agreed upon allocation.

With this in mind, parties often include a term in their agreement of purchase and sale that the parties

- accept the reasonableness of the allocation; and
- agree to file their respective income tax returns consistent with the allocation of the purchase price, as agreed.

This ensures the parties will actually use the negotiated allocation and may reduce the risk that the CRA will challenge their allocation.

4.2.2 Allocating the consideration

Properly allocating the consideration paid by the purchaser may reduce the taxes payable by the vendor in the year of sale and at the same time not affect the taxes payable by the purchaser.

In the case where the consideration paid by the purchaser includes the issuance of debt to the vendor, and provided the debt is not due until after the end of the vendor's taxation year in which the sale closed, then the vendor may be able to claim a reserve from income. Provided the requirements are met, a reserve may be claimed by a vendor in connection with reporting the income or capital gains arising from the sale or disposition of inventory and capital property, respectively.

4.3 Assets to be acquired

4.3.1 Inventories

(a) Corporate considerations

Inventory may be described as both products held for sale and material that the business processes, manufactures, or assembles into products for sale. By its nature, inventory changes in quality and amount on an ongoing basis. It is often difficult to calculate and agree upon a value for the inventory in a purchase transaction, let alone allocate a value to specific items of inventory being acquired. Accordingly, the purchase agreement may occasionally ascribe a fixed and usually conservative value to the inventory or, more usually, will provide a method or formula by which the value of the inventory may be objectively determined at a date specifically chosen before or after the closing of the transaction. In either case, an arbitration procedure may be provided so that an independent arbitrator will determine any dispute as to the subsequently determined value.

Frequently the auditors of the parties can be engaged to perform this function.

If the value of the inventory will not be determined until after closing, a "holdback" of a portion of the purchase price may be provided for, or funds can be deposited in escrow with a third party. The funds can be released upon the determination of appropriate inventory levels.

The purchaser will normally want to avoid paying for inventory that is obsolete or of little value. Usually the purchase agreement will provide that the purchase price paid and allocated to inventory will be adjusted to exclude these items. As an alternative, a clause may be included by which the purchaser is entitled to sell back to the vendor any obsolete or useless inventory within a specified time from the date of closing.

Representations and warranties given by the vendor to the purchaser can help deal with the question of obsolete inventories. They can provide that the inventory is useable in the business, in good condition, and not obsolete. In any event, the purchaser should physically check all inventory to be satisfied as to its condition.

(b) Tax considerations

(i) Vendor

Usually the inventory in a business is sold at its book value, and the resulting income tax consequences are minimal. Under s. 23 of the *ITA*, any gain or loss arising from the sale of inventory will be on income account, rather than on capital account.

(ii) Purchaser

Since the sale of inventory by a business gives rise to ordinary income, the cost of inventory is deductible (for tax purposes) in computing the profit to the business from the sale of the inventory. A purchaser will therefore prefer that the part of the purchase price allocated to inventory will be deductible for tax purposes.

(iii) Other taxes

Inventory is an asset normally held for resale to customers. A sale of inventory to a purchaser is a taxable supply under the *ETA* for HST purposes. Although the purchase of inventory is subject to HST, a registrant would claim an ITC for the amount of HST paid on purchasing inventory. In the absence of buying inventory and other assets used to carry on a business or part of a business and the filing of a joint election by the vendor and purchaser (both HST registrants), an HST-registered vendor must collect HST from the purchaser of inventory.

4.3.2 Land and building

(a) Corporate considerations

In many purchases, land is one of the most valuable assets involved in the transaction. To be certain that the vendor owns the land that the vendor claims to own and that the purchaser is acquiring good title to all of the land, the purchaser's lawyer will search title in the appropriate registry or land titles office.

In commercial transactions, particularly where there is an acquisition of land and buildings, the application of environmental laws and environmental liabilities must be considered. Environmental liabilities may be treated like other liabilities: they may be investigated and assessed, and the risk may be allocated by contract. However, environmental liabilities are somewhat difficult to deal with since these statutory liabilities may adversely affect the financial condition of the owner or the occupier of land or the person who owns or controls the business conducted on land. They may even prevent the use of the land for a particular purpose or the continued operation of the business. Many purchasers now require satisfactory environmental audits as a condition of closing in order to ascertain whether there are any contaminants or hazardous materials in, on, or under land and buildings and whether there has been compliance with environmental laws.

(b) Tax considerations

For tax purposes, capital properties may be either depreciable or non-depreciable. A building is an example of a depreciable asset, since a taxpayer claiming CCA may deduct the building's decline in value from the taxpayer's income (i.e., from the depreciable asset's tax cost or the amount remaining—UCC). Land and a share in a corporation are examples of non-depreciable assets.

(i) Vendor

Building: Depreciable assets are described in classes or pools in Schedule II of the *Income Tax Regulations* (*ITR*s). A taxpayer may deduct the tax cost of assets listed in the various asset classes by claiming CCA at the different rates specified for the asset's class. For example, a building acquired after 1987 is included in Class 1, and CCA may be deducted (on a declining balance basis from the UCC) at the lower rate of 4% per annum.

If a building is later sold (and assuming that the building is the sole asset in the particular class), the vendor is required to include in income an amount of recaptured CCA that is equal to the difference between the UCC of the building and the lesser of

- the portion of the purchase price allocated to the building; or
- the capital cost of the building.

If the sale price the vendor receives exceeds the building's capital cost, the excess is treated as a capital gain of which one-half of the capital gain is included in income as a taxable capital gain.

On the other hand, if the sale price the vendor receives is less than the UCC, the difference may be deducted by the vendor in the year of sale as a terminal loss against any other income of the vendor (i.e., the vendor has not yet deducted enough CCA to reflect the decline in value of the building—to the time of sale). It should be noted that if the sale of the building gives rise to a terminal loss and the sale of the land gives rise to a capital gain, the rules in the *ITA* provide that the terminal loss will be reduced.

Land: A vendor will realize a capital gain (or loss) equal to the amount by which the sale price exceeds (or is less than) the vendor's ACB of the land. One-half of the capital gain is included in income as a taxable capital gain. One-half of the vendor's capital loss (the allowable capital loss) is only deductible against taxable capital gains. Any excess capital loss can be carried back three years or forward indefinitely, but may still only be used to offset taxable capital gains.

(ii) Purchaser

Building: That part of the purchase price that is allocated to the building may be deducted for tax purposes by the purchaser claiming CCA at the rate of 4% per year on a declining-balance basis of the depreciable asset's tax cost or UCC.

Land: A purchaser is not entitled to current tax deductions with respect to the part of the purchase price allocated to the land (a non-depreciable asset). The part of the purchase price allocated to the land is added to the purchaser's ACB in the land. The purchaser's ACB is relevant to determining the capital gain (or loss) that will be realized by the purchaser on a subsequent sale of the building and the land, after allocating the future sale proceeds between the building and the land.

(c) Other taxes

Where assets are being purchased, the LTT is payable on the portion of the purchase price allocated to the real property situated in Ontario (both land and building).

HST is now applied to the purchase of real property, i.e., land, buildings, and fixtures in Ontario. Generally, under the *ETA* the sale of commercial real property is a taxable supply for purposes of the HST. If a purchaser is an HST registrant, in most cases an HST registered vendor will not have to charge and collect HST on the sale. Rather, this purchaser must self-assess (itself for HST on the real property purchased) on its HST return for the period during which the purchase of real property took place and, at the same time, claim any applicable ITCs with respect to the real property (i.e., used in a business).

A joint election may also be available under s. 167(1.1) of the *ETA* where all or substantially all of the assets used in a business are being sold. Where real property is included in the assets of a business that is being sold, no HST is payable with respect to real property that is included in this joint election. However, it will be subject to the self-assessment as discussed above.

4.3.3 Machinery and other depreciable property

(a) Corporate considerations

In any business, there may be numerous "miscellaneous" pieces of machinery and equipment that are used to operate the business. This is particularly true of a manufacturing business where there may be thousands of individual pieces of machinery, equipment, tools, cars, trucks, fork-lifts, desks, chairs, office equipment, etc. For the lawyer involved in an asset sale, the challenge will be the conveyance to the purchaser of each item.

Preferably, each individual item would be specifically listed, with its serial number if applicable, in a schedule to the asset purchase agreement. Clearly this is a very time-consuming job, and in many large transactions, a more generic description of the assets and their location is used.

(b) Tax considerations

Machinery and equipment are a type of depreciable asset commonly involved in an asset purchase transaction. The rate of CCA that may be claimed for machinery and equipment varies; however, a deduction for CCA on manufacturing machinery can often be claimed at the rate of 30% on a declining-balance (UCC) basis.

Other depreciable assets usually involved in an asset purchase transaction may include the following:

- transportation equipment (i.e., cars and trucks);
- intangibles (i.e., patents, franchises, concessions, licences, leaseholds); and
- office equipment, computer hardware, and software.

Example

A vendor is selling a piece of machinery with an original cost of $1,000, a UCC of $500, and a FMV of $2,000. Assume the machinery is the only asset in the class.

A sale of the machinery for $2,000 results in

- recaptured CCA (ordinary income) of $500 ($1,000 original cost less $500 UCC), which is taxable at ordinary rates; and
- a capital gain of $1,000 ($2,000 FMV less $1,000 original cost), one-half of which is included in income as a taxable capital gain.

If the machinery were sold for a FMV of $750 the vendor would have recapture of $250 ($750 FMV sale proceeds less $500 UCC) and no capital gain.

If the machinery were sold for a FMV of $250 the vendor would be entitled to a deduction of $250 as a terminal loss ($500 UCC less $250 FMV) against any income.

(c) Other taxes

A sale of machinery and other depreciable property (automobiles, office equipment, computers, etc.) is a taxable supply under the *ETA*. If a joint election is not available under s. 167(1.1) of the *ETA*, HST will be payable by the purchaser and collected by a vendor of equipment that is an HST registrant.

4.3.4 Accounts receivable

(a) Corporate considerations

Generally, the vendor of a business would like to take the position that the purchaser pay full value for all receivables, less any provision for bad debts, and be responsible for collecting those receivables. The vendor is motivated by the fact that once the business has been sold, the vendor no longer has an efficient method of collecting the receivables and can no longer take advantage of the ongoing business relationship as a form of moral (or even legal) persuasion to force payment.

The purchaser, not having a history with the accounts and not generally knowing the vendor's sale and collection policies or the impact of the sale on the bad debt experience, is concerned about their collectibility. Accordingly, the purchaser will normally initially propose that no payment be made for the accounts but rather that the purchaser will collect them on the vendor's behalf and at its expense and account to the vendor for any amount collected. The real issues pertaining to the transfer of accounts receivable are who will pay the collection costs and who will run the risk of non-collection. A purchaser who pays full value for the receivables will want an assurance that they are collectible and that there will be recourse against the vendor for those that are not.

As a result, if one of the foregoing methods is not acceptable, then the parties generally agree upon one of the following accommodations:

- The purchaser will purchase the receivables at a sufficient discount from book value to protect the purchaser, and the purchaser will assume sole responsibility for the collection of those receivables.
- The purchaser will purchase the receivables, again possibly at a discount, and collect the receivables for a period of time. If at the end of that time the purchaser has not recovered the payment, the remaining accounts will be turned over to the vendor to pursue through whatever remedy it feels appropriate. In this case, there is often a holdback, and the purchaser will retain from the holdback any difference between the amount collected and the purchase price for the receivables.

(b) Tax considerations

When a taxpayer carries on a business and supplies goods and services to customers, the revenue from the charges for the goods and services is included in the taxpayer's income from the business for income tax purposes. The taxpayer's profit from the business will be the amount determined after deducting the expenses associated with earning that revenue (i.e., the cost of inventory and other expenses of carrying on the business).

It is also likely that a taxpayer will not always be paid immediately for those goods and services supplied to customers—in which case the taxpayer will have accounts receivable from customers. If a taxpayer determines at the end of the tax year that it is doubtful amounts from the accounts receivable can be collected, the taxpayer may deduct an amount from income that is a reserve for doubtful debts. Under the *ITA*, this deduction is available because an amount in respect of the doubtful debt has already been included in the taxpayer's income (i.e., revenue from goods and services sold to customers). In the following year (and later years), the amount the taxpayer has claimed as a doubtful debt reserve for the prior year must then be included in income. However, a new amount may be claimed by the taxpayer as a doubtful debt reserve (i.e., a new reserve amount is established and claimed) if the collection of the accounts receivable continues to be doubtful. When a taxpayer finally determines that an amount (from the accounts receivable) is not at all collectible, a deduction may be taken and claimed for this amount as a "bad debt."

(i) Vendor

In a sale of assets, it is likely the accounts receivable for the business will be sold to the purchaser. The tax consequences to the vendor from selling the accounts receivable are as follows:

- **Income is included:** The vendor is required to include in income the amount claimed in the previous year as a doubtful debt reserve.
- **Capital gain (or loss) is realized:** A vendor of accounts receivable (i.e., in the course of selling a business) will realize either a capital gain (or capital loss) depending on whether the sale price for the accounts receivable is greater (or less) than the face amount of the receivables. Generally speaking, the sale of accounts receivable will give rise to a capital loss—since a purchaser not familiar with the business or customer owing the money is not prepared to pay the full face amount for the accounts receivable because even the vendor has not yet been able to collect the accounts receivable. One-half of the capital loss realized may be carried back three years and forward indefinitely, but is deductible only against taxable capital gains of the vendor.

Example: Sale of accounts receivable

Face amount of receivables	$100
Doubtful debt deduction (reserve) claimed in previous year	10
Sale price	90
Vendor's tax consequences:	
(a) Income inclusion of deduction (reserve) previously claimed	10
(b) Capital loss ($90-$100)	10

Since only one-half of capital losses (the allowable capital loss) can be deducted against taxable capital gains, this is not the most favourable tax result (treatment) to a vendor.

(ii) Purchaser

Under the tax rules, a purchaser of accounts receivable is not able to deduct an amount (reserve) from income in respect of doubtful debts (accounts receivable) because the purchaser will not have met the technical requirement in the *ITA* of having already included an amount on account of the accounts receivable in income (i.e., the purchaser did not carry on the business that gave rise to the accounts receivable). Any loss realized by a purchaser from not collecting the accounts receivable is a capital loss, one-half of which may be deducted only against taxable capital gains (i.e., the uncollected accounts receivable do not entitle the purchaser to claim a bad debt deduction).

(iii) Section 22 election

The sale of accounts receivable does not provide the best tax consequences to the vendor and purchaser.

Under s. 22 of the *ITA*, the vendor and purchaser of all or substantially all of the assets used in carrying on a business can make a joint election that improves the tax consequences to each party in connection with the sale and purchase of accounts receivable.

The tax consequences to the vendor from making a joint s. 22 election (for accounts receivable) are as follows:

- an income inclusion equal to the doubtful debt deduction (reserve) claimed by the vendor in the previous year; and
- a deduction from income equal to the difference between the face amount of the accounts receivable and the purchase price allocated to the accounts receivable.

Example

Using the same example as above, the vendor's tax consequences of making a s. 22 election would be calculated as follows:

Income inclusion of deduction (reserve) previously claimed	$10
Income deduction equal to face amount less consideration	$10

In this case, the vendor's ordinary (business) loss from the sale of accounts receivable at less than face value fully offsets the income inclusion (of the reserve previously claimed).

The tax consequences to the purchaser from making a joint s. 22 election for accounts receivable are

- an income inclusion equal to the difference between the face value of the accounts receivable and the purchase price allocated to the accounts receivable; and
- the ability to take a deduction in the year of purchase and subsequent years for doubtful debts or bad debts associated with the accounts receivable.

A s. 22 election for accounts receivable is only available where a vendor is selling all or substantially all of the assets of a business necessary to carry on the business. It is a question of fact whether a vendor's sale of the assets of a division sufficiently constitutes a separate business such that the election is available.

The CRA's administrative position on the tests to be applied in determining whether a division constitutes a separate business is set out in Interpretation Bulletin IT-206R, "Separate Businesses."

A joint (signed) election is made by filing a Form T2022, "Election in Respect of the Sale of Debts Receivable," with the CRA. While the *ITA* does not specify a time limit for making this election, in practice the parties file the

election in the year the assets of the business are sold (bought).

(c) Other taxes

The HST treatment of accounts receivables that are sold or transferred remains fraught with difficulty. While the sale or transfer of the accounts receivable is relatively straight forward and treated as a supply of an exempt financial instrument (see the definitions of "debt security" and "financial instrument" under s. 123(1) of the *ETA* and the financial services exemptions in Part VII of Schedule V of the *ETA*), a major HST issue arises when the sold accounts receivable become a "bad debt" in the hands of the transferee or buyer. Generally speaking, the problem is that the HST component of the bad debt, which is usually recoverable in the hands of the original supplier under s. 231 of the *ETA*, is not generally recoverable in the hands of the new buyer/transferee of the accounts receivable (i.e., see the provisions of s. 231 of the *ETA*). In those circumstances where the accounts receivable can be taken back by the original supplier (the seller), as in the context of accounts receivable that are sold to a buyer but "with recourse" against the vendor, this problem resolves itself (see also GST/HST Policy Statement P-029R), but only in that specific instance. Accordingly, lawyers dealing with the buying and selling of accounts receivable in the HST context should take extra time in reviewing the current applicable provisions and the current CRA policy in respect of same.

4.3.5 Prepaid expenses

(a) Corporate considerations

On a sale of assets, the vendor will want to be reimbursed for any expenses paid prior to the date of closing but relating to the post-sale period. These amounts, covering items such as rent, business taxes, insurance premiums, and advances on royalties to intellectual property owners, are normally adjusted to the closing date. Unless the purchaser is not going to obtain the benefit of the prepayment, as would be the case where the purchaser arranges its own insurance, the purchaser usually agrees to reimburse the vendor for these expenses. If the purchaser is compensating the vendor for these prepayments, counsel should ensure that the underlying asset is properly transferred to the purchaser—for example, that the insurance has been assigned and the purchaser has been named as the new insured party.

4.3.6 Intellectual property

(a) Corporate considerations

Business names, trade-marks, licences, copyrights, patents, and other intellectual property that the purchaser is acquiring require special considerations. The principal issue is to ensure that the property in question is properly identified and the appropriate steps taken in the documentation to ensure that it is effectively transferred to the purchaser. In a situation in which the purchaser must obtain use of the property but the vendor cannot deliver title (i.e., a trade-mark or patent used by a Canadian subsidiary of a foreign parent that will continue to use the trade-mark or patent outside Canada), appropriate agreements must be prepared to allow the purchaser to use the intellectual property.

(b) Tax considerations

Purchasers must carefully consider all the provisions in any agreement dealing with a franchise, concession, licence, patent, and similar property, since the terms of renewal, options, and extensions may affect not only the determination of the "life" of that property, but also whether it is for a limited or unlimited period of time.

Certain intellectual property is depreciable property and listed in the asset classes (for claiming CCA) in the *ITR*.

For example, a franchise, concession, licence, patent, and similar property may be acquired for a limited period of time (i.e., either because the asset will be used for a fixed period or has a limited useful life). In this case, a franchise, concession, licence, patent, and similar property are considered Class 14 property, and their cost is expensed under the CCA rules on a straight-line basis over this fixed period (*ITA*, s. 20(1)(a); *ITR*, s. 1100 and Schedule II, Classes 14 and 44).

On the other hand, a franchise, concession, licence, patent, and similar property that have an indefinite useful life (and are not depreciable property in a particular class) likely qualify as "eligible capital property" (*ITA*, ss. 14 and 20(1)(b)). The cost of such property is expensed through the CEC account (i.e., is intangible property).

4.3.7 Goodwill and related assets

(a) Corporate considerations

Goodwill is generally described as the basket of intangible assets that add value to a business. Examples include the location of its premises, its mailing list, its business names, its reputation, and generally the value built up as a result of years of carrying on business. It is the price over and above the value of specific tangible

assets that a purchaser is prepared to pay in order to acquire the business.

(b) Tax considerations

Generally speaking, intellectual property (i.e., goodwill and other intangible assets connected with a business) that is not depreciable property in a particular class (for claiming CCA) is "eligible capital property" (ECP) under s. 14 of the *ITA*. In addition to goodwill, ECP includes the legal costs of incorporation and licences for an unlimited period or "indefinite lifetime." The CRA lists other examples of ECP in Interpretation Bulletin IT-386R, "Eligible Capital Amounts" and IT-143R3, "Meaning of Eligible Capital Expenditure."

(i) Vendor

A vendor's CEC account is three-quarters (75%) of the aggregate of all amounts paid to acquire goodwill (i.e., customer lists, a licence with an indefinite useful life, etc.) minus three-quarters (75%) of the sale proceeds from selling any goodwill (subject to a maximum deduction equal to 75% of the amounts paid to acquire goodwill—the CEC account cannot be negative). Under the *ITA*, the treatment of a taxpayer's ECP (i.e., goodwill) and the CEC account balance is analogous to a taxpayer's depreciable property and the UCC for depreciable capital property since excess deductions are subject to recapture on sale or disposition of the property. Where the proceeds of disposition exceed the original cost, such gains are treated as a capital gain.

Previously, the *ITA* rules provided that no reserve can be claimed under the *ITA* for any proceeds not yet received from the sale of ECP (i.e., goodwill). However, a recent amendment to s. 14 of the *ITA* (*ITA*, s. 14(1.01) election) and the CRA's written views on this (i.e., CRA views letter 2002-0133797) confirm that if payment is received over time, the capital gain may be brought into income over time as well. Specifically, the election has to be made to treat the disposition of the ECP as a capital gain, and then the reserve can be claimed. Any expenses incurred by the seller in selling ECP can be deducted from the sale proceeds.

As the capital gains inclusion rate is now one-half, special tax rules (i.e., adjustments) apply to the sale of goodwill to ensure that the proper income and capital gain is calculated on the sale of goodwill. The untaxed portion of any capital gain is also added to the capital dividend account (CDA) of a private corporation. Generally speaking, the following rules apply on the sale or disposition of ECP by a taxpayer:

- Three-quarters of the sale proceeds are still deducted from the CEC pool balance to ensure there is full recapture of prior "depreciation" claimed on the CEC pool. Consequently, the recapture will be determined as the lesser of
  - three-quarters of the sale proceeds less the CEC pool balance; and
  - the amount of "depreciation" previously claimed on the CEC pool.
- Where the three-quarters of the sale proceeds exceeds three-quarters of the original cost of the property, an "adjustment" is necessary to reduce the amount of this excess to ensure the correct amount of the capital gain is determined, i.e., reduce three-quarters of the excess to reflect a gain that matches the capital gain inclusion rate of one-half.
- The adjustment factor applied to the 3/4 excess amount (to ensure that it matches this 1/2 capital gain inclusion rate) is 2/3 (i.e., 3/4 of excess amount multiplied by a 2/3 adjustment factor = 1/2, so the proper amount of the excess is treated as a capital gain).
- Where a private corporation sells ECP, adjustment also ensures the correct amount is credited (i.e., the non-taxed portion of the gain in excess of the original cost of the ECP) to the corporation's CDA. A positive balance in a private corporation's CDA permits the corporation to elect to treat the future payment of dividends to shareholders as tax-free capital dividends (but only to the extent the private corporation has a positive CDA balance).

Ensuring that the tax treatment of a taxpayer's ECP (i.e., goodwill) and the CEC account balance is consistent or analogous with the tax treatment of other depreciable capital property facilitates and encourages tax compliance by taxpayers.

(ii) Purchaser

A purchaser's CEC account is three-quarters (75%) of the aggregate of all amounts paid to acquire goodwill (i.e., customer lists, a licence with an indefinite useful life, etc.) minus three-quarters (75%) of the sale proceeds from selling any goodwill (subject to a maximum deduction equal to 75% of the amounts paid to acquire goodwill—the CEC account cannot be negative).

A purchaser of goodwill (CEC) is entitled to claim a deduction in computing income equal to 7% of this CEC account on a declining-balance basis. Under the *ITA*, the treatment of a taxpayer's ECP (i.e., goodwill) and the CEC account balance is analogous to a taxpayer's depreciable property and the UCC for depreciable capital property, since excess deductions are subject to recapture on a later sale or disposition of the goodwill. Where the proceeds of disposition exceed the original cost, such gains are treated as a capital gain.

(c) Other taxes

A vendor who is also an HST registrant selling goodwill and other intangibles is treated as making a taxable supply for HST purposes under the *ETA*. Accordingly, HST is payable by a purchaser of goodwill, and the HST collected is then remitted by the vendor to the CRA.

However, where the sale of goodwill is part of the sale of all or substantially all of the assets used in carrying on a business or part of a business, the vendor and purchaser may make a joint election under s. 167.1 of the *ETA*. This election deems the disposition of goodwill to occur at nil consideration so that no HST arises.

4.3.8 Assumed liabilities

In an asset purchase transaction, not only can a purchaser pick and choose the assets to purchase, but also the purchaser is in the position of determining which liabilities, if any, to assume.

The value of the liabilities assumed by the purchaser becomes part of the purchase price to be allocated among the assets acquired.

Example

Assume a purchaser has agreed to buy the assets of a business for $100,000 and assume liabilities worth $20,000. The purchaser agrees to pay $80,000 cash for the "net" assets. In this case, the total consideration of $100,000 should be allocated to the assets acquired.

As a matter of law, a person with an obligation to perform, in this case the vendor, is not relieved of that obligation if the performance of the obligation is assigned to a third person. In this case, if the purchaser failed to perform the obligation, the vendor would be liable. For example, indebtedness owed by the vendor to a chartered bank cannot be assumed by the purchaser with the vendor thereafter no longer being liable for the debt unless the bank consents to the assumption and release of the vendor. Accordingly, in an asset transaction, the vendor should be concerned that the purchaser has the ability to perform the obligations assumed by the purchaser. If there is any question in this connection, the vendor will insist on a release or, as a minimum, an indemnity or a hold-back; the vendor may also insist on a share transaction because the liabilities of the business reside with the corporation being sold and not with the vendor personally. Care should be taken where guarantees of a corporate debtor are in place because a sale of the shares of the corporation will not relieve the guarantor of his or her obligation. Negotiation with the beneficiary of the guarantee (i.e., a bank or other lender/creditor) will be required.

In addition, persons to whom the obligations are owed are not required to accept the performance of a third person where the services are in any way unique. The most usual example is a personal services contract such as an employment or consulting contract. The obligations of a consultant or employee to perform cannot be assigned to someone else without the consent of the other party to the contract.

In a typical asset purchase, the obligations to be assumed or not assumed by the purchaser are usually the subject of negotiation. These include the following:

- Accounts payable: Generally the purchaser will want to assume the accounts payable because by utilizing the vendor's trade terms, the purchaser may have the opportunity to defer payment of part of the purchase price for a matter of weeks and in many cases even months. If the purchaser does not assume the accounts payable, this fact will be reflected in the purchase price, and the vendor will have the benefit of prepayment from the purchaser. Perhaps more important, however, is that in many instances payables are owed to persons such as landlords and ongoing suppliers of the business. The purchaser will want to assume these payments in order to ensure that the persons on whose goodwill the business depends are paid in the ordinary course and will continue to deal with the purchaser.
- Sales orders: If the vendor is going out of business, it will want the purchaser to assume all of its unfilled sale orders. To the extent that these orders are profitable, the purchaser will want to take advantage of them. To the extent that they are unprofitable, the purchaser will want to be aware of them so that this fact can be reflected in the purchase price.
- Indebtedness for borrowed money: Typically, a purchaser does not assume an obligation for indebtedness for borrowed money because the purchaser will have its own financing in connection with the transaction. However, it is possible that some forms of financing may be advantageous or profitable to a purchaser, who will therefore be prepared to assume them provided that the party to whom such obligations are owed (for example, the bank) is prepared to have the obligation assigned and the purchaser assume payment.
- Warranty claims: While the purchaser will usually complete unfilled sales orders and unperformed service obligations, the vendor will also want the purchaser to satisfy warranty and other claims by customers of the business under those transactions of purchase and sale that occurred prior to the date of the business being purchased. The vendor will be motivated by the fact that it is no longer in the business and is unable to perform warranty claims. While it is in the best interests of the purchaser to preserve the goodwill of the business, there are

often disputes as to who will pay and on what basis with respect to such warranty claims. This is especially true if the vendor has sold or manufactured an item over the past few years that has had several defects or warranty claims. Product liability claims can be very expensive, and accordingly, this may become an issue of great discussion.

- Liabilities not ordinarily assumed: These could include insurance and non-arm's length transactions.
- Third-party contracts and approvals: Long-term contracts with landlords, equipment lessors, suppliers, and customers may be either an important asset to a business or a significant liability. Typically the agreement of purchase and sale for assets will provide that the vendor must deliver copies of all contracts, agreements, leases, licences, and franchises relating to the business that the vendor has entered into with third parties and provide the purchaser a reasonable opportunity to review such documents and determine which contracts the purchaser wishes to assume. Certain long-term arrangements may require approvals from third parties such as landlords for any premises leased by the vendor and owners of equipment leased by the vendor.
- Licences and permits: Caution should be exercised in order to ensure that the legislation and various regulatory authorities allow the assignment of any required licences and permits. The purchaser may have to apply for those permits or approvals independently, and if competent enough, the transaction could be subject to these permits and/or approvals being obtained.

4.3.9 Employees

There are often substantial employee-related costs inherent in the purchase of a business. If employment is to be reduced, the cost of the reduction and who bears it must be determined.

(a) Common-law position

The position at common law is that upon the purchase of the assets of a business and the vendor ceasing to carry on the business, the vendor, as employer, has dismissed each of the employees and the vendor is liable for such claims, subject to an employee's duty to mitigate and seek alternative employment. However, this is not the usual course of action in an asset purchase, since the purchaser usually agrees to offer employment to most, if not all, employees of the vendor upon the closing of the agreement of purchase and sale on at least substantially the same terms and conditions as such employees were employed by the vendor. If the employee accepts such employment with the purchaser, then that employee will not have suffered any damages with respect to termination of his or her employment. An employee who refuses an offer of employment by the purchaser will be deemed to have not mitigated his or her damages and will therefore not likely have a claim for substantial damages against the vendor for wrongful dismissal.

Typically, a purchaser will carefully review the employees and their length and terms of employment and make a determination prior to closing as to which of those employees it wishes to keep. Those that the purchaser does not wish to keep will be terminated by the vendor prior to closing, with the vendor being responsible for the costs of such termination. As an alternative, many agreements of purchase and sale provide that the purchaser will offer employment to all employees upon closing but that the purchaser will have a period of time following closing to operate the business and determine whether all of those employees are required. If the purchaser then subsequently determines that some of the employees are not required in the business, the purchaser will dismiss these employees and will become legally responsible for employee claims, unless the parties agree otherwise. If this method is used, the purchaser should bear in mind that the costs associated with terminating these employees relate to the entire period of employment with both the vendor and the purchaser and not just for the time period with the purchaser. To protect itself, the purchaser usually includes a provision in the agreement of purchase and sale providing that the purchaser may claim the costs associated with terminating these employees from the vendor. In such circumstances, the obligation for payment still rests with the purchaser, and accordingly the purchaser should ensure that it is satisfied with the ability to claim such amounts from the vendor.

(b) Termination under the Employment Standards Act, 2000

Under s. 9 of the *ESA*, if an employer sells a business or a part of a business to a purchaser who agrees to hire the employees, then those employees' jobs are not terminated by the sale. The period of employment is deemed to have been employment with the purchaser for the purposes of any subsequent calculation of an employee's length of employment.

Where a vendor sells a business and the purchaser does not then offer employment to an employee of that vendor, the vendor, as an employer, must comply with Part XV of the *ESA* dealing with termination of employment. Under s. 54, there are two types of notices of termination. The first type of notice applies to the termination of employment of less than 50 employees who have been employed for three months or more. In this case, the required amount of notice to be given by

the vendor/employer depends upon the length of service of that employee and ranges from one week to eight weeks' notice. For those employees who have been employed for less than three months, no notice is required. The second type of notice provided for under the *ESA* applies to the termination of 50 or more employees in a period of four weeks. Under s. 58 of the *ESA* and O. Reg. 288/01, made under the *ESA*, the length of notice required will depend upon the number of employees being dismissed and ranges from eight weeks' notice of termination if more than 50 but less than 200 employees are being terminated, all the way up to a notice period of 16 weeks where there is a termination of employment of 500 or more persons.

The *ESA* also requires an employer to pay "severance pay" for each year worked up to a maximum of 26 years where 50 or more employees have their employment terminated by an employer in a period of six months or less and the terminations are caused by the permanent discontinuance of all or part of the business of the employer at an establishment. The amount of severance pay is calculated by multiplying the employee's regular wages for a regular workweek by the sum of the employee's

- completed years of employment; plus
- completed months of employment divided by 12.

The total severance payment shall not exceed 26 weeks' regular wages for a non-overtime workweek. This severance pay must also be paid where one or more employees have their employment terminated by an employer with a payroll of $2.5 million or more. Only employees who have worked for the employer for 5 or more years are entitled to this severance pay. Note that severance pay under s. 64 is in addition to the right of notice of termination under s. 54.

(c) Position under the Labour Relations Act, 1995

Pursuant to s. 69(2) of the *Labour Relations Act, 1995*, the purchaser of a business (a "successor employer") is, until the Ontario Labour Relations Board otherwise declares, bound by any collective agreement by which the vendor is bound. It should be noted that these provisions are broader than those under the *ESA* and apply whether or not the purchaser offers employment to the vendor's employees.

(d) Canada Pension Plan

In an asset purchase, the purchaser will be considered a new employer for the purposes of the Canada Pension Plan (CPP) and CPP contributions. The purchaser will be required to withhold and match all required CPP contributions even if all payments and deductions for the year were made by the vendor prior to closing. While an employee can recover any overpayment in CPP contributions when filing his or her tax return, employer contributions are not subject to a refund. Accordingly, consideration should be given to the timing of a transaction involving substantial employees in order to avoid the double payments.

The status of pension plans and similar agreements should also be considered.

(e) Workplace Safety and Insurance Act, 1997

The record of the vendor will be relevant to a purchaser in connection with the payments due under the *Workplace Safety and Insurance Act, 1997* since the purchaser will inherit the work record of the vendor and the level of payments due as a result of this record (s. 146). However, the vendor will not be relieved of its financial obligations under this *Act* until the vendor, the purchaser, or both pay all amounts owing.

4.4 Payment of the purchase price and other considerations

4.4.1 Payment of the purchase price

(a) Corporate considerations

There are three choices and various alternatives available in connection with the payment of the purchase price by a purchaser to a vendor:

- All cash: The purchase price is determined and allocated among the various assets, and then at closing, the purchaser pays to the vendor, by certified cheque or bank draft, the amount agreed upon.
- Cash together with a promise to pay the balance of the proceeds after the sale: Usually, a promissory note is given on closing to evidence the balance of the purchase price. An additional issue that arises is security for the payment of that purchase price in the future. The vendor wants to ensure that the purchaser has the ability to pay that amount in the future in accordance with the promissory note and accordingly will often take security over the assets that have just been sold in order to ensure that payment takes place. This could be done by virtue of a security agreement, and typically, there is an agreement that the security to the vendor will rank behind the purchaser's banker in connection with the assets. Alternative security could be a letter of credit from a financial institution backing up the purchaser's promise to pay.
- Some combination of cash plus a promise to pay a fixed amount as well as a promise to possibly pay additional amounts based on an earn-out provision.

(b) Tax considerations

There are various tax issues to be considered when payment of all or part of the purchase price on a transaction is deferred:

- Reserves: The *ITA* permits a limited deferral of tax when some or all of the sale proceeds are due after the year of sale. The tax rules recognize that it would be unfair to require a vendor to pay the entire tax liability in the year of sale in circumstances where the vendor has not yet received all the sale proceeds.

  The deferral rules, known as claiming a "reserve" for tax purposes, are found in s. 40(1) dealing with the sale or disposition of capital property. The amount of the reserve that may be claimed is generally the part of sale proceeds that are not yet due. The maximum deferral for recognizing the capital gain from the disposition of capital property is five years, including the year of sale. A vendor should realize that all taxes will have to be paid within five years (year of sale and four years following) regardless of whether any or all of the sale price has been received.

  There are similar reserve provisions available to the sale of non-capital property in s. 20(1)(n) (i.e., disposition of inventory in carrying on a business, but subject to limitation/restrictions in s. 20(8)) of the *ITA*. The maximum deferral under these provisions is three years.

  Where HST is payable on the sale, the HST is due on the earlier of the date the consideration is due or paid. This provision will also permit a deferral of the HST in the case of instalment sales but not for all types of property.

- Interest: Where a vendor's receipt of sale proceeds is deferred, the parties may agree that interest will accrue in favour of the vendor on the unpaid balance. Any interest paid by the purchaser will be deductible for tax purposes and likewise included in the income of the vendor. Where the vendor is a non-resident of Canada, the purchaser may be exempt from withholding tax on interest payments paid to the non-resident vendor/recipient (commencing in 2008 on arm's length interest but not participating interest) under Part XIII of the *ITA*.

  Where the payments to the vendor are deferred and there is no provision for payment of interest to the vendor or where the interest payable is below market rates, the vendor may still be required to include in income that part of the sale proceeds that may reasonably be considered as interest (s. 16(1) of the *ITA*). The CRA would likely only apply this provision in exceptional circumstances, i.e., when the parties attempt to increase the purchase price and not charge interest on any unpaid amounts in order to thereby obtain other tax advantages from their transaction.

- Bad debts: Where all or part of the purchase price owing by a purchaser is not paid and the vendor can establish the amount is uncollectible (see Interpretation Bulletin IT-159R3, "Capital Debts Established to Be Bad Debts"), tax relief is provided to the vendor in ss. 50 and 20(4) of the *ITA*. These rules provide that the vendor will realize a capital loss in the year the debt becomes uncollectible, and where the bad debt relates to the proceeds of disposition of depreciable property, the vendor may also deduct from income any recapture of CCA previously included in the vendor's income.

- Cash and earn-out: An earn-out clause is often a provision included in a purchase agreement that will adjust the total price of the transaction. An earn-out mechanism is normally based on the actual earnings achieved by the purchaser from the acquired business in a certain period of time following the purchase. Earn-outs typically represent a compromise between the purchaser's ability to pay a higher amount for the business than it is worth and the ability of the business to in fact achieve those earnings in the future based on the amount of earnings expected/contemplated by the vendor. Under the earn-out provision, if the business earns a particular level of earnings in the future, then an increased purchase price will be paid based on those earnings.

  Alternatively, an earn-out may be a deferred payment mechanism. In this case, the payment to be made in a particular year will be based on earnings realized in that year.

  In structuring an earn-out, the vendor and purchaser should ensure that the provision is compatible with

  – the accounting procedures to be used in the future; and

  – especially in an asset transaction, the income attributable to the particular assets purchased and sold is identifiable.

  Under s. 12(1)(g) of the *ITA*, the amount of any part of the purchase price payable in instalments but dependent on the revenues or profits derived by the purchaser from the property is taxable to the vendor on account of income and not as a capital gain. Since the future payments in this type of earn-out are based on the earnings generated by the property acquired by the purchaser, s. 12(1)(g) of the *ITA* may cause payments to be income when received by the vendor, even if the property that was sold was a capital property and the payments represented the sale price of the property. From a tax policy perspective, structuring payments under an earn-out by reference to the profits of the business allows them to be taxed as income, not as a capital gain. It is as if the vendor has not left the business but rather continues to participate and share in the profits of the business.

The CRA's views on earn-outs and the application of s. 12(1)(g) of the *ITA* is described in Interpretation Bulletin IT-462, "Payments Based on Production or Use." The CRA considers s. 12(1)(g) of the *ITA* to be applicable to those payments (i.e., the payment amount varies) made under earn-out agreements that are contingent on the future earnings of the business.

To minimize the risk of the CRA applying s. 12(1)(g) to a vendor, the purchase price (i.e., total amount to be paid) should be a fixed amount. In practice, it may be difficult to structure an agreement of purchase and sale and the payment of the purchase price in this manner, particularly where the value of the business or assets is dependent on future revenues earned by the purchaser. Consequently, parties may wish to structure payments as a reverse earn-out. In a reverse earn-out, the sale price is set at a fixed amount with a provision to reduce the purchase price (and the later instalment payments) if future earnings do not reach a specified amount(s).

4.4.2 Risk of loss

The purchase agreement should clearly provide whether it will be the vendor or the purchaser who carries the risk of damage to the assets prior to closing and what options are open to the purchaser if damage occurs. Usually, risk remains with the vendor, and the purchaser has the option of not completing the transaction, completing the transaction with an abatement in the purchase price, or completing the transaction and receiving any insurance proceeds that otherwise would be payable to the vendor. Since the assets become the property of the purchaser at closing, the purchaser should make appropriate arrangements for its own insurance coverage to be effective from at least that date.

4.4.3 Non-competition agreements and consulting agreements

(a) Non-competition agreements

Usually, a purchaser intends to operate the business formerly carried on by the vendor. To be successful in doing so, the purchaser will want to retain the customers and contracts of the vendor. To achieve this, the purchaser would normally require that the vendor and its principal shareholders agree not to compete with the business. While the courts generally view a covenant not to compete as a restraint of trade, such a covenant will be enforced if it is carefully drawn as to

- the length of time in which it operates;
- the geographic area in which it operates; and
- the scope of the business activities covered by it.

In each case, the restriction must be seen as being not more broadly drawn than is necessary to protect the purchaser's valid business interests under the circumstances. Consideration paid for the covenant enhances its enforceability.

Often a purchaser may be reluctant to make this payment, since it may only be claimed as an eligible capital expenditure for income tax purposes. On the other hand, past tax cases dealing with the recipient of the payment have held the payment received for a non-competition covenant was a non-taxable capital receipt since the right to compete/not compete was not income from a productive source under s. 3 of the *ITA* nor eligible capital amounts to the taxpayers (since they did not operate the business personally) nor property the disposition of which might otherwise give rise to a capital gain (*Fortino v. R.*; *Manrell v. Canada*).

Unfortunately, this very favourable tax treatment of the recipient prompted a proposed legislative response from the federal Department of Finance with retroactive application to October 8, 2003 (*ITA*, new proposed s. 56.4 and consequential amendments to ss. 6, 14(5.1), 56, 60, 68, and 212), which if enacted, would reverse these tax cases. Generally speaking, the proposed legislative rules would treat payments that are received or receivable under a restrictive covenant (i.e., non-competition agreement) as being ordinary income and therefore fully included in income in that year, unless there is alternative treatment allowed or specified in the rules (i.e., the parties jointly elect to treat it as (i) capital where shares are sold, or (ii) eligible capital proceeds, etc.).

From the payor's perspective, under the new legislation there is no proposed general rule, so it may be expected that for tax purposes the payor is acquiring ECP, unless the parties utilize a joint election or the payment is treated as employment income and therefore fully deductible by the payor.

(b) Consulting agreements

It is typical to expect a purchaser to ask the vendor (either an individual or principal of a corporation) to remain with the business for a period of time after closing either as a part-time or full-time employee or on a consulting basis (i.e., independent contractor). In such circumstances, entering into a consulting agreement may be suggested. The new owner may use this approach (post-closing consulting arrangement) even where the vendor or its principal does not have an active role in the continuation of the business in order to defer payment of the purchase price. Such a deferral offers the purchaser the advantage of reducing the initial payment, and the recipient, the benefit of deferring receipt of payments

(and the resulting tax) to a later time period, depending on the duration or length of the consulting relationship.

A purchaser may deduct the payment of consulting fees and such fees are taxable to the recipient when received. Parties considering a consulting arrangement should ensure the agreement specifies the duties of the consultant and that the amount of the consultant's fee is reasonable. The agreement would typically stipulate the consultant be available and perform the duties outlined (or as requested, if this is provided for) in the terms of the agreement.

It is common to tie a non-competition agreement into a consulting agreement by requiring a vendor or its principal to enter into both documents and by having each run for a similar term. The advantage to the purchaser in this type of approach is that a payment under a consulting agreement is fully deductible from income (provided it is reasonable in the circumstances) and the time frame of the non-competition agreement can be usually lengthened.

These agreements should be set up as free-standing agreements separate from the agreement of purchase and sale so as to ensure their survival upon closing. A non-competition agreement by itself when made by an individual may not be a taxable supply (of goods and services) for HST purposes. Most consulting arrangements will however give rise to HST.

4.4.4 Bulk Sales Act

The purpose of Ontario's *BSA* is to protect trade creditors of a vendor when the vendor disposes of its "stock in bulk" out of the usual course of business. Trade creditors have extended credit to the vendor on the basis of the vendor's business and assets, and the policy of the *BSA* is that it would be unfair for the vendor to sell such assets out of the ordinary course without some mechanism to ensure payment for those trade creditors. Section 2 of the *BSA* provides that it applies to every "sale in bulk" subject to a number of exceptions including sales by executors, administrators, receivers, trustees-in-bankruptcy, and creditors realizing upon security. A "sale in bulk" is defined in s. 1 to mean the "sale of stock in bulk out of the usual course of business or trade of the seller." "Stock" is defined as meaning

- goods, wares, merchandise, or chattels ordinarily the subject of trade and commerce;
- 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
- the fixtures, goods, and chattels with which a person carries on a trade or business.

Case law suggests that the BSA can apply to certain intangibles in certain situations (see for example *Re Excelsior Brands Limited and Italfina Inc. et al.*, which involved the sale of the vendor's trade-mark, inventory, etc.), but does not apply to shares.

There are three methods by which a vendor may comply with the *BSA*:

- **Exemption order**: Under s. 3 of the *BSA*, a vendor may apply for an order from a judge of the Superior Court of Justice exempting a sale in bulk from the application of the *BSA* where, on affidavit of the seller and any other evidence, the sale is shown to be advantageous to the vendor and will not impair its ability to pay creditors in full.
- **Disclosure of creditors**: The purchaser obtains from the vendor a statement, verified by affidavit, giving particulars of the amounts owing by the vendor to secured and unsecured trade creditors, if any. The purchaser, before receiving the statement from the vendor, may only pay a deposit of up to 10 per cent of the purchase price. Pursuant to s. 8(1) of the *BSA*, the purchaser is entitled on receipt of the statement to pay additional amounts and acquire the stock in bulk by paying all creditors of the vendor as disclosed by the statement (or receiving a waiver from each creditor who will not be immediately paid). Within five days of completion of the sale, the buyer must file with the court an affidavit setting out particulars of the sale together with the vendor's statement and any creditor waivers.
- **Formal trustee procedures**: This is usually regarded as the last-resort type of procedure and involves, pursuant to s. 8(2) of the *BSA*, the payment of the purchase price to a trustee and the consent of a specified majority of creditors.

The result of non-compliance with the *BSA* is that the sale of stock involved may be set aside or declared void by a court at the instance of a creditor of the vendor. If the sale in bulk has been set aside or declared void and the purchaser has received or taken possession of the stock in bulk, the purchaser is liable to account to the creditors of the seller for the value of the stock in bulk.

Notwithstanding the *BSA*, it is common in many asset purchase transactions for the parties to agree to "waive" compliance with the provisions of the *BSA* or to agree that the purchaser shall not require the vendor to comply with it. Although a waiver of compliance or acceptance of non-compliance may be appropriate in certain circumstances, the purchaser should always obtain an indemnity from the vendor for any potential loss or damage that it may suffer as a result of non-compliance with the *BSA*. Clearly, the creditworthiness of the vendor is the most relevant consideration with respect to that indemnification.

4.4.5 Harmonized sales tax implications

The HST implications of buying and selling a business should always be considered by the parties and, if necessary, reflected in the agreement.

Ontario's former RST of 8% was levied under the *RSTA* on the purchase and sale of TPP in Ontario. Ontario's RST was replaced with the HST on July 1, 2010, and therefore the former 8% RST is now a component (the "provincial component") of the HST. In Ontario, the HST is now levied (after June 30, 2010) on the taxable supply of goods (i.e., property or assets) and services at a combined rate of 13% (5% federal component and 8% provincial component).

The HST is imposed under Part IX of the *ETA*. HST is a broadly based value-added sales tax that applies to a supply of virtually all goods and services consumed in Canada and a "participating" province or territory (i.e. those provinces and territories that have "harmonized" their provincial sales tax with the GST.

HST is imposed under s. 165 of the *ETA* when a "taxable supply" is made in the course of a "commercial activity" (defined in s. 123 of the *ETA*). Therefore, it is important to determine whether the purchase and sale of a business (i.e., the form or structure of the transaction) is such that the business sale involves the making of a taxable supply.

The provisions of the *ETA* dealing with the application of the HST distinguishes between

- taxable supplies (which may either be fully taxable or zero rated); and
- exempt supplies.

Generally, all "financial instruments," (defined in s. 123 of the *ETA*) are categorized as exempt supplies. Taxable supplies are also defined in s. 123 of the *ETA* to include any supply made in the course of a "commercial activity" (a term that excludes exempt supplies).

A taxable supply in Ontario under the *ETA* for HST purposes that is not zero rated, is subject to 13% HST (as of July 1, 2010, subject to certain transitional rules). If the taxable supply is made in Ontario, the HST must be collected by the vendor (under s. 221(1) of the *ETA*) from the purchaser.

Where the purchaser is registered for HST purposes and engaged in making taxable supplies, any HST paid on purchases will generally qualify for ITCs to the purchaser (under s. 169(1) of the *ETA*).

Where the purchase of a business is structured as a share purchase transaction (not a purchase of assets of a business), the vendor does not need to collect HST, since shares fall within the exempt supply category of a financial instrument.

Generally (and subject to certain limited elections, i.e., under s. 167(1.1) of the *ETA*), the purchase and sale of a business that is structured as a sale of assets will likely be subject to HST, since the assets sold are often a mixture of taxable supplies and exempt supplies. Consequently, TPP, including inventory, real property, and intangible property, will come within the taxable supply category and be subject to HST. Only financial instruments, such as accounts receivable and marketable securities, will fall within the exempt supply category and not be subject to HST.

Where the purchase and sale of a business is structured as an asset sale, it is important to consider the possibility of the parties and the transaction qualifying for any available HST elections. The most common election available is under s. 167 of the *ETA* for the sale of all or substantially all of the assets of a business or part of a business and the parties have the transfer occur at nil consideration. Section 167.1 also ensures that any consideration attributable to goodwill sold (with all or part of a business) will be excluded in calculating the applicable HST. Consequently, goodwill sold or transferred with the other assets of a business will usually not be subject to HST.

Section 167 of the *ETA* permits a vendor to supply a business or part of a business to a purchaser with no HST payable if certain conditions are met and the parties jointly file an election. These conditions include the following:

- The recipient must be registered for HST purposes at the time of the sale.
- The transaction constitutes a sale of a business or part of a business.
- The recipient is acquiring ownership, possession, or use of at least 90% of the property needed to carry on the business or part of a business.

The cash-flow benefits of this election can be significant. If the parties are not eligible to elect under s. 167, HST must be collected and remitted by the vendor. The purchaser should ensure it is registered for HST purposes as of the date of the sale so that it is entitled to claim any available ITCs.

The HST consequences surrounding any transaction, including the purchase and sale of a business, whether structured as a purchase of shares or assets, are complex and are not necessarily consistent with the income tax or LTT consequences flowing from the transaction. The potential downside risks to parties and practitioners of not addressing HST issues on any transaction can be

substantial and therefore need to be considered as critically as the income and other tax aspects.

4.4.6 Land transfer tax

See discussion of "Other Taxes" for the various types of assets to be acquired in "Land and building," above.

4.4.7 Non-resident vendors

A purchaser of property from a vendor who is a non-resident of Canada has to consider the obligations imposed on the purchaser under s. 116 of the *ITA*. These tax rules are designed to ensure that a non-resident vendor pays the relevant Canadian income tax applicable to the vendor's sale transaction. Section 116 of the *ITA* applies to a non-resident vendor's sale of any

- capital and depreciable property used in carrying on a business in Canada;
- real estate situated in Canada; and
- certain other property.

There are now two aspects to s. 116 of the *ITA* for purchasers to consider, as well as a new exclusionary rule (introduced in the federal 2010 budget) dealing with the exemption of certain property (shares) from the definition of taxable Canadian property (TCP).

With respect to s. 116, first, there is a requirement to withhold and remit to the CRA (or otherwise be liable for) 25% or 50% of the purchase price depending on the type of asset unless the vendor provides to the purchaser a certificate (known as a "s. 116 (clearance) certificate") issued by the CRA in connection with the sale.

Secondly, in certain cases, there are now relieving provisions that may be relied upon (applicable for certain dispositions of property beginning in 2009). The new relieving provisions apply to gains and/or income realized by a non-resident that are not taxable in Canada due to treaty protection (i.e., not taxable by Canada under a bilateral tax treaty with another country). In these circumstances, the relieving provision allows for a notification to Canadian tax authorities for certain dispositions of property after December 31, 2008, and is therefore an alternative to the s. 116 clearance certificate. This new relief is available for "treaty-protected property."

In the case of "treaty-protected property," a purchaser may not need to withhold part of the purchase price provided all of the following requirements are met:

- The purchaser is satisfied after reasonable inquiry that the vendor is a resident of a country that has a tax treaty with Canada.
- The property is treaty protected under this treaty, i.e., gains/income are exempt from Canadian tax under the treaty.
- The purchaser notifies the Minister of National Revenue within 30 days of acquiring the property.

For example, this new relieving notification provision (Form T2062C, "Notification of an acquisition of treaty-protected property from a non-resident vendor") may be applicable in the case of a non-resident person's sale of shares of a private Canadian company or a non-resident person's receipt of a capital distribution from a trust or estate.

There is no "reasonable inquiry" defence for the determination of whether property constitutes "treaty-protected property." Therefore, if a purchaser incorrectly comes to the conclusion that the purchased assets constitute "treaty-protected property," the purchaser may be liable for the 25% or 50% amount described above. For this reason, it has been suggested that an arm's length purchaser would not likely rely on these provisions.

Where this new relieving provision is not available, the purchaser will ask the non-resident vendor to obtain and provide the s. 116 clearance certificate (or withhold and remit the requisite portion of the purchase price). Administratively, it may take a non-resident vendor or the vendor's Canadian agent more than 30 days to have the CRA process the request and issue the s. 116 certificate. Accordingly, a non-resident vendor should submit the application to the CRA well in advance of the sale. The application is made on Form T2062 for non-depreciable taxable Canadian property and on Form T2062A for depreciable taxable Canadian property. The CRA only issues the certificate after the non-resident vendor has paid the estimated taxes on the sale or has provided acceptable security for the same taxes to the CRA.

The 2010 federal budget amendment now excludes from the definition of TCP, shares of corporations (and certain other interests) whose value is not principally derived from

- real or immovable property located in Canada;
- Canadian resource or timber properties; and
- options in respect of the above properties.

This amendment removes the s. 116 clearance certificate requirement for these types of properties and brings Canada's tax rules in line with its tax treaties and the tax laws of Canada's major trading partners.

4.4.8 Ontario's Business Corporations Act, s. 184

Subsection 184(3) of Ontario's *Business Corporations Act* (*OBCA*) provides that a sale, lease, or exchange of all or substantially all of the property of a corporation other than in the ordinary course of business of the corporation requires the approval of the shareholders of the corporation. The approval required is that of a special resolution (two-thirds approval of those present at a meeting). As well, s. 184(6) provides that where the sale would affect a particular class or a series of shares in a manner different from another class or series of shares that are entitled to vote on the sale, then the class of shares that is affected, even if not ordinarily entitled to the right to vote, is nonetheless entitled to a right to vote as a separate class.

Shareholders who dissent on the resolution to sell, lease, or exchange all or substantially all of the corporation's property have dissent and appraisal remedies under s. 185 of the *OBCA*, namely the right to have their shares purchased by the corporation at fair value. In addition, shareholders would be entitled to avail themselves of the other provisions of the *OBCA* dealing with minority shareholders, such as the oppression remedy.

Purchaser's counsel will want to be satisfied that the requirements of s. 184 of the *OBCA* have been met and will, at closing, normally seek a certified copy of the special resolution passed by the shareholders of the vendor, as well as an opinion of counsel for the vendor.

5. Share purchase considerations

The sale of shares generally tends to be a more attractive route from the vendor's point of view, since the gain realized on the sale of shares will be treated as capital gain for income tax purposes. By comparison, the purchaser normally prefers to acquire assets because, on a share purchase, the purchaser's after-tax cost is higher and the purchaser will be subject to all of the undisclosed liabilities of the vendor's business. On the other hand, there may be several factors that make a share purchase attractive to a purchaser. These include the following:

- HST and provincial sales and transfer taxes would not be payable on share transactions.
- An asset transaction may be more complex.
- The assets of the business may only be acquired by buying shares in some cases (for example non-assignable contracts and government licences).
- The nature of the business may be such that there is no tax advantage in an asset purchase.

5.1 Corporate considerations

5.1.1 Contents of share purchase agreement

There are a number of matters that are covered in most share purchase agreements:

- the actual purchase and sale provisions consisting of the mutual covenants of the vendor and the purchaser to sell and to purchase the shares of the corporation;
- the purchase price, which may be either fixed or based on a formula such as net book value as determined from financial statements provided at closing;
- the mechanics of the transaction such as the closing procedure, interim investigations, confidentiality, etc.;
- representations and warranties of the vendor and purchaser that contain, for the benefit of the other, certification of certain facts about the parties or the corporation;
- closing conditions, which specify those matters that must be completed or circumstances that must exist in order for the parties to be obligated to complete the transaction; and
- basic legal provisions such as assignability and applicable law.

In the normal course, the purchaser's lawyer will assume responsibility for drafting the share purchase agreement. In drafting the agreement of purchase and sale, the purchaser will want the vendor to disclose certain facts about the business being purchased and thus confirm the appropriateness of the purchase price.

5.1.2 Representations and warranties

The following representations and warranties are typical and are all aimed at eliciting certain information with respect to the target corporation:

- The corporation has been incorporated and is existing under the laws of the jurisdiction in which it was incorporated.
- Both the authorized and issued capital of the corporation are stated; either there are no outstanding options or the number of shares subject to option, the option period, and option price are stated; and the vendor is the beneficial owner of the issued shares free and clear of all liens, charges, and encumbrances.
- The latest annual financial statements and similar statements for one or more previous years have been prepared in accordance with generally accepted accounting principles (GAAP) applied on a consistent basis with those of the previous years and represent fairly the assets and liabilities of the corporation as at the financial statement dates. It

should be noted for fiscal years beginning on or after January 1, 2011, "publicly accountable enterprises" are required to report financial results using the International Financial Reporting Standards (IFRS) rather than Canadian GAAP. Publicly accountable enterprises are entities other than private, non-profit, and public sector enterprises. On the other hand, "private enterprises" (i.e., generally defined as profit-oriented enterprises that are not publicly traded and are not a bank, credit union, mutual fund, securities dealer/broker or insurance company) are eligible to either adopt IFRS or use a modified set of accounting standards called "accounting standards for private enterprises" (ASPE). ASPE were developed for the unique needs of private enterprises and those persons using their financial statements. Particular changes, in comparison to previous Canadian GAAP, include simplification of recognition, measurement, and presentation of the private enterprise's financial matters in areas that were viewed as being too complex, for example, accounting for financial instruments. The new ASPE standards also reduce the otherwise abundant financial disclosure requirements. Similar to publicly accountable enterprises, private enterprises were required to adopt either ASPE or IFRS for their fiscal years beginning on or after January 1, 2011.

- The earnings of the corporation during the period covered by the financial statements are not less than those set out in the financial statements.
- The financial statements of the corporation subsequent to the last annual financial statements accurately reflect the financial position of the corporation as of the date to which they are made.
- The inventories have been accurately valued, giving specific reference to the basis of valuation and to other problems referred to under "Inventories" in "Assets to be acquired," above.
- The valuation of the accounts receivable is accurate.
- The amount of salaries, bonuses, and other money paid to the selling shareholders and their associates is, or does not exceed, the stated amount (accompanying this warranty should be a covenant that the amount of the remuneration that will be paid to the shareholders prior to closing will not exceed a certain amount).
- No bank accounts exist other than those listed in the agreement.
- All taxes due are paid and various other tax matters relating to compliance with federal, provincial, and municipal taxing statutes are adhered to.
- All deferred compensation agreements, group life insurance agreements, pension plans, and service agreements are as described in a schedule to the agreement.
- All employee benefit plans, pension commitments, etc. are fully funded (as applicable).
- No contract exists involving forward commitments that will extend beyond closing for a specified period.
- The status of lawsuits and proceedings is as stated.
- The corporation is not in default under any agreement to which it is a party.
- The corporation will have good title to its assets and will not be subject to any encumbrances other than those specifically disclosed.
- The corporation is in compliance with environmental laws (including its operations in federal, provincial, and municipal jurisdictions, as well as foreign jurisdictions), and there is no contamination or hazardous materials (the vendor will generally indemnify the purchaser for the cost of all clean-up orders, remedial orders, and abatement orders and for all civil liabilities).

Typically a legal opinion will be required of the vendor's solicitor as to a number of matters involving the corporation such as its incorporation, status, and issued and outstanding shares.

5.1.3 Third-party contracts and approvals

An increasing number of leases and other contracts now contain a "change of control" clause, which requires the approval of the other parties to the agreement if control of the target corporation changes by way of a sale of shares or otherwise. In these cases, the approval of the necessary third parties must be obtained if the corporation is to retain the benefit of the leases and contracts. Moreover, if the business is a regulated one, the applicable legislation may also provide that upon a change of control, the approval of the regulatory authority must be obtained.

5.1.4 Non-competition clauses

As is the case in asset purchase agreements, it is essential to have a non-competition agreement if the purchaser does not wish to merely finance the vendor as a new competitor. In a share purchase, the purchaser's lawyer should always ensure that the non-competition agreement is given in favour of both the purchaser and the corporation since in most cases the vendor would be competing with the business that the vendor sold, rather than directly against the purchaser.

The current tax treatment of payments for restrictive covenants, i.e. for non-competition agreements (and recently proposed legislative amendments to the *ITA* to significantly alter this favourable tax treatment) is discussed above in "Non-competition agreements."

5.1.5 Releases

On closing, it is prudent to obtain from the shareholders, directors, and officers of the target corporation comprehensive releases of claims that they may have in any of their respective capacities against the target corporation and the purchaser.

5.1.6 Conditions

The agreement will contain a number of conditions that, if not satisfied, will give the purchaser or the vendor, as applicable, the right not to close the transaction.

5.1.7 Securities Act considerations

The sale of the shares will be a "trade" of these shares and must be concluded in a manner permitted by the *Securities Act* (normally under an exemption).

If the corporation's shares are listed on a stock exchange and, in some other circumstances, depending on a number of factors, the transaction will constitute a take-over bid.

5.1.8 Price adjustment clauses

In the typical situation, the vendor and purchaser will reach an agreement with respect to the purchase and sale of the business, which is then reduced to a letter of intent. Alternatively, they may enter into a definitive agreement calling for a deferred closing once a number of conditions are satisfied. For example, on January 1, the parties may allow a reasonable period, say three months, for the searches and paperwork to be completed so that the closing and the payment of the purchase price occurs on March 31. The amount of the purchase price is often fixed in the letter of intent or conditional agreement (in this case January 1), and the profits or losses of the business in the three-month interval will be for the account of the purchaser. The purchaser has therefore effectively acquired the business as of January 1 although the purchaser did not pay for or acquire title to the shares until March 31. In this situation, it is very important for the share purchase agreement to contain covenants as to the preservation of the business, its assets, and its profits during the period pending closing and as to what the vendor will do and will allow the purchaser to do in that interim period.

The same types of considerations that were discussed in the asset purchase transaction part of this chapter would be relevant in determining whether the purchase price is payable in cash, in cash plus a promise to pay, or on an earn-out basis. The most obvious security for the unpaid purchase price in a share purchase transaction is a pledge of the purchased shares. If a pledge is taken, possession of the share certificates representing the shares should be taken to perfect the security interest under the *PPSA*.

A first charge against the purchased shares may not be available if the purchaser makes the acquisition using third-party financing. The vendor may consider a second charge on the purchased shares to be inadequate to secure the portion of the purchase price that remains unpaid after closing. The assets of the corporation will likely also be subject to a prior charge in favour of a third-party lender, a situation that leaves very few alternatives. A second charge behind the third-party lender should not be rejected automatically, although there may be little residual value in the case of the realization of the security.

The purchaser may be in a position to provide the vendor with security on other assets of the purchaser or may be able to provide a letter of credit from a bank or a third-party guarantee.

5.2 Income tax issues and considerations

5.2.1 Overview

Generally speaking, a vendor will realize a capital gain or loss on the sale of shares, one-half of which is included in the vendor's income as a taxable capital gain or deductible as an allowable capital loss against taxable capital gains.

If the vendor is an individual, some or all of the capital gain may qualify for exemption (i.e., may be non-taxable) under the lifetime cumulative capital gains exemption. The cumulative limit for qualifying shares (QSBC shares) of an SBC is $750,000.

5.2.2 Reserves

If part of the purchase price is to be paid to a vendor over a period of time (and beyond or after the year of sale), the vendor is entitled to claim a reserve for any capital gains realized under s. 40(1) of the *ITA*. The maximum period over which a capital gain may therefore be reported (by claiming a capital gains reserve) is five years including the year of sale (i.e., the year of sale plus the four following tax years).

5.2.3 Bad debts

If a vendor who is owed sale proceeds can establish that some or all of the sale proceeds are not collectible, a capital loss may be claimed by the vendor under s. 50 of the *ITA*.

5.2.4 Earn-out

Where a vendor's sale proceeds are dependent on the future earnings of the corporation, the CRA's view, as

outlined in Interpretation Bulletin IT-426R, "Shares Sold Subject to an Earnout Agreement," is that the provisions of s. 12(1)(g) of the *ITA* will not apply (i.e., otherwise treats the vendor as receiving the deferred sale proceeds on account of income instead of the more favourable capital gains treatment) if the following conditions are satisfied:

- The vendor and purchaser deal at arm's length.
- The gain (or loss) on the sale of the shares is clearly of a capital nature.
- It is reasonable to assume that the earn-out mechanism is attributable to the goodwill value of the business (as a going concern), which could not reasonably be expected to be agreed upon at the time of sale by the vendor and purchaser.
- The duration of the earn-out under the sale agreement does not exceed five years.
- The vendor includes with the vendor's income tax return for the year in which the shares were disposed of
  - a copy of the sale agreement;
  - a letter requesting the application of the cost-recovery method to the sale; and
  - an undertaking to follow the procedure of reporting the gain or loss on the sale under the cost-recovery method as outlined in Interpretation Bulletin IT-426R.

5.2.5 Change of control

(a) Deemed year-end

Generally speaking, control of a corporation will be changed (i.e., an acquisition of control occurs) if as a result of the sale and purchase of shares, a purchaser then owns more than 50% of the voting shares of the corporation. The *ITA* also has special rules that describe when control of a corporation is not considered to have been acquired. In most instances, an acquisition of control will occur where the purchase and sale of a business is structured as the purchase and sale of shares.

When there is an acquisition of control (and unless otherwise specified by the parties, control is deemed to be acquired at the earliest moment in the day, i.e., immediately after midnight), the rules in the *ITA* provide that the taxation year of the corporation is deemed to end immediately before the time control is acquired (i.e., the day before). A new taxation year for the corporation is also considered to have commenced at the time control is acquired. As a result, the corporation will be required to prepare financial statements and file a tax return for the tax year that is deemed to have ended.

Example

Assume a corporation has a December 31 fiscal year-end and a sale of all the issued shares in the capital stock of the corporation occurs on June 1. As a result, the corporation would have two taxation years (assuming the corporation retains a December 31 year-end): one from January 1 to May 31 (the day before the shares are acquired), and the second from June 1 to December 31. Therefore, two separate tax returns would be required for the periods of January 1 to May 31, and June 1 to December 31.

Generally, the tax implications of a short taxation year include the following:

- Certain deductions are pro-rated, such as CCA, certain financing costs, and the annual SBD limit (which is relevant to the calculation of the income subject to the SBD, i.e., low rate of tax on a certain amount of active business income of a CCPC).
- Certain tax deadlines are accelerated, such as
  - the requirement to file a tax return and pay any tax liability on income in that period;
  - the obligation to make payments to a registered pension plan and deferred profit-sharing plan;
  - the time within which property must be (re)acquired for purposes of the replacement property rules; and
  - the time within which shareholder loans must be repaid without having the amount of the loan included in the shareholder's income.
- A short tax year still counts as a full year for other purposes of the *ITA* such as the reserve provisions and carryover periods (i.e., non-capital or operating losses and charitable gifts).

Particularly for vendors of shares, there may be an additional consequence to consider. For example, consider the situation where shares are sold to a non-resident person and the seller of the shares wants to claim the capital gains exemption. In this case, the exemption may not be available if the corporation ceased to be a CCPC at the commencement of the day the shares are sold. To alleviate this, the *ITA* was amended to provide that for acquisitions of control after 2005, the deemed acquisition of control at the commencement of the day will not apply for purposes of determining the status of a corporation as a CCPC or a SBC.

(b) Loss carryforwards

If a corporation realizes a loss from carrying on its business in a year, that non-capital (or operating) loss can be deducted against the income of the corporation from any other source in the year the loss was incurred. If the corporation is unable to utilize the loss (i.e., does not

have sufficient other income against which it can deduct the loss) in the year it has occurred, the entire loss can be carried back to reduce the income of the corporation in any of the three previous taxation years and in the 20 years following the year the loss is incurred. For example, if the corporation's operating loss was incurred in 2011, the loss could be used to reduce the income of the corporation for any of its fiscal years in the period from 2008 to 2031.

This extended carryforward period for non-capital losses (i.e., business losses) has changed in recent years as follows:

- The extended carryforward period (increased from 10 to 20 years) for non-capital losses (i.e., business losses) applies to business losses arising in taxation years ending after 2005.
- For business losses arising in taxation years ending between March 23, 2004, and December 31, 2005, such business losses may be carried forward only 10 years.
- For business losses arising in taxation years ending before March 23, 2004, such business losses may be carried forward only seven years.

There have been no changes to the three-year carryback period for business losses.

Similar rules apply to losses realized from the disposition of capital assets. However, capital losses may only be used to reduce capital gains (not business or operating income), and the carryover period for capital losses is three years back and forward indefinitely.

It should also be noted that an acquisition (or change) of control of a corporation has a number of other tax implications associated with the utilization of losses, including the following:

- The loss carryforward period is affected by the short taxation year (i.e., a short year counts as a full year for counting the carryover period).
- Certain losses, such as net capital losses, allowable business investment losses (ABIL), and investment losses, all expire on an acquisition of control (*ITA*, ss. 111(4) and (5)(a)) (accordingly, if it is not possible to utilize these losses in the pre-change of control period, the ability to use these losses is completely lost).
- Business (or operating) losses arising in the pre-acquisition of control period may be carried forward after the acquisition of control, and business losses arising in the post-acquisition of control period can be carried back to the pre-acquisition of control period; however, such operating losses are only deductible against income of the corporation in the later year(s) if the following requirements are met:
  - The business that produced the loss is carried on with a reasonable expectation of profit.
  - The loss can only be used to reduce income arising from the same or a similar business to that which produced the loss initially (i.e., the losses become "streamed" for income tax purposes under s. 111(5)(a)).
- Accrued (i.e., inherent) but unrealized losses are deemed to be realized on an acquisition of control and are subject to the rules referred to in the two points immediately above (under ss. 37(6.1), 111(5.1)–(5.3), and 127(9.1) of the *ITA*, and s. 1801 of the *ITR*).

Accordingly, this last point offers a planning opportunity for the purchaser to have the target company access unrealized losses (on the assets of the target company) following the acquisition of control. As a result, the target company can use such "released or freed-up" losses to reduce its future income and thereby save income taxes.

5.2.6 Tax liabilities of target corporation

A prudent purchaser should always investigate (perform due diligence on) a corporation's income tax position and its tax liabilities prior to entering into an agreement of purchase and sale with the vendor. In most circumstances, this would include a review of the corporation's federal and provincial income tax returns and all assessments and reassessments for income and capital tax. A purchaser would also likely seek to obtain protection by requiring a vendor to provide appropriate representations, warranties, and indemnities in the agreement of purchase and sale relating to the various income tax matters and liabilities of the target corporation.

5.3 Tax planning to minimize tax consequences on the sale

5.3.1 Pre-sale dividend

Generally speaking, it is possible for a vendor of shares to lower the tax payable on the sale of the shares by paying a dividend prior to the sale of the shares, which will therefore reduce the sale proceeds for the shares (and any resulting capital gain). For example, if a vendor's shares of a corporation have a FMV of $10,000, a vendor could reduce the tax payable on the sale of shares by paying a dividend of, say, $2,000 prior to closing the sale and thereby reduce the sale proceeds for the shares to $8,000.

In order for this pre-sale (dividend) plan to be effective, it will be necessary that the dividend be received on a tax-free basis by a taxpayer. This means the dividend has to be paid to a corporation (i.e., to take advantage of the inter-corporate dividend deduction). Where a vendor of

shares is an individual, the shares should first be transferred to a holding company prior to the receipt of the dividend, so that the target corporation's dividend can be paid to the holding company without triggering tax.

It should be pointed out that the provisions of the *ITA* (i.e., s. 55(2)) restrict the amount of dividends that can be paid to a holding company on a tax-free basis. Tax practitioners refer to the amount of the dividend that can be paid tax-free as "safe income." The calculation of the safe income dividend is similar to the retained earnings on the corporation's balance sheet but is subject to many tax technicalities. The objective of the rules in s. 55(2) of the *ITA* is to deny the payment of a tax-free dividend representing goodwill and other unrealized gains in the corporation. The tax rules involving s. 55(2) are quite complicated. It is strongly recommended that proper tax advice be obtained before entering into this type of a transaction since the consequences of incorrect implementation are severe.

5.3.2 Post-sale consulting arrangements

It is often an advantage to a purchaser (and the vendor) for the vendor to be available to assist in the initial operation of the business following its purchase. In such circumstances, a vendor may accept a lower sale price for the business in conjunction with entering into an attractive consulting arrangement with the purchaser of the business.

From an income tax perspective, this arrangement offers the purchaser an advantage since the consulting payments will be deductible to the corporation provided the amount of the payments are reasonable in relation to the services actually performed and rendered by the vendor to the corporation after the closing. On the other hand, the vendor will be fully taxed on the amount of the consulting payments received.

If the CRA determines that the amount of the consulting fee is not reasonable, not only will a portion of the consulting fee paid by the corporation be non-deductible, but the payments may be considered as disguised sale proceeds. In that case, a purchaser may have an income inclusion for the excessive payment under s. 15(1) of the *ITA* on the basis the corporation conferred a benefit on the shareholder by paying the consulting fees and thereby reduced the purchase price for the shares.

As a practical matter, any consulting agreements should be free-standing and separate from the purchase agreement to ensure their survival upon and after closing. If the consultant is an independent contractor, then HST will apply to the consulting fees charged to the corporation unless the individual qualifies as a small supplier of goods and services.

5.3.3 Retiring allowances

Instead of paying tax-free dividends prior to a share sale, a target corporation may determine it is useful to pay to a selling shareholder (also an employee of the corporation) a retiring allowance prior to closing the sale of shares of the corporation. Payment of a reasonable retiring allowance by the corporation should be deductible for income tax purposes to the target corporation.

Paying a retiring allowance would again reduce the sale price of the shares of the target corporation. To the vendor selling shares, the amount of the retiring allowance would be taxable. However, a shareholder (employee) receiving a retiring allowance may be entitled to defer a portion of the tax liability otherwise payable on receipt of a retiring allowance by transferring a portion of the retiring allowance to a registered retirement savings plan (RRSP) under the limits in s. 60(j.1) of the *ITA* and without affecting the RRSP contribution limit/room of the employee. This provision can only be used where the individual has years of employment before 1996.

Example

A and B are spouses, and both worked as employees for a company (ABCo) for a number of years before the company was sold to a competitor and their employment relationships with ABCo terminated in 2010. A and B had worked for ABCo since 1980, and in recognition of the long years of service, ABCo decided to pay a retiring allowance to each of A and B in 2010 of $45,500.

A and B decide to take the retiring allowances and shelter as much as possible by contributing the amount to their RRSPs under s. 60(j.1) of the *ITA*. A and B can shelter and contribute the retiring allowance to their RRSPs (without any effect on their current RRSP contribution room) as follows:

- $2,000 per year of service before 1996 (i.e., from 1980 up to and including 1995 = 16 years X $2,000 = $32,000); plus
- an additional $1,500 per year of service before 1989 (i.e., from 1980 up to and including 1989 = 9 years X $1,500 = $13,500) during which they were not members or earned pension accrual entitlement or eligibility under a deferred profit sharing plan (DPSP) with ABCo. Since ABCo did not have an employee pension plan or DPSP, A and B's contribution of the additional amount of $1,500 per year of employment (pre-1989 employment with ABCo) as a retiring allowance to their RRSPs is unaffected.

Accordingly, based upon the above, A and B can each shelter the full amount of the $45,500 ($32,000 + $13,500) retiring allowance payment. In total as a couple, A and B can shelter $91,000 received as retiring allowances by contributing the same amounts to their own RRSPs.

Of course, if A and B, worked for ABCo prior to 1980, they would be able to ask ABCo to increase the amount of the retiring allowance and therefore increase the amount that could be sheltered by contributing it to an RRSP.

In addition, if A and B also have unused RRSP room being carried forward, the payment of any retiring allowance that cannot be sheltered under the above rules (amounts before 1989 and 1996) can still be sheltered from current taxation due to their unused RRSP carryforward room.

6. Investment Canada Act (ICA)

6.1 General

In simplified terms, the federal *Investment Canada Act* (*ICA*) applies to the establishment of a new business in Canada or the acquisition of an existing business in Canada by "non-Canadians." All such transactions by non-Canadians are "notifiable transactions," in that they must be reported to Industry Canada (*ICA*, ss. 11–12), but only certain types of transactions will then be reviewable by Industry Canada or by the Department of Canadian Heritage (subject to special thresholds for World Trade Organization (WTO) member country investors).

An investment is reviewable (*ICA*, s. 14) if the asset value of the Canadian business being acquired exceeds the following thresholds:

- The investor is a non-Canadian and is not a WTO member, and any investment is over $5 million for a direct acquisition and over $50 million for an indirect acquisition (i.e., the purchase of shares of a foreign corporation that has a Canadian subsidiary, which is thus indirectly acquired): An indirect acquisition where the asset value is $5 million or more but less than $50 million is also reviewable where the Canadian assets acquired represent more than 50% of the asset value of all businesses acquired in the transaction.
- The investor is a non-Canadian and is a WTO member, and any direct investment is in excess of $312 million in 2011: An indirect acquisition is not reviewable unless the value of the assets of the business located in Canada amount to more than 50% of the asset value of the transaction. However, if the asset value of the Canadian assets represents 50% or more of the asset value of the transaction, the direct acquisition threshold applies. Even for WTO investors, the limits in the first bullet apply if the Canadian business is a cultural business.

Notwithstanding the above limits, any investment that is usually only notifiable, including the establishment of a new Canadian business, and that falls within a specific business activity listed in Schedule IV of the *Investment Canada Regulations*, SOR/85-611, made under the *ICA*, may be reviewed if an Order-in-Council directing a review is made and a notice is sent to the investor within 21 days following the receipt of a certified complete notification.

Notification must be filed no later than 30 days after the implementation of the investment. If a transaction is reviewable, with limited exceptions, the investor must receive a decision from the relevant Minister (either the Minister of Industry or the Minister of Canadian Heritage) that the investment is of "net benefit" to Canada before the investment may be implemented.

7. Competition Act

The federal *Competition Act* regulates commercial conduct in Canada and subjects anti-competitive conduct, including certain criminal offences and reviewable trade practices, to a regime of investigation, adjudication, and criminal and civil remedies (including administrative monetary penalties). Certain commercial transactions, such as mergers, are subject to significant scrutiny by the Commissioner of Competition, Canada's "competition watchdog."

7.1 General merger provisions

The *Competition Act* contains a regime for mergers. "Merger" is defined very broadly in s. 91 of the *Competition Act* to catch all mergers and acquisitions, whether by acquisition of shares or assets, amalgamation, combination, or otherwise and whether direct or indirect, where one or more persons acquires control over or a significant interest in the whole or part of a business of a competitor, supplier, customer, or other person.

Where, on application by the Commissioner of Competition, the Competition Tribunal (a quasi-judicial body established under the *Competition Tribunal Act* to adjudicate the non-criminal provisions of the *Competition Act*) finds that a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially within a relevant sector, s. 92(1) of the *Competition Act* provides that the Competition Tribunal may order, in the case of a completed merger, the following:

- the dissolution of the merger;
- the disposal of designated assets or shares; or
- in addition to or in lieu of the first two bullets and with the consent of the person against whom the

order is directed and the Commissioner, any other action;

or, in the case of a proposed merger, the following:

- the merger not to proceed;
- part of the merger not to proceed; or
- in addition to or in lieu of the first two bullets, certain acts or things not to take place in the event the merger is completed or, with the consent of the person against whom the order is directed and the Commissioner, any other action.

No application may be made in respect of a merger more than three years after a merger has been substantially completed (s. 97). There are also mechanisms available to the Commissioner to apply to the Competition Tribunal for interim orders to delay or enjoin a proposed merger in circumstances where an application opposing a merger has, or has not, been made by the Commissioner (ss. 100 and 104).

The *Competition Act* contains an advance ruling mechanism, which allows a party to a proposed merger to apply for a binding advance ruling from the Commissioner with respect to a contemplated merger (s. 102). The Commissioner is obliged to consider a request for such a certificate as expeditiously as possible, but the *Competition Act* sets no mandatory time period. Once the Commissioner has issued an advance ruling certificate and the related transaction is substantially completed within one year after the certificate is issued, the Commissioner is not permitted to apply to the Competition Tribunal for a review of the transaction solely on the basis of the same or substantially the same information as that on which the certificate was based (s. 103). There is, however, no requirement that the Commissioner issue the advance ruling. The Commissioner may decide not to issue the advance ruling but instead wait and decide whether to challenge the merger within the three-year limitation period following substantial completion of the merger (s. 97).

7.2 Notifiable transactions

Part IX (ss. 108 to 124) of the *Competition Act* deals with notifiable transactions. The rationale for these provisions is that in the case of mergers between large commercial entities (and typically involving large, complex transactions), it is important that the Commissioner of Competition have an opportunity to examine the competitive impact before a merger is completed. Section 114 of the *Competition Act* requires that persons proposing a transaction that exceeds the thresholds set out in ss. 109–110 must notify the Commissioner in advance of the completion of the transaction. Contravention of s. 114 without good and sufficient cause is punishable by a fine not exceeding $50,000 (s. 65(2)).

There are two threshold levels relating to the notifiable transactions provisions. First, the parties to the transaction, together with their affiliates, must have assets in Canada or annual gross revenues from sales in, from, or into Canada that exceed $400 million (the "party threshold"). The second threshold varies depending upon the nature of the transaction (the "transaction threshold"). The Commissioner must be notified in the following cases:

- In respect of a proposed acquisition of assets of an operating business (defined in s. 108(1) as a business undertaking in Canada to which employees employed in connection with the undertaking ordinarily report for work), the value of the assets or the annual gross revenues from sales in or from Canada generated from those assets would exceed $50 million.
- In respect of a proposed acquisition of voting shares of a corporation carrying on an operating business, the value of the assets of the acquired corporation or the annual gross revenues from sales in or from Canada generated from those assets would exceed $50 million, and the persons acquiring the shares would acquire an interest in the corporation exceeding either 20% in the case of a public corporation or 35% in the case of a private corporation. If the parties already surpass the 20% or the 35% threshold and make a subsequent share purchase that results in their owning more than a 50% interest, then the subsequent transaction also requires notification.
- In the case of a corporate amalgamation where one or more of the corporations carries on an operating business, the value of the assets of the continuing corporation or the annual gross revenues sales in or from Canada generated from those assets would exceed $70 million.
- In the case of a proposed combination, the value of the assets of the continuing business or the annual gross revenues from sales in or from Canada generated from those assets would exceed $50 million.

The notification obligation arises only where both the party threshold and the transaction threshold have been met.

When notification is made, the information may be provided by way of either a prescribed "short form" or a "long form" document. In the event a short form notification is used, the Commissioner may, within a prescribed time period, request the long form information to be provided. Once notification is given, the parties to the merger are required pursuant to s. 123 to wait from 14 to 42 days before completing the merger, depending on the type of transaction and the manner in which notification was made. This period can be shortened if the Commissioner informs the parties that the Commissioner does not intend to make an

application to the Competition Tribunal in respect of the proposed transaction. After the expiration of the waiting period, the parties are free to complete the transaction unless, as a result of a request by the Commissioner, the Competition Tribunal has issued an interim order preventing completion of the transaction.

All mergers, whether or not they exceed the pre-notification thresholds, are subject to examination by the Commissioner to determine if they have or are likely to have the effect of preventing or lessening substantially competition in a definable market. The assessment of the competitive effects of a merger is made with reference to the factors identified under s. 93 of the *Competition Act*. Subsection 114(1) requires the person or persons who are proposing a notifiable transaction to notify the Commissioner and supply the relevant information before completing the transaction. The obligation to notify arises before the transaction is completed. In cases where notification is required, it is essential for that information to be supplied prior to the transfer of the ownership of assets or voting shares, the effective date of articles of amalgamation, or the contribution of assets to a combination.

8. PIPEDA

The *Personal Information Protection and Electronic Documents Act* (*PIPEDA*) is federal legislation that governs the collection, use, and disclosure of personal information by businesses in the course of commercial activity. "Personal information" is defined as "information about an identifiable individual ... [not including] the name, title or business address or telephone number of an employee of an organization" (*PIPEDA*, s. 2(1)).

As part of its due diligence review of a vendor in the case of either an asset or a share transaction, the purchaser will wish to satisfy itself that the practices adopted by the vendor respecting the collection and use of personal information are in compliance with *PIPEDA* or other applicable private sector privacy legislation and that the vendor has in place appropriate privacy policies and procedures to comply with *PIPEDA* or other applicable private sector privacy legislation (including an appropriate response plan in the event of a privacy breach). In Ontario, for example, the *Personal Health Information Protection Act, 2004* is a key consideration in cases where the parties to a commercial transaction are involved in the healthcare sector and in respect of businesses in which personal health information is collected, used, or disclosed. The *Personal Information Protection Act* in British Columbia, the *Personal Information Protection Act* in Alberta, as well as *An Act respecting the protection of personal information in the private sector* in Quebec may be applicable to the transaction. During any commercial transaction, it is critical to ensure that any personal information transferred or shared in the course of that transaction, including during any due diligence phase, is only transferred or shared in accordance with applicable privacy legislation. Particular attention must also be paid to any transfers of personal information across Canadian borders. In addition, and as part of any due diligence effort, a prospective purchaser must ascertain whether there are any notification requirements arising as result of the transfer of personal information and, should such requirements apply to the transaction, have in place an appropriate notification plan.

A purchase of shares will not usually involve any transfer of the personal information collected and retained by the target company. It will therefore not generally require consideration as to whether the persons whose personal information is held by the target company have consented to its transfer. In the case of a sale of assets, some of the assets being sold may consist of or include the personal information of individuals. The purchaser will wish to be satisfied that those third parties have consented to the transfer of their information to a purchaser of the business and that the purchaser may use the personal information in the business.

9. Registrations

Upon the closing of either an asset purchase or a share purchase, there are a number of registrations and filings that may be required. The following list is a summary only.

9.1 Assignment of accounts receivable

Unless it is a sale of an account as part of a transaction to which Ontario's *BSA* applies, under the *PPSA*, every assignment of an account, whether or not intended as security (which would include a purchase of accounts receivable in an asset transaction), requires registration under the *PPSA* by the filing of a financing statement.

9.2 Other assignments

Consideration should be given to other security interests that may be assigned as a result of an asset transaction and the necessity of filing a financing change statement under the *PPSA*.

9.3 Land

In an asset transaction, if real property is transferred, real property transfer documents will have to be registered in the appropriate land registry office.

9.4 Leases

Consideration should be given to filing in the appropriate land registry office a notice of an assignment of lease where the lease has originally been registered.

9.5 Security for unpaid purchase price

Where security is given for the unpaid purchase price on either an asset or share purchase, the appropriate security documents should be prepared and financing statements should be registered.

9.6 Corporate filings

A number of corporate filings may be required following a share purchase:

- notice of change of directors and officers under the *Corporations Information Act*;
- registration, change of registration, or cancellation of registration of business names under the *Business Names Act*;
- articles of amendment changing the name of the vendor (if required pursuant to the agreement); and
- any necessary insider trading reports under the *Securities Act* if the corporation is a reporting issuer (i.e., a public company).

9.7 Income tax filings

For income tax compliance purposes, there may be several tax (i.e., election) filings required under the *ITA*, including

- a joint s. 22 election with respect to the purchase and sale of accounts receivable; and
- a joint s. 85 election (tax-deferred rollover, if applicable) with respect to the purchase and sale of property (assets and/or shares).

9.8 HST filings

For HST tax compliance purposes, certain transactions may require the filing of a joint election under s. 167 of the *ETA*.

9.9 Trade-mark registrations

Consideration should be given to the filing of any assignments of trade-marks or other intellectual property.

10. Money laundering legislation

10.1 General

A solicitor completing a business transaction for a client should be aware of the provisions of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (*Money Laundering Act*) and the *Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations*, SOR/2002-184 (*Money Laundering Regulations*).

The *Money Laundering Act* was assented to on June 29, 2000, and various sections of the *Regulations* came into force at various dates since May 9, 2002.

10.2 Regulations relating to legal counsel and legal forms

Sections 33.3–33.5 of the *Money Laundering Regulations* read as follows:

> **33.3—(1)** Subject to subsection (2), every legal counsel and every legal firm is subject to Part 1 of the Act when they engage in any of the following activities on behalf of any person or entity:
>
> (a) receiving or paying funds, other than those received or paid in respect of professional fees, disbursements, expenses or bail; or
>
> (b) giving instructions in respect of any activity referred to in paragraph (a).
>
> **—(2)** Subsection (1) does not apply in respect of legal counsel when they engage in any of the activities referred to in that subsection on behalf of their employer.
>
> **33.4—**Subject to subsection 62(2), every legal counsel and every legal firm shall, when engaging in an activity described in section 33.3, keep the following records:
>
> (a) a receipt of funds record in respect of every amount of $3,000 or more that they receive in the course of a single transaction, unless the amount is received from a financial entity or a public body; and
>
> (b) where the receipt of funds record is in respect of a client that is a corporation, a copy of the part of official corporate records that contains any provision relating to the power to bind the corporation in respect of transactions with the legal counsel or legal firm.
>
> **33.5—**A legal counsel or legal firm that, in connection with a transaction, receives funds from the trust account of a legal firm or from the trust account of a legal counsel who is not acting on behalf of their employer,
>
> (a) must keep and retain a record of that fact; and
>
> (b) is not required to include in the receipt of funds record that is kept in respect of those funds
>
> > (i) the number and type of any account that is affected by the transaction, or
> >
> > (ii) the full name of the person or entity that is the holder of that account.

10.3 Compliance requirements

There are numerous requirements to be attended to if compliance is required, and there are also some exceptions where compliance is not required.

Estate Planning

Chapter 32

Will planning, drafting, and execution

1. Introduction

The lawyer who is called upon to draft a will for a client has a heavy onus placed upon him or her. As well as being accountable to the client, the lawyer may also be liable to the intended beneficiary or beneficiaries for any act or omission in carrying out the instructions of the client that frustrates the client's testamentary intentions.

The lawyer's responsibilities encompass taking necessary steps to ensure each of the following:

- The client has testamentary capacity.
- The client's expressed wishes are not the result of undue influence or duress exerted by others.
- The client provides a full and accurate inventory of his or her property, together with any information or documentation that may have a bearing on the client's authority or ability to dispose of any of the property.
- The client is apprised of relevant income tax issues and other issues or limitations that may affect his or her proposed scheme of distribution.
- The client understands and approves of the contents of the will.
- The appropriate degree of diligence is applied to see that the will is signed on a timely basis.
- There is compliance with the statutory formalities for signing the will.

The lawyer should ensure that the will is drafted in language sufficiently clear and unambiguous, so as to minimize the likelihood of an application for the advice and direction of the court as to the meaning of the particular words used. This would include taking appropriate care in descriptions of specific property and of the intended beneficiaries (whether described by name or by class), as well as in the description of any conditions governing entitlement of a beneficiary to a bequest or devise.

The lawyer should also ensure, as much as possible, that there are no practical barriers in the way of the estate trustee's administration of the estate. For example, the will should give appropriately extensive powers and authority to the estate trustee. This will minimize the likelihood of an application to vary the terms of a trust set out in the will so as to expand the estate trustee's authority to permit particular actions.

Finally, it is a prudent post-signing practice for the lawyer to alert the client to future events that may require a review of the will to see if it is still appropriate. Such events would include, for example, marriage, divorce, births, deaths, adoptions, change of domicile or residence, and substantial changes in net worth.

2. Client communications generally

It is only through communication with the client that the lawyer can fulfill a number of his or her duties referred to earlier. For example, that communication (assuming it is properly conducted) will allow the lawyer to ascertain

- whether the client has testamentary capacity;
- whether any undue influence or duress is at play;
- the client's personal and financial circumstances relevant to the exercise of drawing a will;
- the client's testamentary intentions; and
- the client's understanding and approval of the contents of the will as drafted.

The lawyer should ensure his or her file notes contain sufficient information to support the affirmative conclusions as to (i) testamentary capacity, and (ii) absence of undue influence or duress. Such notes may assist the estate trustee in a subsequent will challenge where the presumption as to the testator's testamentary capacity and knowledge and approval of the contents of the will has been "spent" as a result of the presence of "suspicious circumstances" (*Vout v. Hay*).

2.1 Testamentary capacity

A lawyer should consider whether the testator is legally capable of disposing of assets by will. First and foremost, does the testator have the requisite degree of mental competence to give instructions for a will? For the will to be valid, a person must be capable of understanding the nature and extent of the assets and of comprehending and appreciating the persons who should receive the assets (sometimes described as "the natural objects of his/her bounty"). The testator may be eccentric or may lack capacity one moment and be lucid the next.

Although the test for determining testamentary capacity is a legal one, the lawyer should be sensitive to situations that would warrant calling on outside expertise—whether in the realm of medicine or psychology—to test the mental faculties of the would-be testator.

Since it is the duty of the lawyer to ascertain the testator's mental capacity, it is clear that the lawyer must have an opportunity to observe, interview, and assess the testator in person. Taking instructions over the telephone or, worse still, through an intermediary, will not suffice—unless the lawyer ultimately meets with the testator in person prior to the will's being signed.

Where the client is either ailing or elderly, the lawyer must be especially alert to capacity issues. The lawyer will have to make a professional judgment as to whether he or she is prepared to take initial instructions from another family member and then confirm capacity in a meeting with the testator to sign the will. There are risks associated with this approach. First, suppose it is clear at the meeting that the testator lacks testamentary capacity and will not likely recover it. In that case, the lawyer may be in an awkward position when it comes to getting paid for the time spent. Second, and more important, suppose the lawyer is merely uncertain as to whether the testator has testamentary capacity and wants to have the comfort of an outside professional opinion. This will entail a further delay, during which time the testator may either die or fall clearly below the level of testamentary capacity.

2.2 Undue influence or duress

The instructions given must reflect the wishes of the testator. The validity of a will may be compromised, either in whole or in part, where the instructions given to the lawyer are the result of pressure brought to bear on the testator—pressure of such a degree that the testator has reached the point of thinking, "It is not my wish, but I must do it." This is especially true in the case of an ailing or elderly testator who may be heavily dependent upon another person for care or assistance, a person who may be in a position to exploit the testator's consequential vulnerability to pressure.

Undue influence or duress may be subtle in nature. This is one reason that the lawyer should be wary about having anyone other than the testator present when instructions are being given or when the will is being signed.

2.3 Other communication considerations

A testator's personal circumstances can compromise the lawyer's ability to ascertain the testator's wishes and to assess his or her testamentary capacity. The lawyer must be vigilant to ensure that those circumstances do not impair the lawyer's ability to conduct effective communications with the testator. In this regard, the lawyer should address with appropriate caution any invitation by another family member to act as that interpreter. Accepting such an offer may be tantamount to taking instructions second-hand, with all the dangers that entails.

As an example, consider the situation in which the lawyer is not conversant in the testator's first language. In that case, serious consideration ought to be given to having an independent interpreter present for all meetings with the testator.

Language is not the only impediment to effective communication. Illiteracy is common among adults in our modern society. The lawyer should be on guard for cues that indicate a testator's diminished literacy. Limited literacy skills can be problematic in at least two respects:

- They may interfere with the testator's ability to communicate to the lawyer either the nature or the value of his or her property. (This is simply one more justification for the lawyer to request documentation in support of asset information provided orally by the testator.)
- They may compromise the testator's ability to understand the draft will when it is given to him or her for review and comment. Bear in mind that those afflicted by illiteracy are often at pains to hide that disability from others. The lawyer should not assume that a testator with limited literacy skills will disclose his or her problem to the lawyer. This is one justification, among others, for the lawyer to consider establishing a routine of reading (or at least paraphrasing) the key provisions of the will for the testator immediately prior to having him or her sign it.

Not infrequently, it is the client personally who requests that a family member or other person attend the meeting where information is conveyed or instructions are given. There are problems with a lawyer's acquiescing to such a request:

- The lawyer will have no way of knowing whether undue influence or duress—which, as noted earlier, may be subtle in nature—may have been at play in motivating the client's request. (Even if there was no undue influence or duress motivating the client's testamentary instructions, the presence of a third party at any meeting between the lawyer and the client may encourage or even facilitate a subsequent challenge to the validity of the will by someone who is unhappy with the scheme of testamentary distribution.)
- The client may not appreciate that the lawyer's primary obligation to maintain confidentiality and preserve the privacy of the client's affairs will necessarily be compromised.
- The information or instructions conveyed by the client to the lawyer may come as a great surprise — indeed, a shock—to the other family member present. In the extreme, it could give rise to

litigation—either as a consequence of disclosure of the client's previous actions or in attempts to interfere with the client's intention to make a new will.

- Should litigation ensue, the benefit of any privilege attaching to communications between the client and the lawyer may be lost.

One final suggestion on effective communication with the testator: a lawyer should endeavour, wherever possible, to use plain language in all his or her writings. This should apply not only to the preparation of wills and other estate planning documents, but also to any correspondence sent to the testator. Even where language and literacy are not issues of concern, so-called "legalese" may be a hindrance to effective communications.

3. Information gathering

Collecting complete and accurate information from the client, while essential to the proper discharge of the lawyer's role, is a stage in the process that is not always appreciated by the client (and sometimes, not by the lawyer either). For example, if the whole of his or her estate is to be disposed of in exactly the same manner (to a spouse or marital partner, for example), the client is likely to question the importance of providing the lawyer with a detailed description of the assets, including their nature, location, value, details of ownership, and any limitations on the ability to dispose of them on death.

For the lawyer to be able to overcome the client's reluctance to provide that level of detail, he or she must be able to provide a persuasive rationale for doing so. For example, the lawyer must be ready to explain

- how valuation may be relevant for purposes of assessing exposure of the estate to income tax and estate administration tax;
- how the nature and location of assets may raise questions as to whether the laws of some other jurisdiction may constrain the ability to dispose of those assets by will;
- that certain kinds of joint ownership will take the asset out of the estate of the client; and
- how the estate trustee(s) may be legally bound by contract—e.g., a shareholder's agreement, a co-tenancy agreement, or a separation agreement—to deal with a particular asset on death in a manner contrary to what the client intends.

Collecting information about the client's personal circumstances can be equally critical. Here are just a few examples:

- While unlikely to be an issue, has the client attained the age of majority, or is there an exception (for example, is the client married or in the armed forces or a mariner at sea) that allows him or her to make a valid will?
- A client living in a common-law relationship or engaged to be married should be warned that a marriage subsequent to the signing of the will would revoke the will, unless the will contains a declaration that it is being made in contemplation of that marriage (*Succession Law Reform Act* (*SLRA*)). (A will declared to have been made in contemplation of marriage remains valid even if the marriage does not take place. Of course, if the marriage is called off, it may have a substantial impact on the testamentary intentions of the testator.)
- If the client has an adult child who is living in a common-law relationship, the lawyer should question the client on whether any children born of that relationship are to be included in the scheme of distribution.
- If anyone meets the definition of a "dependant" (of the client) within the meaning of that term in the *SLRA*, the lawyer should explain a potential claim under Part V of that statute.
- If any one of the client's children has a disability, an exploration of the child's current financial needs and future prospects must be canvassed.
- If any of the client's children is married, a discussion of the implications of Ontario's *Family Law Act* (*FLA*) is in order.

The lawyer who fails to obtain answers to critical questions regarding the client's personal and financial circumstances risks exposure to liability at the instance of a disappointed beneficiary. What is perhaps a more complex issue is whether the lawyer is entitled to rely on the information provided without asking for a copy of the documentation that would confirm the accuracy of a given answer.

It is quite common, for example, that a client who has signed a separation agreement does not always know or accurately recall what support or property obligations will be imposed in the event of the client's death. At a minimum, the lawyer should ask for a copy of the separation agreement. If the client is unable or unwilling to provide that information, the lawyer should document that fact and make it clear that the client must assume the risk that his or her understanding or recollection of those obligations may be faulty.

Similarly, it is good practice to ask a client to provide a copy of title documents for real property particularly if that real property is held jointly with one or more other persons. Whether property is held in a joint tenancy or a tenancy in common makes all the difference in the world as to the freedom the client has to dispose of his or her fractional undivided interest in that property.

With regard to joint bank accounts and joint investment accounts, ascertaining the client's intention in creating the joint account is essential. There are three possible intentions with regard to the rights of the other joint account holder: (1) he or she is an equal owner of the funds or investments; (2) he or she is a joint owner merely in order to be able to assist the client in managing his or her financial affairs; and (3) as a result of the Supreme Court of Canada decision in *Pecore v. Pecore*, he or she is entitled only to receive whatever is in the account on the client's death. (While it is important for the lawyer to record the client's intentions, they may not carry sufficient weight in a subsequent judicial proceeding if they were being expressed for the first time and it was long after the creation of the joint account.)

4. Statutory constraints on testamentary freedom

Two Ontario statutes may circumscribe the client's testamentary freedom: (1) Part V of the *SLRA* (dependant support), and (2) Part I of the *FLA* (property rights of legal spouses). The lawyer must be alert to these limitations and advise the client accordingly in situations where a client's testamentary intentions may be foiled by a dependant's support claim or by a matrimonial property claim.

4.1 Dependant support claims

Part V of the *SLRA* is intended to ensure that certain persons who were financially dependant upon the deceased during his or her lifetime are not put into dire straits by virtue of inadequate provision having been made by the deceased for those persons. In order to make a claim under Part V of the statute, three criteria must be met:

- The claimant must stand in the right relationship to the deceased, namely, be a legal or common-law spouse, parent, grandparent, child, grandchild, or sibling of the deceased (with the parent-child relationship encompassing situations where the former has "demonstrated a settled intention" to treat the latter as "a child of his or her family").
- Immediately prior to death, the deceased must have been actually providing support to the claimant or have been under a legal obligation to do so.
- The deceased did not make "adequate provision" for the claimant.

Until recently, "adequate provision" had been considered to be a reflection of the claimant's budgetary needs. (Where the deceased's child or legal or common-law spouse is the claimant, those budgetary needs would take into account family lifestyle.) As a result of the Ontario Court of Appeal decision in *Cummings v. Cummings*, there are two new dimensions to be considered in dependant support claims. First, moral considerations are now firmly established as being equally as important as financial ones in the exercise of the court's discretion to fashion the appropriate remedy; and second, in so far as a legal or common-law spouse is concerned, an equitable sharing of the family wealth has been established as a legitimate objective of Part V of the statute. The uncertainty that this decision has brought into play must be made clear to the client.

The client should also be apprised that the assets available to satisfy a dependant support claim include a number of categories of property that for all other purposes are not available to satisfy claims against the estate. These categories are set out in s. 72 of the *SLRA*.

4.2 Matrimonial property claims

The passage of the *FLA* in 1986 ushered in a matrimonial property regime in Ontario that was dramatically different from its predecessor in three respects:

- The distinction between shareable "family assets" and (generally) non-shareable "non-family assets" was abolished.
- The matrimonial property rule of an *in specie* division of family assets was replaced by a division of value.
- The rules became applicable even where a marital relationship ended with the death of one of the spouses.

It is as a result of this last-mentioned change that will planning became much more complex. Absent a marriage contract waiving it, a surviving spouse now has the right to choose between accepting his or her entitlement under the will and claiming an "equalization payment" representing a sharing of the "marriage spoils."

Unless the will provides that the surviving spouse's entitlement, if any, under the will is in addition to his or her equalization entitlement, the surviving spouse will be put to an election, having to choose either the former or the latter. If the latter is chosen, the will entitlement is forfeited, and the will is administered as if the surviving spouse had predeceased the testator.

Theoretically, a will leaving anything less than 100% of the estate to the surviving spouse raises the spectre of the spouse's choosing to elect in favour of an equalization claim. It might be thought that the way to avoid that risk is to provide a will entitlement to one's spouse that is guaranteed to be not less than the equalization claim. There are at least three reasons why this strategy may not be effective:

- In most cases, each spouse's net family property (broadly stated, a measure of the increase in a spouse's net worth during the marital relationship)

is a moving target; i.e., the value of each spouse's net worth on the valuation date—and therefore, his or her net family property—will not be known at the time the will is drawn.

- Although the general rule is that the equalization claim, if any, is one-half the amount by which the deceased spouse's net family property exceeds the surviving spouse's net family property, s. 5(6) of the *FLA* sets out a number of factors that will entitle the court hearing an application to order an equalization payment that is more or less (if an equal division of net family properties would be unconscionable).
- The equalization claim is calculated on the basis of asset values on the valuation date, even if the estate value declines substantially after the deceased's death. For example, suppose the surviving spouse's net family property is nil and the deceased spouse's net family property is $400,000. The surviving spouse would be entitled to an equalization payment of $200,000. Suppose the deceased spouse had chosen to err on the side of caution and leave by will to the surviving spouse 60% of the estate. Finally, suppose the value of the estate had declined to, say, $150,000 by the time the equalization payment was ordered to be made. In this situation, the surviving spouse would be better off electing in favour of equalization, giving him or her the whole of the estate in satisfaction of the $200,000 equalization payment, as compared to taking 60% of $150,000 (or $90,000) by accepting the will entitlement.

Prior to the enactment of the *FLA*, one would frequently be instructed by the testator to prepare a will granting the spouse a life interest in the estate, with the remainder interest passing to the testator's children (who might or might not have been born of the union between the testator and his or her spouse). The rationale was that this would protect the estate for the testator's children (after the spouse's death), thereby guarding against loss because the surviving spouse

- might enter into a new marital relationship and leave his or her entire estate to the new marital partner; or
- might be incapable of managing the inheritance wisely.

Now, the life interest is no longer a guaranteed strategy because the surviving spouse can forego it in favour of an equalization claim.

What advice can be given to the client whose testamentary plans are vulnerable to an equalization claim? Without question, the best legal advice is that the client should have a marriage contract with his or her spouse under which, in exchange for appropriate consideration, the latter will give up any right to elect in favour of an equalization claim. However, since an enforceable marriage contract calls for independent legal advice and full financial disclosure to be given to both parties, the practical prospect of obtaining a marriage contract may be small in a particular client's situation.

The other alternative is the "self-help" remedy; that is, unilateral steps by the client to minimize his or her exposure to an equalization claim on death. This would entail

- maximizing opportunities for excluding the value of assets from one's net family property; and
- minimizing one's net worth on the valuation date; or
- a combination of the two.

Taking optimum advantage of the opportunities to exclude asset values from net family property may involve nothing more than keeping careful records that will support a later position that a particular property belongs to one of the categories of so-called "excluded property." As for minimizing net worth on the valuation date, the lawyer should caution the client that a disposition of property for the sole purpose of reducing a spouse's equalization claim could, under the appropriate circumstances, be set aside as a fraudulent conveyance. (*Stone v. Stone*)

The lawyer may be in an awkward position when asked to take instructions for wills for both spouses where one spouse intends (absent a marriage contract) to leave less than the entire estate to the other spouse. The conflict of interest for the lawyer will become apparent only after that spouse discloses his or her testamentary intentions. At that point, the lawyer must decide whether he or she can act for only one of the spouses—or perhaps for neither of them. The lawyer should become familiar with the commentary found in r. 2.04(6) of the *Rules of Professional Conduct*, which deals with the joint retainer of spouses or partners, as the latter term is defined in the *Substitute Decisions Act, 1992*, in the preparation of wills. When meeting with a joint retainer couple for the first time, or perhaps even before that first meeting, the lawyer should ask the clients to sign a form of acknowledgment and consent regarding the constraints imposed on the lawyer's conduct as set out in that commentary.

There is another reason why will planning requires the *FLA* to be taken into careful consideration. The client may have concerns that the inheritance passing to his or her children will be exposed to an equalization claim by a present or future son-in-law or daughter-in-law. Certain strategies can be suggested to the client in this regard:

- As a general rule, gifts and inheritances received by a spouse during marriage are excluded from the recipient spouse's net family property.
- Income derived from gifts and inheritances received during marriage is also excluded, provided the donor or testator expressly so stated.
- If the gift or inheritance is received prior to marriage, its value at the marriage date will represent a deduction in calculating the child's net family property at a later time. Furthermore, there will be an opportunity for the child to enter into a marriage contract prior to the marriage.
- Where a parent intends to forgive a debt owed by a child, it will be of benefit to the child only if the debt is forgiven before the child's marriage (assuming it is not a mortgage debt associated with a property that becomes the child's matrimonial home upon marriage). In that case, it will increase the child's net worth on the date of marriage, thereby giving the child a larger "opening credit" in later calculating his or her net family property. By contrast, forgiveness of a debt owing by a married child serves only to increase his or her net worth on the valuation date, thereby increasing his or her net family property calculation.
- The client who wishes to provide greater protection for a child can establish a discretionary testamentary trust for a child, instead of making an outright bequest.

There are several caveats to the foregoing:

- A matrimonial home is the exception to the rule regarding gifts and inheritances received during the child's marriage. This can be problematic where the parent intends to leave a married child all or a fractional interest in a family cottage. Regular use of the cottage by the child and his or her spouse would make it a matrimonial home.
- If the parent forgives a mortgage on a child's matrimonial home or if the child spends inherited cash to pay down the mortgage, the child's net family property will be increased.
- Even though the value of a gift or inheritance received during marriage is excluded from the child's net family property, it may still be vulnerable to an equalization claim in that its value can be used to satisfy that claim (where the child's other assets are not sufficient for that purpose).
- The onus of proving entitlement to an exclusion of a gift or inheritance received during marriage lies with the spouse claiming it. If the child has been careless in segregating an inheritance or in keeping records to prove the source of a particular inheritance (or how it may be traced into other property), the claim for an exclusion may fail.

5. Estate administration tax (formerly probate fees)

In order to obtain an initial certificate of appointment of estate trustee (with or without a will), an estate trustee must pay an estate administration tax at the rate of $5 per $1,000 (or part thereof) for the first $50,000 of estate value and $15 per $1,000 (or part thereof) for the estate value in excess of $50,000. The value of property falling into any of the following categories is excluded from the calculation of estate administration tax:

- real property situated outside Ontario;
- property owned by the deceased jointly with one or more other persons, where there is a right of survivorship;
- the proceeds of life insurance payable on the death of the deceased to a designated beneficiary; and
- any benefits payable under a "plan" (within the meaning of that term under Part III of the *SLRA*) to a designated beneficiary.

The value of any other property governed by the will is included in the calculation of estate administration tax.

Generally speaking, debts and liabilities of the deceased do not reduce the value of the estate for the purpose of calculating estate administration tax. Under the *Estate Administration Tax Act, 1998,* the one exception to that rule is the value of an encumbrance registered against real property whose value is included in the property of the deceased person.

Part of the lawyer's planning discussion with the client should include a consideration of what steps, if any, should be taken to reduce exposure to estate administration tax. Such steps might include the following:

- disposing of property during one's lifetime (either directly to the beneficiary ultimately intended to receive it on the client's death or to a trust such as an alter ego trust or joint partner trust);
- transferring property into joint ownership with one or more other persons; and
- ensuring that life insurance, RRSPs, RRIFs, TFSAs, and other "plan" benefits are made payable to a designated beneficiary (rather than to the client's estate).

Under current Ontario law, the use of multiple wills is another technique for reducing exposure to estate administration tax. The essence of the scheme involves characterization of each asset owned by the client as either a "bad" one or a "good" one. "Bad" assets are those that require—either legally or practically—a probated will to transfer ownership from the name of the deceased. Each category of assets is governed by a separate will, with the intention that only the will governing the bad

assets will be submitted for probate. The decision in *Granovsky Estate v. Ontario* confirmed that estate administration tax is payable only on the value of the assets governed by the will submitted for probate.

The use of multiple wills is particularly effective where the client owns shares of a private corporation, since it is generally considered that shares of a private corporation held by a deceased shareholder can be legally transferred in accordance with an unprobated will. Strictly speaking, it is up to the director(s) of the private corporation to decide what evidence will be acceptable to prove the authority of the estate trustee to direct what is to happen to the shares formerly owned by the deceased shareholder. Accordingly, the client should be cautioned about including in a separate will his or her shares of a corporation that is controlled by other persons. If the director(s) of that corporation were to decide that probate of the will governing those shares was required, the scheme to reduce estate administration tax will come to nought.

A private corporation controlled by the client can also be used as a bare trustee or nominee to hold the client's other valuable assets and, by appropriate drafting, have those assets governed by the same will that is to be withheld from probate. However, it is important that the corporation sign a trust declaration to confirm that it is not the beneficial owner of any of those assets that it holds as a nominee. First, this will prevent the Canada Revenue Agency from asserting that the client disposed of property that could give rise to immediate tax consequences. Second, it will protect those assets from the corporation's own creditors.

The potential adverse consequences of transfers of property—typically by a parent to a child—into joint ownership with right of survivorship are many. They include the following:

- The testator parent will lose exclusive control over the property. For example, where a parent transfers real property into joint ownership with a child, any subsequent decision to sell or encumber the property will require the consent of the child. The child will also have to consent to a transfer of his or her one-half interest back to the parent (for example, because future changes to the provincial estate administration tax regime substantially reduce or eliminate the need to avoid those taxes).
- Where the child has financial problems, his or her creditors will have access to the fractional interest in the property—possibly leading to a partition and sale.
- Where property qualifies as the child's "matrimonial home" under the *FLA*, the joint tenancy will be deemed to have been severed if the child predeceases the parent.
- The parent may have made a taxable disposition for income tax purposes. In some cases, this may result in the triggering of an immediate and significant income tax bill—hardly a beneficial outcome in trying to avoid a substantially lower future liability for estate administration taxes.
- If, under the *Income Tax Act*, the property transferred is the parent's principal residence (and if it is not the child's principal residence), the transfer will result in a loss of a portion of the principal residence exemption for future taxation years.

Careful attention should be paid to cases where a client advises the lawyer of a previous transfer of property formerly held by the client alone to the client and his or her child as joint owners with right of survivorship. Of particular concern will be transfers to joint ownership with a child where the parent has another child or children. Did the parent intend to make a gift exclusively to the child with whom joint ownership is shared? Or was the transfer made with some other objective in mind? The Supreme Court of Canada recently held in *Pecore v. Pecore* that where the intention of the parent who transfers property into joint ownership with an adult child is unclear, the presumption of a resulting trust will be applied. Consequently, the surviving adult child will be treated as holding the property by way of a resulting trust for the parent's estate.

6. Income tax

One cannot engage in a meaningful discussion with the client about his or her testamentary intentions without a good understanding of the special income tax rules that arise on and after the death of an individual. Without intending to be exhaustive, the key considerations are as follows:

- An individual is deemed, immediately before death, to have disposed of capital property and land inventory at its then fair market value. The (capital) gain is included in the tax return for the deceased's year of death.
- Where capital property or land inventory is transferred as a consequence of death
  - to a surviving spouse or common-law partner; or
  - to a testamentary trust for the spouse's exclusive lifetime benefit,

  the property will transfer at its tax cost to the deceased, unless the personal representative elects to have the property transfer made according to the previous rule.

- Capital gains from a deemed disposition of "qualifying small business corporation shares," "qualified farm property," or "qualified fishing property" may be sheltered under an individual's lifetime capital gains deduction (maximum $750,000).
- Charitable gifts made by will are deemed to have been made in the year of death and, thus, give rise to a tax credit that, if large enough, can reduce to zero (i) the taxable income in the year of death; and (ii) the taxable income in the year preceding the year of death. Direct charitable beneficiary designations for RRSPs, RRIFs, TFSAs, and life insurance give rise to similar tax benefits.
- The general rule is that the value of RRSPs and RRIFs as at the date of death of the deceased annuitant is included as income of the annuitant for the year of his or her death. To the extent that the RRSP money or property qualifies as a "refund of premiums" (or, in the case of a RRIF, as a "designated benefit"), the value of the money or property can be taxed in the hands of the recipient.
- Where a trust is to be established that may run for an extended period of time, the income tax rules impose a fiction of a deemed disposition (i.e., sale) of capital property at certain times (every 21 years) or, in the case of a testamentary spousal trust, on the death of the spouse or common-law partner.

It is important that the client understand the tax liability arising on death in connection with a particular asset (e.g., capital property, land inventory, RRSP, or RRIF) does not—except in the case of one of the "rollovers" described above—follow the asset into the hands of the recipient. Rather, it is a liability of the estate. This may result in a distribution of estate value among two or more beneficiaries that is dramatically different from what the client intends. If this is a problem, it can be addressed by appropriate language in the will that imposes on the recipient of a particular asset the liability for the tax relating to that asset.

7. Foreign laws

If the client is a citizen or resident of, or owns property situated in, a foreign jurisdiction, the lawyer should be cognizant of

- taxes and death or succession duties in that other jurisdiction; and
- possible legal constraints on testamentary dispositions of property in that other jurisdiction.

This may entail retaining local counsel in that other jurisdiction.

8. Client instructions

When taking the client's instructions, the lawyer must ensure that he or she clearly comprehends and faithfully records those intentions. The lawyer must be ready to offer appropriate guidance (whether or not requested to do so by the client) so that the client gets not only what he or she wants, but what he or she needs as well.

8.1 Appointment of estate trustees

The estate trustee has a very clearly defined role in administration of the estate: attending to the funeral and burial arrangements; proving the will (if necessary); collecting and protecting estate assets; paying creditors and satisfying liabilities (including taxes owing); distributing specific bequests and conveying devises of real property; and finally, distributing the residue of the estate. In the case of a "trust" will, the estate trustee may also have to establish one or more trusts for specified beneficiaries and administer any such trust until the time specified for final distribution.

In many instances, the appointment of estate trustees to administer the estate in accordance with the terms of the will is a straightforward proposition. Where neither the structure of the testator's estate nor the nature of the intended distribution is complicated, there are unlikely to be any minefields. Suppose, for example, one marital partner intends to distribute to the other marital partner his or her entire estate, which consists principally of liquid assets. In that event, it would be appropriate to appoint the other marital partner as the sole estate trustee, unless the latter has significant limitations (health or language, for example) that would warrant a different appointment. Similarly, an outright distribution to one or more legally capable adult children will often warrant appointing the child(ren) as estate trustee(s).

It is not uncommon for a client to instruct the lawyer to draft the will with the appointment of two or more persons as joint estate trustees. On receiving such instructions, the lawyer should canvass with the client a number of issues, having regard to the fact that the estate trustees must act jointly:

- Where there are more than two estate trustees, how decisions are to be made: (i) unanimously; (ii) by majority; or (iii) by majority with one specified estate trustee having to be part of that majority (that is, having a veto).
- The likelihood that the estate trustees will be able to work together without serious conflict.
- The problems that may arise if the estate trustees live distant from one another.

The client with several adult children will often wish to appoint all of them jointly, out of worry that leaving one out will create unhappiness for the one excluded. The best response to such a client is to point out to him or her that the appointment as estate trustee is a burden, not an

honour and that the decision to exclude one of the children may be effectively sold by the client to that child on such a rationale.

Other issues arise when there are unusual assets or "foreign" elements or where the administration of the estate is expected to be a protracted affair, including the following:

- Appointment of a "foreign" estate trustee—that is, one who is neither resident in a Canadian province or territory nor resident anywhere in the British Commonwealth—will likely require a foreign estate trustee's bond. More important than the added cost of a bond is the question of whether a bonding company can be found to issue one. Practitioners have found that most bonding companies are very reluctant to issue a bond for an estate trustee outside North America—usually leading to the foreign estate trustee's having to renounce the appointment to allow a "local" estate trustee to take on the appointment.
- One further issue may arise where a client with an investment portfolio intends to appoint a U.S. resident—typically, a child of the client—as an estate trustee. Canadian brokerages are evidently heeding the warnings from the U.S. Securities & Exchange Commission against taking trading instructions respecting Canadian assets from a U.S. resident client.
- Appointment of an estate trustee who may have an inescapable conflict of interest is problematic. It is not uncommon, for example, that a testator will consider a business partner of many years to be a competent and trustworthy individual to act as estate trustee. If the business agreement between the testator and his or her partner entitles or requires the latter to buy out the former's interest in the business venture, the partner will be wearing two hats: that of a seller and that of a buyer—an untenable position if there is any element of negotiation required under the business agreement.
- Where assets are complex in nature, it may be desirable to appoint an estate trustee (or at least one of the estate trustees) with particular expertise in relation to those assets. A prolific author/artist may be well advised, for example, to appoint a literary/art estate trustee with responsibility for disposing of the testator's collection. That having been said, there is no reason why the estate trustee cannot hire the necessary talent to assist him or her in dealing with unusual assets.
- Where the potential exists for an estate to run for many years (say, for example, because a trust is to be set up for a disabled child with a normal life expectancy), it would be prudent for the testator to appoint a trust company—either together with, or as a substitute for, an individual estate trustee—to deal with the contingency of the individual estate trustee's dying or becoming incapacitated before the estate has run its course.
- Should the client's surviving spouse choose to make an equalization claim against the estate under the *FLA*, he or she will forfeit the right to act as estate trustee. Accordingly, where there is a risk of such an equalization claim, the client should either not name the surviving spouse as estate trustee or should name one or more other persons to act as estate trustee(s) together with or as alternative(s) to the surviving spouse.

8.2 Custodians for minor children

Clients often find that the most difficult decision in planning for death is determining who shall have custody of any minor children. Indeed, parents are often in conflict on this issue. The couple's inability to reach a consensus on this issue is often the reason that neither has made a will.

The *Children's Law Reform Act* permits the parent with custody of a minor child to appoint a custodian for the child in his or her will. In the case of two parents having custody of a minor child, the testamentary appointment of a custodian will fall to the later of the two parents to die. If the parents were to die simultaneously, the only effective appointment will be one common to both wills. So, for example, if the mother appoints A and C as custodians and the father appoints B and C as custodians, the simultaneous deaths of the mother and father would result in C alone having legal custody of the minor child(ren).

The lawyer should point out the following matters to the client(s) wishing to include a testamentary custodial appointment for minor children:

- The appointment is legally effective for only 90 days after the testator's death. Thereafter, it will be necessary to apply to the court for a permanent custodial appointment—assuming one is felt to be necessary.
- On an application for appointment of a permanent custodian, the following will occur:
  - The court will do what is in the best interests of the minor child(ren).
  - Courts give considerable weight to the parent's testamentary choice of custodian.
  - Courts are generally reluctant to disturb the status quo (i.e., the temporary custodial arrangement) without good reason.
  - Where the minor child is sufficiently mature, the court will solicit the child's views on a custodial appointment.

8.3 Guardians of property of minor child

Appointment of a guardian of a minor child's property can also be effected by a will. The rules for testamentary appointments of a guardian of a minor child's property are analogous to those for testamentary appointment of a custodian of a minor child's person. However, one cannot make a testamentary appointment of a guardian of a minor child's property unless one is a guardian of that child's property. In Ontario, a parent is not automatically his or her minor child's guardian of property. That requires a court order. As a result, the parent who does not have a court appointment as guardian of his or her minor child's property has no authority to appoint a guardian of property by his or her will.

8.4 Funeral and burial instructions

As a matter of law, the estate trustee has control of the body and therefore has the authority to determine the place and manner in which funeral and burial will take place. In this regard, the testator cannot bind the estate trustee by means of instructions in the will. In any event, the will may not be discovered in time to carry out any instructions it contains regarding funeral and burial arrangements. For these reasons, the lawyer ought to discourage the client from including funeral and burial instructions in the will. A better choice would be simply to ensure that every family member who may be called upon to look after funeral and burial arrangements is made aware of the client's wishes. The estate trustee is often not brought into the picture until after the funeral and burial arrangements are attended to by family members. The only practical benefit for including funeral and burial instructions in a will is that the estate trustee who follows those wishes will be able to point to the will to defend his or her actions.

8.5 Beneficiaries

The lawyer should canvass a number of issues with the client with regard to choice and identification of beneficiaries, as well as to the conditions, if any, on the gift:

(1) Proper description of each beneficiary, whether by name or by class:

- In the case of a named individual, ask for the relationship, if any, to the client and the city of residence (to assist the estate trustee).
- In the case of a description by class in terms of legal relationship:
  - Ensure that the client understands that step-children do not normally fall within the meaning of "children" (and likewise for step-siblings).
  - Confirm whether the client intends to include or exclude a person born outside marriage or the tracing of his or her entitlement through a person born outside marriage (the default being inclusion of such persons, unless the will provides otherwise).
  - Ascertain when the class is to close (date of the testator's death, date of death of life tenant, etc.), explaining to the client, where appropriate, the administration problems that could arise from requiring a class to be kept open out of "fairness."

(2) For charitable bequests:

- If possible, confirm the name by contacting the charity directly.
- Where the client's bequest is motivated in part by tax considerations:
  - In the case of a specifically named charity, ensure that the recipient is a registered charity for income tax purposes.
  - Where the executors are given authority to choose the recipient (having regard to the purposes intended by the bequest), ensure that the purposes are exclusively charitable.
- For gifts other than (i) cash, or (ii) property than can be readily sold, confirm that the charity is prepared to accept the gift.
- Clarify with the client the nature of a cash bequest (for example, outright bequest, perpetual gift, or gift for a specified purpose).
- Discuss what is to happen if the charity does not exist or changes its objects (by the time of the client's death in the case of an outright bequest, or at some later time in the case of a perpetual gift).

(3) Where conditions on a bequest are imposed, consider or ensure the following:

- whether the condition is to be a condition precedent or a condition subsequent;
- that the condition will not be unenforceable on grounds of public policy;
- that the condition will not be void for uncertainty; and
- that the estate trustee will be readily able to ascertain on an objective basis whether the condition has been satisfied.

8.6 Dispositions of property

Where specific property is being disposed of, explore the following issues with the client:

(1) Description of the property should be sufficient for the estate trustee to identify it as the object of the bequest.

(2) Consider whether there are constraints on the client's legal ability to direct disposition, including the nature of client's ownership interest (joint tenancy, life interest, etc.) and any agreements with third parties (for example, shareholder agreements, marriage contracts, or separation agreements).

(3) Consider the contingency of prior disposition of property by the client:

(a) Should the bequest govern any replacement property (the family home, for example)?

(b) Should the bequest adeem (i.e., should it fail because the specific property is no longer owned by the testator at death)?

(c) Should a replacement bequest be made to the beneficiary (for example, a cash bequest)?

In addressing these issues, the lawyer should keep in mind the possible application of certain statutory anti-ademption rules:

- The *SLRA* gives a beneficiary rights in limited circumstances with respect to property substituted for the property gifted to the beneficiary in the will. Those circumstances are as follows:
  - a conveyance or other act relating to property that gives rise to a right, chose in action, or equitable estate or interest;
  - loss or damage to property giving rise to a right to insurance proceeds;
  - expropriation of property, giving rise to a right to compensation; and
  - a mortgage, charge, or other security interest in property sold by the testator.

  In those cases, absent a contrary intention in the will, the beneficiary who would have taken the property in question is entitled to the testator's interest that has been substituted for his or her interest in that property. Consider the following example:
  - The testator's will leaves Blackacre to her sister, Jane.
  - Prior to her death, the testator enters into a purchase and sale agreement whereby she agrees to sell Blackacre to a third party for $300,000 in an all-cash transaction.
  - The testator dies before the closing.

  Although at the time of her death, the testator is no longer in a position to convey Blackacre to Jane, Jane will still be entitled to the $300,000 payable on closing.

  As a further illustration of this "anti-ademption" rule, let us change the facts slightly. Suppose, instead, that the purchaser is to pay $100,000 on closing and give the testator a mortgage for the remaining portion of the purchase price. Suppose that the testator dies after closing. In that case, Jane will be entitled to an assignment of the mortgage receivable.
- The *Substitute Decisions Act, 1992* also contains a special anti-ademption rule that can apply where
  - specific property of a person who is incapable of managing property is the subject of a bequest or devise in that person's will; and
  - that property is disposed of by the person's attorney under a continuing power of attorney or by a guardian of the person's property.

  Unless the person's will evidences a contrary intention, the beneficiary who was to receive the specific property will receive from the residue of the estate a sum of money equal to the proceeds of disposition of that property, without interest.
- Where the property in question is deemed, for income tax purposes, to have been disposed of by the testator at its fair market value immediately before death, the testator should be asked for a clear direction as to who is to bear any increased income tax liability arising as a consequence: the recipient of the property or the residuary beneficiaries. Absent any provision to the contrary, that tax liability will be borne by the residuary estate.

8.7 The family home/family cottage

The disposition of the family home (and family cottage) is often a difficult issue. The lawyer should start by explaining to the client the duty of the estate trustee is to turn assets that are not income-producing into ones that are. Accordingly, unless the estate trustee is given express direction and authority to retain the family home or family cottage for the benefit of specific persons, he or she will be obliged to sell the property (or properties) in due course and invest the proceeds.

Retention of the family home or family cottage will be more important where the client leaves minor children surviving. Some of the questions the lawyer should pose to the client in this regard are the following:

- Should the family home be made available to the custodian (and his or her marital partner and children, if any) if the custodian's own residence would be too small to accommodate an expanded family?
- After the last of the testator's children has attained the age of majority, at what point will the child(ren) be entitled to request the custodian (and family, if any) to vacate the home?
- After the last of the testator's children has attained the age of majority, under what circumstances may the child(ren) request that the house be sold?

Similar questions may be posed regarding the family cottage.

It is not uncommon that one (and usually only one) of the client's several adult children is living at home with his or her parent(s), with little likelihood that the child will be willing or able to move out in the future. In that case, the client may wish to leave the family home to that child as part of his or her share of the estate. This may be problematic if the value of the family home constitutes more than that child's equal share of the estate—particularly if the child is not financially self-sufficient. In these circumstances, the lawyer should very carefully canvass with the client as to which is the more important consideration:

- equality (and immediacy) of distribution of the estate; or
- accommodation of the needs of the stay-at-home child.

Where the family home will be given to the stay-at-home child as part of his or her share of the estate, the lawyer should discuss two issues with the client (and draft appropriately). Is the provision to apply to any property purchased in substitution for the current family home? Secondly, is the provision to apply in the case where the parent(s) may no longer be living in the home, by virtue of having been placed in an institutional setting for health reasons?

Where the testator intends to leave the family home or cottage to two or more children, the lawyer should discuss the issue of how title to the property is to be taken. Where the respective fractional interests of the children are not equal, the only possibility is a tenancy in common. Where those interests are to be equal, the choice is between a tenancy in common and a joint tenancy. (If the will is silent, the children will take title as tenants in common.) In that case, the lawyer should discuss with the testator the key difference between the choices; namely, the right of survivorship associated with the joint tenancy. Where the testator opts for the joint tenancy, the lawyer should also point out that each child may sever unilaterally the joint tenancy, thereby rendering it a tenancy in common and leaving the child free to devise by will his or her undivided fractional interest in that property. In the case of a family cottage, this will lead quite readily into a discussion of the merits of a co-tenancy agreement between or among the children governing, among other things, the right of each child to dispose on death of his or her fractional interest. If the testator likes the idea of a co-tenancy agreement and wants to refer to it in the will, the lawyer should clarify whether the reference is to be expressed as a mere wish or the reference is to be imposed on the children as a condition precedent to the devise.

9. Will drafting

Once the lawyer has collected all the relevant information about the client and is satisfied that he or she understands the client's objectives and instructions, the drafting stage can begin.

9.1 Administrative provisions

There are a number of administrative powers that are desirable to include, since they will facilitate the proper administration of the estate, including the following:

- complete sales and conversions;
- pay debts;
- deal with a minor's share of estate;
- delegate investment discretion;
- deal with interests in companies and other business and partnership interests;
- deal with real estate;
- deal with notes and guarantees;
- distribute estate *in specie*; that is, divide assets between the beneficiaries without first converting them to cash;
- determine capital and income;
- lend and borrow;
- pre-take estate trustee's compensation prior to a passing of accounts; and
- make income tax elections.

One power that may be helpful—although it is dependent on the client's intentions and circumstances—is the power to purchase estate assets for the estate trustee's own benefit. Without an express authority to purchase estate assets, the estate trustee will have to obtain approval from all of the beneficiaries or from the court if any of the beneficiaries is a minor. A failure to do so could expose the estate trustee to a court order obliging him or her to disgorge any and all future benefits accruing to him or her as a result of the purchase, notwithstanding a purchase at fair market value and on fair market terms.

9.2 Memoranda/incorporation by reference

For various reasons, the client may not wish the lawyer to have the will set out in express terms a long list of dispositions of personal effects. If the client is content that the estate trustees will give effect to his or her wishes, though they are not legally binding, the will may refer to a memorandum that the client prepares at some future time (and amends from time to time) and keeps among his or her personal papers.

If the client expects the dispositions to be testamentary (that is, binding on the estate trustees), the lawyer should

instruct the client to prepare the memorandum before the will is signed and advise the client that any changes made to the memorandum subsequent to the will's signing have no legal effect. The will can then direct the estate trustees to dispose of the personal effects referred to in the memorandum and in accordance with that memorandum.

That such a memorandum can have legal effect flows from the doctrine of "incorporation by reference." In order that this doctrine can be invoked, the memorandum must have come into existence prior to the signing of the will, and the court must have no doubt that the document is the one referred to in the will. There are no witnessing or other formalities for making a memorandum intended to have legal effect. However, it will obviously be desirable to have the client date the document (as evidence of its pre-dating the signing of the will) and sign the document (as evidence that it reflects the client's testamentary intention).

9.3 Inadvertent distributions

A client who has gone to the trouble of engaging a lawyer to draw a will assumes that the will is going to direct the intended distribution of the whole of his or her estate in all circumstances. However, the lawyer who fails to take adequate care in

- interviewing the client; or
- drafting the will

may inadvertently omit to address a scenario, resulting in an unintended disposition.

9.3.1 Lapse/anti-lapse

People occasionally die in "the wrong order." For that reason, the lawyer should take care that every testamentary disposition to an individual beneficiary addresses the contingency that the beneficiary is not alive at the relevant time to receive his or her entitlement. The "relevant time" may be the death of the testator or of another person.

As a general rule, where a beneficiary predeceases the testator, the intended testamentary gift will lapse. Section 23 of the *SLRA* provides that, absent a contrary intention contained in the will, where a bequest or devise to a beneficiary fails because of the beneficiary's predeceasing the testator, the bequest or devise falls into the residue of the estate. Where the interest fails because of a predeceased residuary beneficiary, the interest will pass as on an intestacy. (Class gifts are not subject to this lapse rule, since the testator is considered, in such circumstances, to have expressed the requisite contrary intention. If one or more members of the class should predecease the testator, the bequest passes to those members of the class still alive on the death of the testator.)

Section 31 of the *SLRA* is an "anti-lapse" provision that may take effect in the case of a devise or bequest to a child, grandchild, or sibling of the testator who predeceases the testator and leaves a legal spouse or issue. In that event (and absent a contrary intention in the will), the bequest or devise does not fail but passes as if on an intestacy of the deceased beneficiary (but without a preferential share for the surviving spouse, if any).

Suppose, for example, the testator's will makes a $90,000 gift to the testator's son who predeceases the testator, leaving a surviving spouse but no surviving issue. Unless the will provides a contrary direction, the son's widow will receive the $90,000 bequest. If a wife and three children had survived the predeceasing son, the wife would have received $30,000 and the children would have shared the remaining $60,000 equally among themselves. Typically, the contrary intention that would avoid the application of the "anti-lapse" rule is a stipulation that the intended beneficiary be alive on the testator's death. Had the bequest in this example stated "To my son, if he survives me, the sum of $90,000," the legacy would have lapsed entirely.

The lawyer should not presume what the client would have intended in the event of a particular beneficiary's predeceasing the testator. Rather, the issue should be canvassed expressly with the client to learn his or her intention. Sometimes, the client will wish there to be a gift over to the children of a predeceased beneficiary. Depending on the current state of the relationship with a daughter-in-law or son-in-law, the client may intend—or not—that the bequest to a predeceasing son or daughter pass to the widow(er). (The lawyer should keep in mind that short of divorce, marital discord between a predeceasing child and his or her spouse will not preclude the operation of the "anti-lapse" rule.)

Where the client wishes to provide, in the event of the married child predeceasing the client, a gift over to that child's legal spouse, a further issue should be canvassed with the client. As a result of a recent amendment to the *FLA*, a surviving spouse who elects in favour of an equalization of net family properties is required to set off against the equalization entitlement the value of any property acquired as a consequence of the deceased spouse's death, including property received from a third party. This set-off obligation is subject to a contrary intention expressed either by the deceased spouse or by the third party. Hence, the lawyer should ask the client whether his or her son-in-law or daughter-in-law is to have the bequest in addition to whatever equalization

claim he or she might choose to make against the estate of the client's deceased child.

9.3.2 Doubling-up of legacies

A lawyer who prepares "mirror" wills for a couple should proceed with caution where the clients direct that a cash legacy is to be paid out of the estate after the death of the last to die. The problem here is how to deal with simultaneous deaths. Typically, each will conditions the legacy with the following:

> If my spouse predeceases me or survives me for a period of less than 30 days...

Simultaneous deaths will result in the cash legacy being paid from each of the estates (assuming there are sufficient assets in each estate).

The lawyer should ask the clients whether they care that the legacy could be doubled up in the event of simultaneous deaths. If the clients do not want that to happen, some other approach should be taken. For example, there might be a proviso that if the clients die within 30 days of one another, the legacy payable out of each estate should be halved. Or, the clients may be prepared to accept that the legacy should be included in only one of the two wills.

9.3.3 "Ultimate distribution" scenarios

The lawyer should canvass the possibility that all of the beneficiaries will die before the entire estate has been distributed. This can happen in a number of situations:

- There is a common disaster involving all of the members of the "nuclear" family.
- There is a delayed distribution to a child or children, and no child attains the age specified for the final capital distribution.
- The beneficiary under a life interest outlives everyone else.

However it might happen, the client should indicate what dispositive scheme is to apply in that event. A failure to address this scenario could, for example, result in the spouse from whom the client was separated but not divorced at the time of the client's death inheriting the estate under the intestate succession rules.

There are times when the client is indifferent as to how the estate will be distributed if all of the major players are gone. For example, the client may be content to see the intestate distribution rules apply in that situation. In that case, the lawyer should still spell out the rules for two reasons. First, it can avoid any uncertainty respecting the time as of which the intestate entitlement is to be determined. Secondly, it will allow all the persons who would share on an intestacy to benefit from the *FLA* clause (i.e., the one expressing the testator's intention that the income derived from a beneficiary's bequest shall not form part of his or her net family property). For example, where the client is content with the intestate distribution rules, the ultimate distribution scheme could be expressed in the following terms:

> At the date of death of the last to die of my spouse, my issue, and me (the "Final Distribution Date"), any portion of my estate remaining undisposed of in accordance with the foregoing provisions (the "Remainder Estate") shall be distributed to those persons who would have been entitled thereto, and in the same proportions as they would have been respectively so entitled, if I had died on the Final Distribution Date, intestate and unmarried, and my estate had consisted solely of the Remainder Estate.

9.4 Trust issues

Where the dispositive scheme does not involve an outright distribution, but instead calls for property to be held "in trust" for a specified period of time or until the happening of a specified event, certain legal issues will arise.

9.4.1 Investment authority

To ascertain the scope of the estate trustee's investment authority, one must look first to the will itself. The lawyer should ensure that the will contains an investment authority that accurately reflects the philosophy and estate planning objectives of the client. The client may have very strong views in this regard. Examples include the following:

- The estate trustees should avoid "risky" investments or should restrict investments to those of the "blue chip" variety.
- The estate trustees should not dispose of any investments that the client has seen fit to acquire during his or her lifetime.
- The estate trustees should have *carte blanche* to invest in whatever manner they see fit.
- The estate trustees should hire professional investment managers.

That is not to say that the lawyer should accept instructions without comment where he or she feels they may be inappropriate or problematic in the circumstances. The client may be intent, in spite of any caution or criticism from the lawyer, on imposing a particular investment authority. The lawyer should proceed, as long as he or she is satisfied that the instructions are practicable—and, of course, capable of being expressed in clear and objective terms.

The lawyer should ensure he or she is familiar with the investment authority in the *Trustee Act* (which will govern when the will is silent), since it may be that the

"default" investment authority fits the client's requirements quite satisfactorily. In this regard, the lawyer should be aware of the following features of the statutory investing rules:

- Investment in mutual funds is expressly permitted.
- The trustee has a mandatory duty to diversify the investment portfolio, having regard to
  - the requirements of the trust; and
  - general economic and investment market conditions.

  Where the client holds his or her investment portfolio through a holding company or where the client is a significant shareholder of a corporation carrying on an active business, the lawyer should take care to ensure that the mandatory duty to diversify is appropriately curtailed in the will drafting.
- A trustee may delegate his or her investment authority to an agent, provided certain steps are taken.
- The agent may not further delegate his or her investment authority.
- Either the trustee who has delegated to the agent or a beneficiary is entitled to sue the agent who has breached his duty to the trustee.

9.4.2 Perpetuities

At common law, the "rule against perpetuities"—sometimes referred to as the "rule against remoteness of vesting"—requires that all interests in property must vest within the so-called "perpetuity period." In the case of a will, the perpetuity period commences on the death of the testator and ends on the 21st anniversary of the date of death of the last relevant life-in-being at the beginning of the period.

At common law, this rule was applied in a most harsh and unforgiving manner. As long as there was even a possibility—however remote—that a gift might vest outside the perpetuity period, the gift was void. That was so, even if (as events actually transpired) the gift would have vested within the perpetuity period.

The harshness of the application of the common-law rule was substantially attenuated by the enactment of Ontario's *Perpetuities Act*, applicable to instruments that took effect on or after September 6, 1966. Section 4 of the statute introduced the "wait-and-see" principle. The mere possibility of a gift's vesting outside the perpetuity period would not result in the gift's being void. Instead, the gift becomes "presumptively valid" until actual events establish that the gift is incapable of vesting

- within; or
- without the perpetuity period.

In the former case, the gift would be void; in the latter case, it would be valid.

Instances where the perpetuity period is most likely to be inadvertently breached are those where there are successive interests and vesting of each of those interests is postponed for a period greater than 21 years. For example, suppose the testator directs the following disposition of his or her residuary estate:

- The residue is to be divided into equal portions for the testator's children, each of whom is to receive the final distribution of trust capital from his or her portion on attaining age 40.
- If any child dies before age 40, leaving surviving children (that is, the testator's grandchildren), those grandchildren will take in equal shares *per capita* the deceased child's portion, with a similar requirement of waiting until age 40 (with a further gift over to surviving great grandchildren where a grandchild dies before age 40).

Suppose that there are no grandchildren born at the time of the testator's death, but some are born in the 5-year period after that death. Suppose further that all of the testator's children die within 10 years after the testator's death. In that situation, the relevant lives in being at the testator's death are only his children. The testator's eldest grandchild will be under 10 when the testator's last child dies. The perpetuity period will end on or before the 31st anniversary of the testator's death, but none of the grandchildren will have received his or her full share by that time, all of them being under age 40.

In order to ensure that the interests of a beneficiary cannot vest beyond the perpetuities period, it is common to incorporate a proviso along the following lines:

> Notwithstanding anything to the contrary hereinbefore contained, if on the date twenty-one (21) years following the date of death of the last survivor of me, my spouse, and those of my issue alive at my death (such date being hereinafter referred to as the "Vesting Date"), any portion of a beneficiary's share is undistributed by reason of his or her not having yet attained age___, such portion shall be paid or transferred on the Vesting Date to such beneficiary.

9.4.3 Accumulations

Clients are frequently concerned that a beneficiary not have an automatic right to obtain access to income derived from property being held in trust for him or her. This is particularly so where the size and nature of the trust capital are expected to generate a very substantial income stream over time. This concern may motivate the client to direct that the trustees have authority to pay out only so much of the trust income as they see fit and to reinvest the balance of the undistributed income.

This desire to reinvest "excess" income will be circumscribed by the limitations on reinvestment of trust income set out in Ontario's *Accumulations Act*. That statute sets out a "menu" of accumulation periods from which one may choose, depending on the circumstances. In the case of a will, the trustees may not be directed to reinvest income for a period in excess of the 21st anniversary of the date of the testator's death. Contraventions of this prohibition can arise where income is distributable on a discretionary basis to

- a beneficiary for a period in excess of 21 years; or
- a beneficiary with a succeeding interest to another person.

Consider, for example, a will that provides that the testator's surviving spouse will receive all of the income derived from trust capital for the spouse's lifetime and, on the spouse's death, the income will be held in a discretionary trust for the testator's disabled child for his or her lifetime. Because the accumulations period starts to run on the testator's death, it may well run out prior to the death of the spouse, with the result that none of the income derived from the trust during the lifetime of the disabled child may be reinvested.

Any direction in violation of the prohibition against excessive accumulation will be null and void, and the income that is the subject of that void direction will go to "such person as would have been entitled thereto if such accumulation had not been so directed" (*Accumulations Act*, s. 1(6)). The weight of authority appears to be that "the income that is the subject of that void direction" will pass as on an intestacy, although there are cases suggesting that this may be too broad a statement and that the particular will must be examined in order to reach the appropriate result. The prudent course to follow in drafting a will is to ensure that there is no inadvertent breach of the *Accumulations Act*, thereby avoiding any uncertainty as to the ultimate destination of any income that is "orphaned" by the statute.

For this reason, it is advisable to include appropriate limiting words in any direction that gives the trustee discretion as to how much of the income derived from trust capital should be paid out in a year. The following is an example:

> Notwithstanding the foregoing discretion granted to my trustees respecting distributions of trust income, in each year following the end of the maximum period, if any, authorized by law for my trustees to accumulate the net income derived from the capital of this trust, my trustees shall pay to the beneficiary the whole of the net income derived in that year.

9.4.4 Rule in Saunders v. Vautier

This ancient rule provides that where all of the beneficiaries having an interest in a trust are of the age of majority, they may together demand the distribution of the trust property, notwithstanding a direction that the trustees are to continue to hold the trust property until a specified date or until the happening of a specified event.

This rule is based on the succession-law principle that one cannot postpone enjoyment of an absolute gift. Accordingly, if a gift, when properly construed, is an absolute one, the beneficiary can demand to receive it upon attaining the age of majority, irrespective of a direction that distribution be delayed until some later time. Similarly, if property is held in trust for a class of beneficiaries, the beneficiaries can collectively demand a distribution when the last of them has attained the age of majority. Typical language that will risk a beneficiary's "busting the trust" is the following:

> My trustees shall keep the trust invested until my son attains age thirty (30), at which time they shall pay or transfer the trust capital to him.

Avoiding the application of the rule is very simple. It will suffice to provide for a gift over to another or others in the event the beneficiary dies before the date or event described. In that case, one cannot say that the beneficiary has an absolute gift. Rather, vesting of his or her interest is subject to a condition, either precedent or subsequent, with another or others having an interest as well.

10. Signing the will

10.1 Formal wills

A "formal" will must be signed at its physical end by the testator and by at least two witnesses. Alternatively, another person on the testator's behalf may sign it in the testator's presence and at the testator's direction (*SLRA*, s. 4(1)(a)). Although the statute requires that the testator either sign or acknowledge his or her signature before at least two witnesses who are present at the same time (*SLRA*, s. 4(1)(b)), each of the required witnesses need sign only in the presence of the testator (*SLRA*, s. 4(1)(c)). Nonetheless, it is good practice to have all three of the signing parties in the room at the same time while each of them signs.

Neither witness should be a beneficiary or the legal spouse of a beneficiary. Otherwise, any bequest or devise to the beneficiary will be void, unless a court is satisfied that neither the beneficiary nor the spouse exerted "any improper or undue influence" on the testator (*SLRA*, ss. 12(1) and (3)).

An affidavit of execution from one of the witnesses should be procured at the time the will is signed or as soon as possible thereafter. This will avoid the problem and added costs where, at the time the will is to be submitted for probate, each of the witnesses is deceased, mentally incapacitated, or cannot be found.

10.2 International wills

Currently, a small number of jurisdictions are signatories to the *Convention Providing a Uniform Law on the Form of an International Will*. In Canada, the *Convention* has been extended to some, but not all, of the provinces and territories (Ontario being one of them). The declared purpose of the *Convention* is to "provide to a greater extent for the respecting of last wills by establishing an additional form of will hereinafter to be called an 'international will,' which if employed, would dispense to some extent with the search for the applicable law."

Where a client has assets in one or more foreign jurisdictions, it cannot hurt to comply with the added formalities of execution set out in the *Convention*. (These formalities can be found in the Annex to the Schedule appended to s. 42 of the *SLRA*.) However, unless the assets are in one of the jurisdictions where the *Convention* has been signed and ratified and has come into force, it will offer no added benefit. A lawyer who wishes to ascertain the status of the *Convention* in a particular foreign jurisdiction can check the Unidroit (International Institute for the Unification of Private Law) website.

10.3 Holograph wills

In Ontario, it is possible to make a valid will entirely in one's own handwriting (again, with the signature of the testator at the physical end of the will). Such a will requires no witnesses or other formalities of execution. While rarely advisable, the ability to make a holograph will (or codicil) can sometimes be useful in emergency situations, such as the following two:

- The client knows what he or she wants to do but time or other constraints preclude a meeting with the lawyer.
- There is no second independent witness available to complete a formal will.

In the former situation, it may be sufficient for the lawyer to dictate the essential terms of the will (or codicil) over the telephone or to send the text via fax or email. However, communication of the necessary terms by fax or email are preferable to telephone communications, as they may serve to provide evidence that will exonerate the lawyer where the client, for whatever reason, fails to follow the lawyer's instruction, giving rise to a claim against the lawyer by a disappointed beneficiary.

That said, the lawyer should be cautious about such accommodations for the client. Without a face-to-face meeting with the client, the lawyer may have no way to ascertain whether the client is being subject to undue influence, even if there is no reason to suspect a lack of capacity. (Even if the lawyer knows the client well enough so as to have no concern over such issues, he or she should be especially reluctant to provide the content for a codicil to the client's will without having had the benefit of seeing the will or a copy of it.)

11. Will storage

A client who wishes to keep the original will should be advised of the potential problem that can arise if, at the time of the client's death, the original will that was last in his or her possession cannot be found; namely, the law will presume that the client destroyed the will. If there is insufficient evidence presented to a court to rebut that presumption, the client will be held to have died intestate. For that reason alone, the lawyer would be well advised to prepare one or more copies ("true," photostatic, or notarial) for his or her own file. Where the client wishes to have the lawyer retain the original will and the lawyer is prepared to accede to the request, the lawyer should ensure that he or she has appropriate safe-keeping facilities—whether renting a safe deposit box with a bank or retaining the document in a water-resistant and fire-resistant filing cabinet on site.

Chapter 33
Powers of attorney

1. Introduction

Broadly speaking, powers of attorney are governed by the common law of agency. An agency relationship is established where one person (principal, donor, grantor) authorizes another person (agent, attorney) to act as his or her agent.

At common law, an agency relationship terminates when the donor becomes mentally incapable. Recognizing that this common-law principle seriously limited the practical utility of powers of attorney with respect to property matters, in the late 1970s, the Ontario legislature provided a statutory override that would allow the authority under a power of attorney for property to continue, notwithstanding the donor's loss of mental capacity, if the donor declared that intention in the document evidencing the attorney's authority. (In some jurisdictions, this is referred to as a "durable" or an "enduring" power of attorney.)

Later, as a result of a lengthy and detailed review of the law governing powers of attorney in Ontario, the government created a comprehensive statutory framework—the *Substitute Decisions Act, 1992* (*SDA*)—governing substitute decision-making, both with respect to property and with respect to personal care. Insofar as property matters were concerned, the new statute overrode some common-law agency principles and supplemented them with new principles. The framework that permitted a person to appoint an attorney to make decisions regarding the appointor's personal care was entirely new. (The *SDA* also included the concept of a "statutory guardian of property" and established a complete code for court-appointed guardians of (i) property, and (ii) the person.)

This chapter will focus specifically on the two new planning documents that were created under the *SDA*: first, the continuing power of attorney (governing property), and second, the power of attorney for personal care.

2. Why have a power of attorney?

The attorney appointed by a power of attorney acts as a fiduciary and, as such, must account, must act with reasonable care, must not act in conflict with the grantor's interests, and must not make secret profits.

By signing a power of attorney while capable, the grantor is able to have his or her own choice as to an attorney to act on his or her behalf in the event of incapacity or where the grantor, while capable, is simply unavailable when important decisions must be made or actions taken on a timely basis. Without a power of attorney in place at the time of incapacity, the process of installing a substitute decision-maker is more time consuming and more costly. And, of course, the identity of the person ultimately placed in that role cannot be known in advance.

3. Continuing power of attorney for property

A power of attorney for property is a continuing power of attorney if the document (a) so declares itself, or (b) expresses the grantor's intention that the authority given to the attorney may be exercised during the grantor's subsequent incapacity to manage property.

3.1 Scope of authority

Subsection 7(2) of the *SDA* specifically provides that a grantor may authorize the attorney under a continuing power of attorney to do anything in respect of property that the grantor, if capable, could do, except make a will for the grantor. (As yet, there is no Ontario jurisprudence offering any guidance on whether other testamentary dispositions—for example, beneficiary designations for RRSPs, RRIFs, TFSAs, and other "plans"—are governed by this prohibition.) The grantor may, however, choose to limit the scope of the authority of the attorney by express provisions in the continuing power of attorney.

For example, the authority to manage the grantor's property may be restricted as to subject matter—being limited to dealing only with certain of the grantor's property. Or, the authority may be restricted in time—intended not to commence before a specified time or event and/or not to continue beyond a specified time or event. The most common example of the former type of limitation is a declaration that the continuing power of attorney not become effective unless or until the grantor becomes mentally incapable.

Great caution must be exercised to ensure that any limitation expressed in terms of an event is specific enough to ensure that there can be no ambiguity. If the meaning of the condition or restriction is uncertain, third parties to whom it is presented may not recognize the authority. If the grantor's loss of capacity is the trigger for the effectiveness of the authority, some mechanism to

establish incapacity should be set out in the document. Perhaps the grantor wants the reassurance of an additional requirement, such as a letter from his or her family physician attesting to the grantor's incapacity. If no test for incapacity is contained in the document, the *SDA* sets out a mechanism that involves an assessment of the grantor by an assessor (a person accredited by the province to conduct assessments of capacity) or the issuance of a certificate in respect of the grantor under the *Mental Health Act* (*SDA*, s. 9(3)).

The grantor who wishes to limit the efficacy of the continuing power of attorney to periods of the grantor's incapacity should recognize that the comfort afforded by that limitation can adversely affect the document's practical utility. First, there may be occasions when the grantor, while mentally capable, is unavailable to carry out certain actions pertaining to his or her property and would want the attorney to act in his or her place. Second, the condition may force the attorney to provide current evidence of the grantor's continuing mental incapacity on every occasion when the attorney intends to exercise his or her authority.

One alternative that avoids the potential problems referred to above would be to have the grantor lodge the signed continuing power of attorney with a third party, along with clear and objectively determinable conditions as to its release to the attorney. That condition may be as simple as the receipt of the attorney's written request for release of the document. Or it may require evidence, either from a medical practitioner or from some other trustworthy third party, that the grantor is indeed mentally incapable.

The requirement of a physician's written confirmation of the grantor's incapacity—whether embodied in the continuing power of attorney itself or in a direction respecting release of the document by a third party—runs a risk. One should not assume that a physician, even one who is familiar with the grantor, will be prepared to provide that written confirmation. Where such a condition is set out in the continuing power of attorney and the condition cannot be met, it will likely be necessary to have the grantor assessed by an assessor and found incapable of managing property in order for the continuing power of attorney to take effect (*SDA*, s. 9(3)).

3.2 Capacity

There is a general view among lawyers that the *SDA* sets out a requirement that the grantor of a continuing power of attorney be at least 18 years old when the document is signed. This appears to be an inference drawn from s. 4 of the statute which provides:

> This Part applies to decisions on behalf of persons who are at least eighteen years old.

However, this section applies only to decisions to be made by the attorney pursuant to the continuing power of attorney. It does not expressly exclude the possibility that the grantor might be under age 18 at the time the document is signed.

Section 8 of the *SDA* sets out a set of sufficient conditions for a grantor to be capable of giving a continuing power of attorney. The grantor is capable of giving a continuing power of attorney if he or she

- knows what kind of property he or she has and its approximate value;
- is aware of obligations owed to his or her dependants;
- knows that the attorney will be able to do on the person's behalf anything in respect of property that the person could do if capable, except make a will, subject to the conditions and restrictions set out in the power of attorney;
- knows that the attorney must account for his or her dealings with the person's property;
- knows that he or she may, if capable, revoke the continuing power of attorney;
- appreciates that unless the attorney manages the property prudently, its value may decline; and
- appreciates the possibility that the attorney could misuse the authority given to him or her (*SDA*, s. 8(1)(g)).

This statutory test of capacity is not expressed as a necessary one. Arguably, one may look to the jurisprudence for an alternative test of capacity. For example, see *Godel v. Public Trustee*.

A person may be incapable of managing his or her own property and yet be capable of giving a continuing power of attorney (*SDA*, s. 9(1)).

The attorney has the capacity to act with respect to property if he or she is at least 18 years old (*SDA*, s. 5).

3.3 Form and execution

The continuing power of attorney need not be in any particular form. As noted earlier, it must be expressly referred to as a continuing power of attorney or it must express the intention that the authority given to the attorney may be exercised during the grantor's subsequent incapacity to manage property.

Powers of attorney require execution by the grantor in the presence of two witnesses, each of whom must sign the document as witnesses (*SDA*, s. 10(1)). Certain persons are disqualified as witnesses:

- the attorney or the attorney's spouse or partner;

- the grantor's spouse or partner;
- a child of the grantor or a person whom the grantor has demonstrated a settled intention to treat as his or her child;
- a person whose property is under guardianship or who has a guardian of the person; and
- a person under 18 years of age.

Despite these formal requirements for execution, a court may declare the efficacy of a continuing power of attorney that does not comply with them "if the court is satisfied that it is in the interests of the grantor or his or her dependants to do so" (*SDA*, s. 10(4)).

The *SDA* contains transitional rules for powers of attorney for property signed before October 3, 1995 (the date after which the *SDA* requirements as to execution must be met). If such a power of attorney contains the requisite language regarding its continued efficacy notwithstanding the grantor's loss of capacity, it will be valid even if it has only one witness, so long as it meets all the other requirements of the prior legislation under which it was signed.

3.4 Foreign law issues

It cannot be assumed that a continuing power of attorney will be sufficient authority for the attorney to deal with the grantor's assets in other jurisdictions. Whenever the grantor has foreign assets, inquiries should be made as to the form and formalities required by that jurisdiction to enable an attorney to act. A solicitor in that jurisdiction should be retained to give advice in that regard. A separate (non-revoking) power of attorney in the form recognized by that jurisdiction may be needed for assets situated there.

3.5 Termination

A continuing power of attorney is terminated on the occurrence of any of the following events:

- The attorney dies, becomes incapable of managing property, or resigns, unless the document appointed a co-attorney or provides for a substitute attorney in such an event.
- A court appoints a guardian of the grantor's property.
- A new continuing power of attorney is signed, unless it states that there may be multiple continuing powers of attorney.
- The grantor dies.
- The grantor revokes the continuing power of attorney.

Once the attorney commences to act under the continuing power of attorney, his or her resignation will not be effective until a copy is given to the grantor and any other attorneys under the power of attorney, including substitutes. If the grantor has become incapable and there is no substitute attorney appointed by the instrument who is able or willing to act, the attorney's notice of resignation must also be given to the grantor's spouse or partner and relatives who are known to the attorney and reside in Ontario (*SDA*, s. 11). If the grantor and his or her spouse are living separate and apart, notice need not be given to the spouse or to persons related to the grantor solely by marriage. There is also an obligation imposed upon the attorney to make reasonable efforts to give notice of the resignation to persons with whom the attorney previously dealt on behalf of the grantor and with whom future dealings are likely to be required (*SDA*, s. 11(2)).

As noted above, execution of a new continuing power of attorney for property automatically revokes a previous continuing power of attorney, unless the new document provides that there are to be multiple powers in co-existence. The client should therefore be cautioned that, in signing a new continuing power of attorney, he or she will be revoking an existing continuing power of attorney previously given for a specified purpose (for example, to conduct banking transactions at a particular institution). The lawyer should issue a similar caution to the grantor who signs an unrestricted continuing power of attorney regarding the risk of inadvertent revocation of that continuing power of attorney by means of a subsequently executed continuing power of attorney with a financial institution that fails to declare the grantor's intention to have multiple continuing powers of attorney. (If the grantor intends that the attorney appointed under the unrestricted continuing power of attorney will conduct transactions with a financial institution, there is no reason why that financial institution should insist on having the grantor sign its own limited purpose continuing power of attorney.)

3.6 Revocation

So long as the grantor retains capacity, he or she can revoke the appointment of an attorney and appoint a new attorney to act. The test for capacity to revoke a continuing power of attorney is the same as the test for making one. (*SDA*, s. 8(2)). This revocation must be in writing, and the formalities for revocation are the same as those for making one (*SDA*, s. 12(2)). Protection is given to third parties who honour the attorney's authority in good faith and without notice of the revocation (*SDA*, s. 13). The statute is silent on whether a court has the authority to declare the efficacy of a revocation that does not comply with the formalities of execution.

As a practical matter, it is a good idea to record how many copies of the power of attorney have been signed

and to whom the documents have been distributed so as to recall them and avoid misuse after they have been revoked or otherwise terminated.

3.7 Authorized expenditures, gifts, and loans

As a fiduciary, the attorney must act solely in the grantor's interests. To be absolutely free of allegations of misuse of the grantor's funds, an attorney acting for an incapable grantor has traditionally been advised to limit expenditure to those reasonably necessary for the grantor's own support, education, and care, except as required by contractual obligation or court order or as set out in the document itself. The *SDA* makes it clear that attorneys may spend the grantor's funds for the support, education, and care of the grantor's dependants and for expenditures necessary to satisfy the grantor's other legal obligations (*SDA*, ss. 37(1) and 38) within certain guiding principles. Those principles include the value of the grantor's property, the grantor's accustomed standard of living and those of the grantor's dependants, and the nature of the other legal obligations the grantor might have (*SDA*, ss. 37(2) and 38). In all instances, and particularly where money is tight, the primary concern must be for the grantor first and then for the dependants, with other legal obligations suffering the shortfall.

What is new and potentially open to abuse is the authority given for an attorney to make gifts or loans to the grantor's friends and relatives from the grantor's property and to make charitable gifts (*SDA*, ss. 37(3) and 38). These expenditures are deemed by the *SDA* to be for the incapable person's benefit (*SDA*, ss. 37(6) and 38). Limits are imposed by the *SDA* to temper the largesse of an attorney (*SDA*, ss. 37(4) and 38). The grantor's property cannot be unduly depleted so as to become insufficient to satisfy the support, education, and care of the grantor himself or herself. Gifts or loans to the grantor's friends or relatives can be made only if the attorney has reason to believe, based on the grantor's intentions expressed before becoming incapable, that the grantor would make them if capable. Specific authority can also be given in the power of attorney document. Charitable gifts by the attorney are permitted if specifically authorized in the document or if there is evidence of similar gifts made by the grantor while capable. Charitable gifts are limited under these circumstances to 20% of the grantor's income in the year or the maximum set out in the power of attorney document, whichever is less. Such charitable gift limits can be exceeded only by obtaining a court order (*SDA*, s. 38(2)).

Gifts or loans to friends or relatives or charitable gifts are prohibited if the incapable person expresses a wish to the contrary (*SDA*, s. 37(4)5), which would seem to impose an obligation on the attorney to ask the grantor before making any such gift or loan, assuming the grantor has the capacity to comprehend such an inquiry.

Keep in mind that the attorney does not have the authority to make a will for the grantor. It would seem from this restriction that any attempt to enter into a large-scale gifting program for the grantor during the grantor's lifetime would be an attempted circumvention of the will-making prohibition—and therefore subject to attack—unless the grantor was in the midst of such an *inter vivos* gifting plan prior to incapacity. As has been made clear in *Banton v. Banton*, it is improper for an attorney to attempt to interfere with the testamentary freedom of the grantor by transferring assets to an *inter vivos* trust that is intended to function as a will substitute.

3.8 Will contents

The attorney for property has an obligation to find and read the grantor's will (*SDA*, ss. 33.1 and 38). This is to ensure that, as much as possible, the attorney does not inadvertently liquidate assets specifically given in the will or destroy the grantor's estate plan. The *SDA* prohibits the attorney from disposing of property specifically given in the will (*SDA*, s. 35.1(1)), unless that disposition is necessary to comply with the guardian's duties or the property is given to the intended beneficiary within the terms of the guiding principles for gifts or loans (*SDA*, s. 35.1(3)). If the attorney sells such property, the beneficiary will have a claim upon the death of the grantor to the proceeds of disposition without interest, and the doctrine of ademption will not be applied (*SDA*, s. 36(1)). If the residue of the estate is insufficient, a *pro rata* sharing will be made (*SDA*, s. 36(2)). This anti-ademption provision may profoundly affect the grantor's overall estate plan in unexpected ways and create as many problems as these provisions were intended to avoid. The anti-ademption rule is subject to a contrary intention contained in the grantor's will.

3.9 Standard of care and accounting responsibilities

A fiduciary relationship exists between the grantor and the attorney under a power of attorney. It has been recognized at common law that the attorney has a duty to account to the grantor. A grantor who is capable would be expected to monitor the activities of the attorney with respect to financial matters, so long as the grantor remains capable. When the grantor becomes incapable, the *SDA* stipulates that the attorney must exercise and perform his or her powers and duties diligently, with

honesty and integrity, and in good faith for the incapable person's benefit (*SDA*, ss. 32 and 38).

The personal comfort and well being of the grantor are also to be considered in making decisions. The attorney must encourage the incapable person to participate, to the best of his or her abilities, in the guardian's decisions about the property. As well, the attorney is required to consult with the grantor's supportive family members and friends who are in regular personal contact with the grantor and with the grantor's caregivers.

Two differing standards of care are applied to the attorney, depending on whether the attorney is compensated for acting. An attorney who is not receiving compensation must exercise the degree of care, diligence, and skill that a person of ordinary prudence would exercise in the conduct of his or her own affairs. A paid attorney, on the other hand, has the higher standard of a person in the business of managing the property of others (*SDA*, ss. 32(7)–(8)).

The attorney must keep accounts of all transactions involving the grantor's property (*SDA*, ss. 32(6) and 38). The attorney, the grantor, the grantor's attorney for personal care, the grantor's dependants, the Public Guardian and Trustee, the Children's Lawyer, a judgment creditor of the grantor, or any other person with leave of the court may apply for a passing of the attorney's accounts (*SDA*, s. 42(2)). The form and content of the accounts to be maintained by the attorney are prescribed in O. Reg. 100/96, made under the *SDA*. Those record-keeping requirements are similar to those required for an executor's accounts.

3.10 Attorney compensation

The power of attorney document may itself specify the amount, frequency, and mechanism for calculation of fees for an attorney for property; or it may specify that the attorney is to act without compensation. If the document is silent, the *SDA* provides that a continuing power of attorney for property may take annual compensation from the property in accordance with the prescribed fee scale on a monthly, quarterly, or annual basis (*SDA*, s. 40). *General*, O. Reg. 26/95, made under the *SDA*, sets out fees of 3% of capital and income receipts, 3% of capital and income disbursements, and 3/5 of 1% of the average market value of the assets as an annual care and management fee. On the passing of accounts, the court has the authority to reduce that quantum.

4. Power of attorney for personal care

A power of attorney for personal care appoints a person or persons to make decisions for the grantor respecting the grantor's "personal care." The term "personal care" encompasses health care, nutrition, shelter, clothing, hygiene, and safety. The power of attorney for personal care may address any one or more of these elements of personal care.

Insofar as health care is concerned, the companion statute that must be considered is the *Health Care Consent Act, 1996* (*HCCA*). That statute sets out the hierarchy of substitute decision-makers who can give or withhold consent to a "treatment." The person appointed as an attorney under a power of attorney for personal care will, subject to any conditions or restrictions contained in the document, place the attorney ahead of all of the grantor's relatives for purposes of giving or withholding consent to a treatment.

Powers of attorney for personal care take effect when the *HCCA* applies to the decision and authorizes the attorney to decide, or when the *HCCA* does not apply and the attorney has reasonable grounds to believe the grantor is incapable of making the decision, subject to such limitations as the document itself might specify (*SDA*, s. 49(1)).

4.1 Capacity

There is a general view among lawyers that the *SDA* sets out a requirement that the grantor of a power of attorney for personal care be at least 16 years old when the document is signed. This appears to be an inference drawn from s. 43 of the statute which provides:

> This Part applies to decisions on behalf of persons who are at least sixteen years old.

However this provision applies only to decisions to be made by the attorney pursuant to the power of attorney for personal care. It does not expressly exclude the possibility that the grantor might be under age 16 at the time the document is signed.

What is expressly set out in the statute is that in order to be capable of giving a power of attorney for personal care, the grantor must

- have the ability to understand whether the proposed attorney has a genuine concern for the person's welfare; and
- appreciate that the person may need to have the proposed attorney make decisions for the person (*SDA*, s. 47(1)).

A person may be incapable of personal care and yet be capable of giving a power of attorney for personal care. (*SDA*, s. 47(2))

The attorney for personal care must be at least 16 years old (*SDA*, s. 44). Certain individuals are prohibited from acting under a power of attorney for personal care.

Unless the individual is the spouse, partner, or relative of the grantor, the individual may not act as attorney for personal care if he or she provides health care to the grantor for compensation or provides residential, social, training, or support services to the grantor for compensation (*SDA*, s. 46(3)).

The *SDA* defines a spouse to include a common-law relationship of one year or longer, or a shorter conjugal relationship if the parties have parented a child together or have entered into a cohabitation agreement (*SDA*, s. 1). A "partner" is someone who has lived with the grantor for at least one year in a close personal relationship that is of primary importance in both persons' lives (*SDA*, s. 1). A "relative" of the grantor would include relations by marriage and adoption as well as by blood (*SDA*, s. 1(2.1)).

4.2 Form and execution

While the statute sets out no particular form for a power of attorney for personal care, it does contain formalities of execution. The witnessing formalities are the same as those applicable for continuing powers of attorney.

4.3 Foreign law issues

Suppose a grantor of a power of attorney for personal care is incapable of making a decision respecting his or her personal care while in a foreign jurisdiction. There are no assurances that the document will be recognized in that jurisdiction. This may be a particularly serious limitation insofar as health care decisions are concerned. Where the grantor spends significant amounts of time in a jurisdiction outside of Ontario, it would be prudent to make inquiries in that jurisdiction as to the extent, if any, to which the authority of the attorney under a power of attorney for personal care will be recognized locally.

4.3.1 Attorney resident in U.S.

Canadian brokerages are evidently heeding the warnings from the U.S. Securities & Exchange Commission against taking trading instructions respecting Canadian assets from a U.S. resident client. As a result, it may be inadvisable for a client who has an investment portfolio with a Canadian brokerage to appoint a U.S. resident adult child as an attorney under a continuing power of attorney. The Canadian brokerage may insist that the attorney liquidate the portfolio, giving rise to potentially accelerated capital gains.

4.4 Termination

A power of attorney for personal care is terminated on the happening of any of the following events:

- The attorney dies, becomes incapable of personal care, or resigns, unless the document has appointed a co-attorney or provides for a substitute attorney in such an event.
- A court appoints a guardian of the grantor's person.
- A new power of attorney for personal care is signed, unless it states that there may be multiple powers of attorney for personal care.
- The grantor revokes the power of attorney for personal care (*SDA*, s. 53(1)).

The rules respecting the resignation of an attorney who has already begun to act are analogous to those described earlier for the resigning attorney under a continuing power of attorney for property (*SDA*, s. 52).

4.5 Revocation

The capacity test for revocation of a power of attorney for personal care by the grantor is the same as the test for making a power of attorney for personal care (*SDA*, s. 47(3)).

4.6 Disputes between co-attorneys

With regard to a health care decision governed by the *HCCA*, a dispute between co-attorneys with respect to a particular decision will result in the decision's having to be made by the Public Guardian and Trustee. This is evidently so even if the grantor has included a rule for dealing with such disputes (for example, majority rule in the case of three co-attorneys). If the grantor intends that this rule be followed, it may be sufficient to include a direction that the Public Guardian and Trustee, if called upon to make a health care decision, shall decide the matter in accordance with that rule (*HCCA*, s. 21(1)).

4.7 Imposing conditions and/or restrictions on the attorney's authority

As powers of attorney for personal care are exercisable only when the grantor becomes incapable, it may be advisable not to impose an effective date based upon the onset of incapacity within the document itself, unless the grantor wishes to control the mechanism to be used for the incapacity test (e.g., the confirmation in writing of the grantor's family physician or some other trusted individual). The *SDA* itself permits personal care decisions to be made by the attorney under either of the following circumstances (*SDA*, s. 49(1)):

- The *HCCA* applies to the decision and would authorize the attorney to make it.
- The *HCCA* does not apply to the decision and the attorney has reasonable grounds to believe that the grantor is incapable of making the decision, unless some more stringent test is set out in the document itself.

Again, the *SDA* contains a test of last resort involving an assessment by an assessor if no incapacity testing

method has been set out in the document itself (*SDA*, s. 49(2)). There are special procedures to be followed when a power of attorney for personal care purports to authorize the attorney or others to use necessary or reasonable force to undertake the capacity assessment. To be effective, such an authorization requires the grantor to sign a statement in prescribed form at the time of execution of the power of attorney or within 30 days afterwards acknowledging an understanding of the effect of the provision, and the completion of an assessment by an assessor confirming capacity (*SDA*, ss. 50(1)–(2)). Revocation of a power of attorney for personal care containing such provisions likewise requires an assessment by an assessor confirming capacity no more than 30 days before the revocation is signed (*SDA*, s. 50(4)).

4.8 "Living will" provisions

As noted earlier, the rules governing the exercise of a power of attorney for personal care in relation to health care decisions are set out in the *HCCA*. The *HCCA* requires any substitute decision-maker (including the attorney appointed under a power of attorney for personal care) to follow the wishes of the grantor, if known. Prior to the enactment of the *HCCA*, there was no statutory scheme to allow an individual to specify what health treatments could or could not be imposed.

With both the *SDA* permitting the appointment of a substitute decision-maker for, *inter alia*, health care decisions and the *HCCA* requiring the attorney to follow the grantor's wishes, if known, the power of attorney for personal care can function as a so-called "living will" by setting out instructions in the document as to what treatments may or may not be administered. (In fact, the instructions can go well beyond the traditional content of a "living will," by including both positive and negative directions and by having those directions apply to a range of other medical scenarios in addition to a "terminal condition.")

The wishes of the grantor need not be embodied in the power of attorney for personal care, but may be separately recorded. The key is to ensure that those wishes are widely disseminated. In this way, any person called upon to make a decision on the grantor's behalf as to the giving or withholding of consent to a proposed health treatment will be fixed with the knowledge of those wishes and legally bound to respect them.

4.9 Standard of care and record-keeping

An attorney for personal care is required to act diligently and in good faith and to explain to the incapable person the attorney's powers and duties. Where decisions are governed by the *HCCA*, that statute governs the manner in which the attorney makes decisions. For other decisions, the attorney is to observe the following principles:

- If the attorney knows of a wish or instruction applicable to the circumstances that the incapable person expressed while capable, the attorney shall make the decision in accordance with the wish or instruction.
- The attorney shall use reasonable diligence in ascertaining whether there are such wishes or instructions.
- A later wish or instruction expressed while the grantor was capable prevails over an earlier wish or instruction.
- If the attorney does not know of a wish or instruction applicable to the circumstances that the incapable person expressed while capable or if it is impossible to make the decision in accordance with the wish or instruction, the attorney shall make the decision in the incapable person's best interests.

In deciding what the incapable person's best interests are, the attorney must take into consideration

- the values and beliefs that the attorney knows the person held when capable and believes the person would still act on if capable;
- the person's current wishes, if they can be ascertained;
- the following factors:
  - whether the attorney's decision is likely to
    - improve the quality of the person's life;
    - prevent the quality of the person's life from deteriorating; or
    - reduce the extent to which, or the rate at which, the quality of the person's life is likely to deteriorate; and
  - whether the benefit the person is expected to obtain from the decision outweighs the risk of harm to the person from an alternative decision.

The records to be kept are prescribed by regulation and include

- a list of all decisions regarding health care, safety, and shelter, the reason for the decision, and date;
- a copy of medical reports or other documents relating to the decision;
- the names of persons consulted, including the incapable person, in respect of each decision and the date;
- a description of the incapable person's wishes, when capable;
- a description of the incapable person's current wishes, if ascertainable and relevant; and

- the attorney's opinion on each of the factors listed in s. 66(4)(c) of the *SDA*, which includes such matters as the effect on quality of life and risk of harm.

4.10 Attorney compensation

The power of attorney for personal care may stipulate the compensation to be paid to the attorney for acting as such. If the document is silent, the attorney may claim such compensation as is prescribed by regulation. No such regulation has yet been made, although case law is developing that provides some direction regarding the appropriate compensation for an attorney for personal care.

5. Avoid combined powers of attorney forms

Although there is no statutory prohibition, it is not advisable to draft combined forms of powers of attorney for personal care and continuing powers of attorney for property, even though the same decision-makers may be contemplated. The tests for incapacity of the grantor for property management and personal care are different. For that reason, the grantor's particular state of mental capacity may result in the document's being partially effective and partially ineffective. Furthermore, since the third parties to whom each document is to be given as proof of authority are different, the grantor may have reservations about disclosing particular medical directives contained in a personal care power of attorney to banks, trust companies, brokers, etc., who require evidence of financial authority only.

6. Practice issues

It is incumbent upon the solicitor who takes instructions for powers of attorney to assess the capacity of the grantor to give this authority and determine that the grantor meets the tests set out in the *SDA*. This obviously necessitates a personal meeting with the grantor and a discussion of assets, family, obligations, medical history, etc. Although the attorney must also have capacity to act, the attorney is not a signatory to the document, and reliance must be placed upon the grantor to select a capable attorney.

The free consent of the parties to the relationship should be present. There should be no fraud, duress, misrepresentation, or mistake present that is instrumental in the grantor's giving the authority.

The lawyer must also ensure that the witnesses to the document do not fall within the prohibited class.

While optional, it is always wise to have the witnesses swear an affidavit of execution, attesting to the following:

1. They were both present at the same time and saw the power of attorney for property (or personal care) executed by the grantor.
2. They were both 18 years of age at the time they witnessed the execution of the power of attorney.
3. They did not fall within the prohibited classes, i.e., they were not
   (a) the attorney named in the power of attorney nor a spouse or partner of the attorney;
   (b) a spouse or partner of the grantor;
   (c) a child of the grantor or a person whom the grantor has demonstrated a settled intention to treat as his or her child; or
   (d) a person whose property is under a guardianship or who has a guardianship of the person.

Thought must be given to the number of copies of each type of document to be signed and whether the documents will be held in safekeeping by a trusted third party or distributed by the client to the attorney(s) immediately upon execution. Although there may be risks associated with distribution of a continuing power of attorney while the grantor is capable (at least where there is no condition of incapacity included in the document), the same cannot be said for a power of attorney for personal care. It is good practice to counsel the client to give the attorney(s) an original power of attorney for personal care so that it is available for use on a timely basis.

One or two signed original powers of attorney of property may be needed for each piece of real estate held by the grantor, depending on the location and registration system that applies, and a copy may be needed for each institution with transfer authority over assets. The client may wish to give one signed original power of attorney for personal care to each attorney so that the attorney will have the document at hand in the event of a medical emergency. Some family physicians want to keep a personal care power of attorney with the grantor's medical records; others do not.

Chapter 34

The procedure for the court appointment of guardians for mentally incapable persons

1. Guardian of property — standard procedure

There are two procedures for becoming a court-appointed guardian of property—the "standard procedure" and the "summary disposition procedure." One major difference between the two is that two assessments (at least one by an official "assessor") are required in the summary disposition procedure. The standard procedure requires a hearing, and the summary procedure is "over-the-counter," meaning the application is read by a judge in chambers without a hearing.

This section contains a step-by-step outline of the standard procedure for the appointment of a guardian for property (see the flowchart in the Appendix at the end of this chapter).

1.1 Initial documentation to be prepared — application record

1.1.1 Notice of application

A proceeding to have a person appointed as guardian of another's property is commenced by notice of application, according to s. 22(1) of the *Substitute Decisions Act, 1992* (*SDA*). The applicable rules for this application are rr. 14.05(2)–(3) of the *Rules of Civil Procedure* (*Rules*). Subsection 25(1) of the *SDA* requires the following:

> An order appointing a guardian of property for a person shall include a finding that the person is incapable of managing property and that, as a result, it is necessary for decisions to be made on his or her behalf by a person who is authorized to do so.

Therefore, the notice of application should seek a finding that the person is incapable of managing property and, as a result, it is necessary to appoint a guardian of property.

The applicant need not be the proposed guardian of property, but usually is. Subsections 24(1)–(2) indicate who cannot be appointed as a guardian of property.

The *SDA* requires personal service of the notice of application on the following people, who are also respondents to the application (ss. 69(1) and (8)):

- the alleged incapable person;
- the attorney under the person's continuing power of attorney (if known);
- the guardian of the person (if known);
- the attorney for personal care (if known);
- the Public Guardian and Trustee (PGT); and
- the proposed guardian of property (if not the applicant).

There are also additional relatives who must be served with the application material by ordinary mail (s. 69(6)), though these people are not automatically respondents in the proceeding.

1.1.2 Affidavit of applicant

Evidence on motions and applications is governed by R. 39. Evidence may be given by affidavit, but such evidence is not to be on "information and belief" except with respect to facts that are not contentious (r. 39.01(5)). Although there is nothing in the *SDA* requiring an affidavit by the applicant, as a basic principle, the court cannot make findings without evidence being brought before it. Therefore, unless the applicant intends to call *viva voce* evidence, an affidavit by the applicant will be required. The affidavit should include the following information:

- relationship and contact data between the applicant and the alleged incapable person;
- family tree of the alleged incapable person;
- indication of consent to appointment by any of the other relatives;
- details regarding the contact that the applicant has had with the alleged mentally incapable person, particularly in the last year;
- observations and opinion of the applicant as to the ability of the alleged incapable person to manage property;
- details of the contact between physicians and other health practitioners and the alleged incapable person;
- details regarding the type of security the applicant proposes to provide or whether the applicant is seeking an order dispensing with the necessity of security (*SDA*, ss. 24(3)–(4) and 25(2)(a));
- statement signed by the applicant confirming that the alleged incapable person has been informed of the nature of the application and the right to oppose the application and describing the manner in which the person was informed or, if it was not possible to give the person this information, a statement describing why it was not possible (s. 70(1)(c));

- consent of the proposed guardian to act as the guardian of property as an exhibit (*SDA*, s. 70(1)(a)) (this statement is usually included as part of the applicant's consent); and
- the completed management plan as an exhibit (*SDA*, s. 70(1)(b); *General*, O. Reg. 26/95, made under the *SDA*, Form 2).

1.1.3 Management plans

The management plans are reviewed in detail by the court and are key elements of an application. When reviewing the management plans (separate plans are filed for a guardianship of property and guardianship of the person), the court will consider only the best interests of the incapable person.

1.1.4 Medical affidavits

There is no provision in the *SDA* indicating that a medical affidavit is necessary in the standard procedure, nor was there under the predecessor statute, the *Mental Incompetency Act*, but a finding of incapacity is a necessary element of a guardianship appointment. Nevertheless, the general practice of the courts (which does admit to exceptions in certain circumstances) is to require evidence of incapacity in the form of a capacity assessment by a duly-qualified assessor. Before the court is going to grant a judgment finding a person incapable of managing property and giving someone else the authority to manage property for him or her, the judge requires very clear medical evidence of these facts. Alternatively, some lawyers use affidavits from at least two physicians, a procedure in accordance with *Re Avery*, to avoid a court criticizing the applicant's affidavit for implicitly asking the court to rely on what could be construed as hearsay evidence, since the capacity assessment is included in the applicant's affidavit instead of an affidavit sworn by the assessor.

To summarize: the notice of application is issued (meaning filed in court and served on all required parties), and an application record is prepared containing the documents stated above.

1.2 Service of the application record

Two types of service are required under the *SDA*:

(1) **Personal service** upon the respondents to the application: The potential respondents are identified in ss. 69(0.1)–(1) and (8)–(9) of the *SDA*. The material must also be served upon the alleged mentally incapable person. In the past, under the *Mental Incompetency Act* procedure, the court was inclined in certain circumstances to dispense with service of the material upon the mentally incapable person. However, it does not appear that the court is permitted to dispense with such service under the *SDA*.

By r. 16.01(1) of the *Rules*, the application must either be served personally in the manner set out in r. 16.02 or by one of the alternatives to personal service pursuant to r. 16.03. Alternatives to personal service include acceptance of service by a solicitor and use of an acknowledgment of receipt card.

One of the respondents is the PGT. The full application record must be served upon the PGT.

(2) **Ordinary mail service** upon specified relatives of the alleged incapable person: The specified relatives include

- the spouse or partner of the alleged incapable person. The definition of "spouse" in s. 1(1) of the *SDA* includes a person to whom the alleged incapable person is married or with whom the person is living outside marriage if the two persons (i) have cohabited for at least one year, (ii) are together the parents of a child, or (iii) have entered into a cohabitation agreement under s. 53 of the *Family Law Act*. Under s. 1(1) of the *SDA*, two persons are "partners" if they have lived together for at least one year and have a close, personal relationship that is of primary importance in both persons' lives. There are no statutory requirements that partners or spouses be of opposite sexes.
- the alleged incapable person's children who are at least 18 years old.
- the alleged incapable person's parents.
- the alleged incapable person's brothers and sisters who are at least 18 years old.

1.3 Response to service of application record

1.3.1 By "respondents"

The respondents who wish to participate in the proceeding must deliver a notice of appearance as required by r. 38.07(1).

1.3.2 By the "specified relatives"

Although served by mail with the material, specified relatives are not automatically parties to the proceeding. However, r. 38.07(3) authorizes them to become parties at any stage of the application.

1.4 Court hearing and judgment

The primary sections stipulating the matters to be dealt with in the judgment and the criteria for evaluating the application are ss. 22 and 24–25 of the *SDA*. There must be a finding in the judgment that the person is incapable and that, as a result, it is necessary for decisions to be made on that person's behalf by a person who is authorized to do so (*SDA*, s. 25(1)). The judgment should also include a specific statement appointing the guardian of property (*SDA*, s. 22(1)). Joint guardians may be

appointed, or the court can appoint two persons each to be guardian for a specific part of the property. The judgment must detail any security to be posted and the extent of the security (*SDA*, ss. 24(3), 25(2)(a), and (3)). The court may make the appointment for a limited period of time and impose conditions upon the appointment (*SDA*, ss. 25(2)(b)–(c)).

There is no provision that specifically requires the court to incorporate the management plan or a form of management plan into the judgment. However, s. 32(10) requires the guardian of property to act in accordance with the plan. It may be preferable to seek a specific reference to the management plan in the judgment or attach the plan as a schedule to the judgment.

Subsection 39(1) authorizes a guardian of property to apply to the court for directions on any question arising in the management of the property, so it is not necessary to include a reference to this possibility in the judgment. Although there is no specific authority in the *SDA* authorizing a court to order the newly appointed guardian to pass accounts within a specified period, this is usually a provision of the original judgment. The court probably has this authority within s. 25(2)(c), which allows the court to impose "such other conditions on the appointment as the court considers appropriate," and s. 42, dealing with passing of accounts.

The judgment should also address the issue of costs relating to the application.

2. Guardian of property — summary disposition procedure

The summary disposition procedure pursuant to ss. 72 and 77 permits the applicant to seek a judgment from the court appointing a guardian of property without a hearing, i.e., "over the [registrar's] counter" to a sitting judge's chambers. The applicant must follow all the steps in the standard procedure except the court hearing. Instead of the hearing, the applicant relies on statements from at least two medical assessors, or one assessor and another person (who saw the alleged incapable person within one year prior to the issuance of the notice of application), who must meet with the alleged incapable person and provide statements in a prescribed form. At least one of these statements must include the opinion that it is necessary to appoint a guardian for property to make decisions on the allegedly incapable person's behalf.

The flowcharts at the end of this chapter illustrate the differences between the standard and summary procedure.

Because of the extra steps required in the summary procedure, this procedure is rarely used. In addition, some judges are very reluctant to declare a person incapable without a hearing. Judges tend to have at least a few questions to ask of the lawyer even in an uncontested guardianship application. In some courthouses, regardless of the statute, the registrar will not even accept an over-the-counter application, but will instead automatically set the matter down for a hearing.

2.1 Initial documentation

The notice of application and the affidavit of the applicant (including exhibits) that forms the core of the application record should be prepared in the same manner as that of the standard procedure. The primary difference is that an additional capacity assessment is required.

The written statements pursuant to s. 72 of the *SDA* by the assessor or a person who is not an assessor include a statement that the person is incapable of managing property. The basis of that opinion must be set out in detail in that written statement.

2.2 Applicant involves either two assessors or one assessor and one non-assessor

As indicated above, the requirement for assessors is technically unique to the summary procedure process. The first decision an applicant has to make is whether to seek an assessment by two assessors or choose the alternative of seeking an assessment by one assessor and one person who is not an assessor and has seen the alleged incapable person within one year prior to issuance of the notice of application (*SDA*, s. 72(1)).

To a great extent, this decision depends on whether there is a non-assessor who is able to render an opinion that the person is incapable of managing property and provide details required by the form (*General*, Form 8). Cost will be a factor since assessors work on a fee-for-service basis.

To arrange a capacity assessment, either write a letter to the Capacity Assessment Office advising that an assessment by one or two assessors is required or phone directly to make the request.

Section 1 defines "assessor." Assessors must be a member of one of the colleges specifically listed in *Capacity Assessment*, O. Reg. 460/05, made under the *SDA*. This regulation controls assessors' qualifications and provides for professional disciplinary proceedings for any improper conduct or negligence on the part of the assessor. This may be as a result of a growing concern about the quality and reliability of the assessments.

2.3 Conducting the assessment

The assessor(s) must meet with the person to make the assessment (*SDA*, s. 72(1)). The prescribed form of statement for the assessor includes a statement that indicates the maker is of the opinion that the person is incapable of managing property, and sets out the facts on which the opinion is based. The assessment must have been made during the "six months before the notice of application to appoint a guardian of property was issued." Consequently, the notice of application must be issued *after* the assessment has been conducted, or this element is not met.

If a non-assessor provides a statement, the statement must include a paragraph that the person knows and has been in personal contact with the alleged incapable person during the 12-month period before the notice of application was issued (and the notice of application must be issued *after* the date of such personal contact).

2.4 Receipt of statements from assessor(s) and non-assessor (if applicable)

The assessor(s) (*Capacity Assessment*, s. 7, Form A) and non-assessor (*General*, Form 8) must provide their statements to the applicant. As noted above, the substantive portion of the prescribed statement provides an opinion regarding whether the person is incapable of managing property and sets out the details upon which that opinion is based. The assessor (and any non-assessor) is required to provide an opinion in the statement as to whether it is necessary for decisions to be made on behalf of the alleged incapable person by a guardian for property. Again, the details providing the basis for this opinion must be set out.

2.5 Preparing application record

The application record should contain the notice of application, the affidavit of the applicant, the statements received from the assessor(s) and non-assessor, as applicable, and the consent of each proposed guardian.

2.6 Service of the application record

The procedure is the same as in the standard procedure.

2.7 Response to service of application record

The procedure is the same as in the standard procedure.

2.8 Submission of material to judge by registrar — s. 77

After the time to deliver the notices of appearance has expired, the applicant can require that the registrar submit the documents directly to a judge, and the judge may make a judgment without a hearing and without anyone appearing (*SDA*, s. 77(1)). The registrar is required to take this step if the applicant certifies in writing the following (*SDA*, s. 77(2)):

- No notice of appearance has been delivered.
- The appropriate documents accompany the application.
- At least one of the s. 72 statements indicates that its maker is of the opinion that it is necessary for decisions to be made on the person's behalf by a person who is authorized to do so.

The registrar must submit the documents to the judge if all of these conditions are satisfied. Practically, it is difficult for an applicant to know when to certify that no notice of appearance has been filed since the *Rules* simply require an appearance to be filed "forthwith" and the *SDA* does not impose a time limit.

The affidavit of service for the notice of application should accompany the documents submitted to the registrar.

The provisions of the *SDA* do not require the application to include a draft judgment, but since the applicant is seeking judgment without a court attendance, it helps the judge to provide one. More importantly, if the applicant is seeking costs payable out of the property of the mentally incapable person, this must be set out in a draft judgment.

2.9 Disposition by the court

By s. 77(3), the judge may make three possible dispositions of the matter:

- make judgment without a hearing;
- require the parties to provide additional evidence or attend at a hearing; or
- order that the application or any issue proceed to trial and give directions for the trial.

As indicated above, at least one of the s. 72 statements must contain a paragraph stating the opinion that it is necessary for decisions to be made by an authorized person on the incapable person's behalf. The prescribed form is written so the maker of the s. 72 statement can either include this statement or cross it out. Where a non-assessor expresses the view that a person must be appointed to make decisions for the incapable person but the assessor does not express that same view, the court might refuse to grant the order.

3. Guardian of the person — standard procedure

Similar to guardianship of property applications, there are procedural alternatives available to a person applying for the appointment of a guardian of the person for an

incapable individual. There is the "standard procedure" and the "summary disposition procedure."

The summary disposition procedure requires all of the steps in the "standard" route, plus two assessments by assessors from the Capacity Assessment Office.

The following is a step-by-step outline of the standard procedure under the *SDA* for the appointment of a guardian of the person (see the flowchart in the Appendix at the end of this chapter).

3.1 Initial documentation to be prepared

The same initiating documents are required as in the application for guardianship of property: a notice of application (*SDA*, ss. 55 and 69(3)), affidavit of the applicant, and arguably a capacity assessment. There is no statutory requirement for a capacity assessment (or medical affidavits), but courts often require them anyway. The proposed guardian's consent to act and s. 70(2)(c) statement (identical to the s. 70(1)(a) statement required for applicants for guardianship of property) must be contained in the application record pursuant to s. 70(2). As a matter of practice, either the guardian's consent is usually attached as an exhibit to the applicant's affidavit (as a simple signed statement declaring consent) or a statement is written directly into the affidavit itself consenting to the appointment(s).

In the notice of application, the applicant should request a finding that the person is incapable in respect of some or all of the personal care functions set out in s. 45 of the *SDA* (and this must correspond to the scope of the order requested), as well as a finding that the person needs decisions to be made on his or her behalf by a person who is authorized to do so and, therefore, a guardianship of the person be appointed. The affidavit should be prepared with an eye to the categories of decision-making listed in s. 45. "Full guardianship" and "partial guardianship" are discussed in ss. 59 and 60.

In preparing the affidavit of the applicant, special attention should be paid to s. 45. This section lists the categories of decision-making that are relevant to incapability of personal care. A consent of the guardian (*SDA*, s. 70(2)(a)) and a guardianship plan (*SDA*, s. 70(2)(b); *General*, Form 3) are necessary. If relatives of the person are consenting to the application, then it would be helpful to both the applicant and the court to include those consents as exhibits, although the consent of relatives is not a requirement under the *SDA*.

One specific difference in applications for guardianship of the person, as opposed to those for guardianship of the property, is that s. 71(1) allows for optional third-party statements. A person who knows the person alleged to be incapable and has been in personal contact with him or her during the 12-month period before the notice of application was issued may make these statements in the prescribed form. The form itself provides no guidance as to the contents of s. 71(1) statements. However, if such a statement is to be included, then details should be included (again with the factors of s. 45 in mind) to demonstrate that the person is incapable of his or her own personal care. Although such an unsworn statement is specifically permissible, it is preferable to have the individual swear an affidavit setting out those facts and include the affidavit as part of the application material.

When these documents are ready, the notice of application is issued, and an application record is prepared containing the foregoing documents.

3.2 Service of the application record

The procedure is the same as for guardianship of property.

3.3 Response to service of application record

The procedure is the same as for guardianship of property.

3.4 Court hearing and judgment

The court considers the criteria in ss. 55(2)(a)–(b) and 57(3)(a)–(c). As noted above, the judgment appointing a guardian of the person must include a finding that the person is incapable in respect of some or all of the functions referred to in s. 45 and, as a result, needs decisions to be made on his or her behalf by a person authorized to do so (*SDA*, s. 58(1)). By s. 58(3), the judgment must specify whether the guardianship is full or partial. The court makes an appointment of a full guardian only if the person is incapable of all the functions in s. 45 (*SDA*, s. 59(1)). Otherwise, the court makes a judgment for partial guardianship regarding some but not all of the functions set out in s. 45 (*SDA*, ss. 60(1)–(2)).

The court may appoint (simultaneous) joint guardians (*SDA*, s. 57(4)), or the court may appoint two or more persons, each directed to act as guardian for mutually exclusive time periods.

The appointment may be made for a limited time period (*SDA*, s. 58(2)(a)), and the court may impose other conditions (*SDA*, s. 58(2)(b)). The court may give the guardian authority with the assistance of a police officer to apprehend the person (*SDA*, s. 59(3)).

By s. 59(4)(b), the court may grant the guardian power to change existing arrangements in respect of the person's

custody or access rights to a child, or to give consent on the person's behalf to the adoption of a child.

Although s. 66(15) requires the guardian to act in accordance with the guardianship plan, it is often good practice to seek a provision in the judgment specifically directing the guardian in accordance with the plan.

4. Guardian of the person — summary disposition procedure

Sections 74 and 77 set out the additional requirements when the summary disposition procedure is used. Two assessors must meet with the alleged incapable person, perform an assessment of the person's capacity during the six months before the notice of application is issued, and provide statements in the prescribed form. At least one of these statements must indicate that the assessor is of the opinion that the person needs decisions to be made on his or her behalf by a person who is authorized to do so.

The following is an outline of the necessary steps in the summary disposition procedure. This outline emphasizes the distinctions between standard and summary procedure in an application for appointment of a guardian of the person (see also the flowchart in the Appendix at the end of this chapter).

4.1 Initial documentation to be prepared

The same material is required as in the standard procedure, except that it is not clear whether medical affidavits are unnecessary due to the fact that assessments will be obtained from two assessors.

4.2 Two assessors meet with alleged mentally incapable person

The procedure is the same as in the summary disposition procedure for a guardianship of property, except that two assessors must provide the prescribed statements. There is no option to obtain one assessment by an assessor and the other by a non-assessor.

4.3 Assessments are conducted

The procedure is the same as in the summary disposition procedure for a guardianship of property.

4.4 Notice from assessors

The procedure is the same as in the summary disposition procedure for a guardianship of property.

4.5 Issue notice of application and send copies to assessors

The procedure is the same as in the summary disposition procedure for a guardianship of property.

4.6 Receipt of statements from assessors

The procedure is the same as in the summary disposition procedure for a guardianship of property.

4.7 Preparing application record

The procedure is the same as in the standard procedure for a guardianship of the person.

4.8 Service of the application record

The procedure is the same as in the standard procedure for a guardianship of the person.

4.9 Response to service of application record

The procedure is the same as in the standard procedure for a guardianship of the person.

4.10 Submission of material to judge by registrar — s. 77(2)

The procedure is the same as in the summary disposition procedure for a guardianship of property. At least one of the two assessors' statements must indicate that the assessor is of the opinion that the person needs decisions to be made on his or her behalf by a person authorized to do so (*Capacity Assessment*, s. 7, Form B).

4.11 Disposition by the court

The three options available to the judge considering the application are the same as in the summary disposition procedure for a guardianship of property (*SDA*, s. 77(3)).

5. Giving consent on behalf of the incapable person

In 1996, the *Consent to Treatment Act, 1992* was repealed and replaced with the *Health Care Consent Act, 1996* (*HCCA*). There is a great deal of interrelationship between the *SDA* and the *HCCA*. Among other things, the *HCCA* gives health practitioners new powers, sets out new rules and rankings regarding who may act as a substitute decision-maker, and establishes schemes for obtaining consent on behalf of incapable persons.

5.1 Ranked list of substitute decision-makers

Pursuant to s. 20 of the *HCCA*, if a person is incapable with respect to giving or refusing consent to a treatment, consent may be given or refused on the incapable person's behalf by one of the following people:

- the incapable person's guardian of the person, if the guardian has authority to give or refuse consent to the treatment.

- the incapable person's attorney for personal care, if the power of attorney confers authority to give or refuse consent to the treatment.
- the incapable person's representative appointed by the Consent Capacity Board under s. 33 of the *HCCA*, if the representative has authority to give or refuse consent to the treatment.
- the incapable person's spouse or partner.
- a child or parent of the incapable person or an agent of a children's aid society or other person who is lawfully entitled to give or refuse consent to the treatment in the place of the parent. (This paragraph does not include a parent who has only a right of access.) If an agent of a children's aid society or other person is lawfully entitled to give or refuse consent to the treatment in the place of a parent, this paragraph does not include that parent.
- a parent of the incapable person who only has a right of access.
- a brother or sister of the incapable person.
- any other relative of the incapable person.

By s. 20(2), a person consenting or refusing to consent on behalf of an incapable person may only give or refuse consent if he or she is

- capable of such with respect to the specific treatment;
- at least 16 years old (unless he or she is the incapable person's parent);
- not prohibited by court order or separation agreement from having access to the incapable person or giving or refusing consent on his or her behalf; and
- available and willing to assume the responsibility of giving or refusing consent.

If there is no one who meets the description of the list of the persons enumerated in s. 20(1) to give or refuse consent on the incapable person's behalf, then the PGT shall make the decision to give or refuse consent (s. 20(5)).

Section 24 of the *HCCA* deals with the specific situation where a substitute decision-maker can consent to the incapable person's admission to a hospital or psychiatric facility. In particular, if the incapable person is 16 years old or older and objects to being admitted to a psychiatric facility for treatment of a mental disorder, then consent to his or her admission may be given only by his or her guardian or his or her attorney for personal care. The guardian must have authority to consent to the admission. The power of attorney must contain a provision authorizing the attorney to use force that is necessary and reasonable in the circumstances to admit the incapable person to the psychiatric facility (and that provision must be effective under s. 50(1) of the *SDA*).

Appendix

Court Appointment of Guardians for Mentally Incapable Persons

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Flowcharts

Chart 1
Guardian of Property – Standard Procedure

1.

Prepare and issue application record containing:

- **Notice of application:** ss. 22 and 69(8)
- **Affidavit of applicant:**
  - details of incapacity — capacity assessment
  - statement required by s. 70(1)(c)
  - security proposed — ss. 24(3)–(4) and 25(2)(a)
  - Exhibit: consent of relatives (if available—not required)
  - Exhibit: consent of guardian — s. 70(1)(a)
  - Exhibit: management plan — s. 70(1)(b) (see O. Reg. 26/95, Form 2)
- **Medical affidavits:** not required by *SDA*, but see *Re Avery*

2.

Serve the application record:

- personal service upon "respondents" — ss. 69(1) and (8)
- ordinary mail service upon specified relatives — s. 69(6)

3.

"Respondents" who wish to participate in proceedings deliver a notice of appearance — r. 38.07(1)

Specified relatives entitled to service by ordinary mail may become parties to the application — s. 69(9)2

4.

Court hearing and judgment: ss. 22 and 24–25

The court may

- declare person incapable and, as a result, a guardian of property is necessary
- appoint guardian of property or joint guardians
- detail any security required
- incorporate management plan
- set out limitations or conditions
- set date for passing of accounts (possibly)

Chart 2
Guardian of Property – Summary Disposition Procedure

1. **Prepare:** **- Notice of application:** ss. 22, 69(8), and 72

   - Affidavit of applicant:
   - details of incapacity — capacity assessments
   - statement required by s. 70(1)(c)
   - security proposed — ss. 24(3)–(4) and 25(2)(a)
   - Exhibit: consent of relatives (if available—not required)
   - Exhibit: consent of guardian — s. 70(1)(a)
   - Exhibit: management plan — s. 70(1)(b) (see O. Reg. 26/95, Form 2)

   - Medical affidavits: may be required

2. Contact Capacity Assessment Office requiring assessment(s) — s. 72(1)

3. Assessor(s) meet(s) with alleged mentally incapable person — s. 72(1)

4. Receive the prescribed statements from assessor(s) and non-assessor — s. 72(2)

5. Issue notice of application

6. Prepare application record containing all documents in Step 1, plus two assessment statements

7. **Serve the application record:**
   - personal service upon "respondents" — ss. 69(1) and (8)
   - ordinary mail service upon specified relatives — s. 69(6)

8. "Respondents" who wish to participate in proceedings deliver a notice of appearance — r. 38.07(1)

   Specified relatives entitled to service by ordinary mail may become parties to the application — s. 69(9)2

9. Applicant ensures that all conditions in s. 77(2) are met regarding no notices of appearance delivered and all appropriate documents are filed with the court

10. Applicant has registrar submit the application record to a judge — s. 77(2)

11. **Judgment without hearing:** ss. 22, 24–25, 77(1), and (3)

    The court may

    (a) grant relief:
    - declare person incapable and, as a result, a guardian of property is necessary
    - appoint guardian of property or joint guardians
    - detail any security required
    - incorporate management plan
    - set out limitations or conditions
    - set date for passing of accounts (possibly)

    (b) require additional evidence or hearing
    (c) direct a trial

Chart 3
Guardian of Person – Standard Procedure

1.

Prepare and issue application record containing:

- **Notice of application:** ss. 55 and 69(8)
- **Affidavit of applicant:**
  - details of incapacity — capacity assessment
  - statement required by s. 70(2)(c)
  - Exhibit: consent of relatives (if available—not required)
  - Exhibit: consent of guardian — s. 70(2)(a)
  - Exhibit: guardianship plan — s. 70(2)(b) (see O. Reg. 26/95, Form 3)
- **Medical affidavits** – if no capacity assessment (not required by *SDA*, but see *Re Avery*)

2.

Serve the application record:

- personal service upon "respondents" — ss. 69(3) and (8)
- ordinary mail service upon specified relatives — s. 69(6)

3.

"Respondents" who wish to participate in proceedings deliver a notice of appearance — r. 38.07(1)

Specified relatives entitled to service by ordinary mail may become parties to the application — s. 69(9)2

4.

Court hearing and judgment: ss. 57–60

The court may

- declare person fully or partially incapable and, as a result, a guardian of the person is necessary
- grant judgment for full or partial guardianship
- appoint guardian of person or joint guardians
- impose conditions and limitations
- incorporate guardianship plan
- impose limitations or conditions *or* grant additional powers allowed by *SDA*

Chart 4
Guardian of Person – Summary Disposition Procedure

1. **Prepare:** **- Notice of application:** - ss. 55, 69(8), and 74

   - Affidavit of applicant:
   - details of incapacity
   - statement required by s. 70(2)(c)
   - Exhibit: consent of relatives (if available—not required)
   - Exhibit: consent of guardian — s. 70(2)(a)
   - Exhibit: guardianship plan — s. 70(2)(b) (see O. Reg. 26/95, Form 3)

   - Medical affidavits: may be required

2. Contact Capacity Assessment Office requiring assessments — s. 74(1)

3. Assessors meet with alleged mentally incapable person — s. 74(1)

4. Receive the prescribed statements from the two assessors — ss. 74(2)–(3) and O. Reg. 460/05, s. 7

5. Issue notice of application

6. Prepare application record containing all documents in Step 1, plus two assessment statements

7. **Serve the application record:**
   - personal service upon "respondents" — ss. 69(3) and (8)
   - ordinary mail service upon specified relatives — s. 69(6)

8. "Respondents" who wish to participate in proceedings deliver a notice of appearance — r. 38.07(1)

   Specified relatives entitled to service by ordinary mail may become parties to the application — s. 69(9)2

9. Applicant ensures that all conditions in s. 77(2) are met regarding no notices of appearance delivered and all appropriate documents are filed with the court

10. Applicant has registrar submit the application record to a judge — s. 77(2)

11. **Judgment without hearing:** ss. 57–60, 77(1), and (3)

    The court may

    (a) grant relief:
    - declare person incapable and, as a result, a guardian of the person is necessary
    - judgment for full or partial guardianship
    - appoint guardian of person or joint guardians
    - incorporate guardianship plan
    - may impose limitations or conditions *or* grant additional powers allowed by *SDA*

    (b) require additional evidence or hearing
    (c) direct a trial

Chapter 35

Guardians, custodians, and the Children's Law Reform Act

1. "Guardians" and "custodians"

In common parlance, a parent will often speak in terms of a minor child's "guardians" appointed by the parent in his or her will. Technically speaking, however, the parent is referring to the person(s) appointed in the will to have "custody" of minor children. Thus, these appointees are "custodians" and not "guardians" at all, although "custodian" is not a term specifically defined in the *Children's Law Reform Act* (*CLRA*). There is, however, a "guardian" in a related context. A "guardian" is a person who has guardianship of the property of the minor.

2. Testamentary appointments/custody

Under s. 20(1) of the *CLRA*, the father and the mother of a minor child are equally entitled to custody of the child. Unless a parent has lost custody of a minor child by order of a court, no court order is required to bestow the right of custody on that parent. Since the enactment of the *Children's Law Reform Amendment Act, 1982* on October 1, 1982, the father and mother of a minor child have been permitted by will to "pass on" the statutory right to custody that each enjoys.

According to s. 61(4) of the *CLRA* (being the consolidated successor statute encompassing the *Children's Law Reform Amendment Act, 1982*), the testamentary appointment of a custodian of a minor child is effective only if the person making the appointment

1. is the sole individual entitled to custody of that child on the day immediately prior to the day the appointment is to take effect; or
2. has, together with another person, custody of the child and the two of them die at the same time or in circumstances that render it uncertain who survived the other.

With respect to the first-mentioned scenario, if the mother of a minor child is the sole living parent (or sole custodian of such minor child—the other parent having lost the right to custody by way of court order), the previous testamentary appointment by the now-deceased father of that minor child would be ineffective. The situation contemplated by the second mentioned scenario is one where only one of the two persons with custody makes a testamentary appointment.

What happens if each of those persons has made a testamentary appointment of a custodian and dies in a "common disaster"? Subsection 61(5) of the *CLRA* provides that only the common appointments, if any, will be effective. For example, if deceased parent F appointed X to be the custodian and deceased parent M appointed Y to be the custodian, neither appointment would be effective. However, if deceased parent F had appointed X and Y as custodians and deceased parent M had appointed Y and Z as custodians, only Y's appointment would be effective.

Although it states the obvious, s. 61(6) of the *CLRA* provides that no testamentary custodial appointment is effective without the consent of the person appointed.

3. Testamentary custodial appointment is temporary

No person has a permanently vested right to custody of a minor child, including the natural and adoptive parents of that child. The best interests of the child prevail, and any parent or custodian can forfeit his or her "right" to custody if circumstances so require.

The well-recognized supervisory role of the court with respect to the welfare of minor children is reflected in the temporary nature of the testamentary custodial appointment. Pursuant to s. 61(7) of the *CLRA*, a testamentary custodial appointment expires 90 days after the appointment becomes effective. The appointed custodian will have to apply to the court within the 90-day period prescribed by s. 61(7) for a "more permanent" order of custody, assuming, of course, that the appointee wishes to continue to act as custodian. On such an application, the court would exercise its supervisory role, determining whether the evidence before the court at the application hearing warranted a "more permanent" order of custody in favour of the applicant in the circumstances.

Similarly, every testamentary custodial appointment may be short-circuited at any time prior to the appointee's application for a more permanent order of custody within the time prescribed by s. 61(7) of the *CLRA*. In other words, a parent's testamentary custodial appointment is at all times subordinate to the court's supervisory role to act in the best interests of a minor child where circumstances come to the court's attention warranting the termination of the testamentary custodial

appointment. In short, any person is at any time entitled to apply for custody of a minor child. Such "anyone/anytime" applications are enshrined in s. 21 of the *CLRA*, and s. 61(8) of the *CLRA* expressly subordinates any testamentary custodial appointment to the outcome of a s. 21 application for custody by someone other than the appointee.

In response to a criminal court proceeding arising out of the tragic death of a child placed in the custody of a person pursuant to a court order, the *CLRA* was amended in 2009 to impose significant new procedural requirements in the case of an application for permanent custody of a minor child by a person who is not the child's parent (*CLRA*, ss. 21.1–21.3).

4. Guardians of the property of minor children

Neither a parent nor a custodian of a minor child has an inherent right to possess or control property or assets otherwise belonging to a minor child. Such parent or custodian may, however, apply to the court to become appointed as a guardian of that minor child's property.

Admittedly, minor children seldom become entitled to own or possess assets or property of any significant value, and therefore, the need to have a guardian of property for a minor child is a relatively rare occurrence.

However, when the surviving parent of a minor child dies, there are a number of situations and consequences that may cause moneys or other benefits to accrue to a minor child, giving rise to a potential need to appoint a guardian of the child's property. For instance, the surviving parent may die intestate or may die with a valid will that fails expressly to authorize the estate trustee to retain a minor child's inheritance in trust and administer the trust during the child's minority. In such cases, the estate trustee is generally required to pay into court the estate funds to which the child is entitled. Similarly, an untimely death may give rise to a minor child's entitlement to life insurance proceeds (where, for instance, the parent has neglected to establish a trust for those proceeds when making a beneficiary designation) or may trigger the payment of what used to be called "orphan's" benefits from publicly or privately funded pension schemes.

Absent a court appointment of a guardian of the minor child's property, such entitlements (with the exception of amounts qualifying under s. 51 of the *CLRA*, as described below) would be paid into court to the credit of the minor child and held there during the child's minority or until a subsequently appointed guardian of property makes a successful application to control those moneys.

Pursuant to s. 47 of the *CLRA*, any person, including a parent or custodian, may apply to the court to be appointed as guardian of property of such child. Where such an order has been obtained, all of the monetary amounts and benefits envisaged in the foregoing paragraphs may instead be paid to the appointed guardian of property. Such an application must be made on notice to the Children's Lawyer, pursuant to s. 47(1) of the *CLRA*. The Children's Lawyer may oppose the application, requiring the applicant to prove why such an appointment would be to the minor child's benefit.

If the application for a guardianship appointment is successful, the guardian is entitled to make a testamentary appointment in respect of the guardianship of property of the minor child in much the same manner as the testamentary custodial appointment is made, as addressed earlier in this chapter. In other words, the court-appointed guardian of property may "pass on" the guardianship of the minor child's property through a testamentary appointment.

Testamentary appointments of guardians of property of a minor child have been available in Ontario since October 1, 1982. Subsection 61(2) of the *CLRA* specifically provides that a guardian of property of a minor child may appoint by will one or more persons to be guardians of the property of such child after the death of the appointor. Note that the same limitations and restrictions enumerated in ss. 61(4)–(6) as applied to the testamentary custodial appointment discussed above apply to testamentary appointments of guardians of property.

Such testamentary appointments of guardians of property are also temporary in nature, pursuant to s. 61(7), and thus, the appointed guardian is required to bring an application for a "more permanent" order of guardianship within the same 90-day period prescribed in the case of custodians appointed by will.

Finally, s. 61(8) of the *CLRA* preserves the right of any person at any time to apply to become a guardian of property (pursuant to s. 47 of the *CLRA*), thus subjecting the temporary testamentary guardians of property and court-appointed guardians of property, generally, to the ongoing scrutiny of the court.

5. Distributions and payments from trustees to custodians and guardians

A will that contains benefits held in trust for a minor child will often contain a clause that purports to authorize the estate trustee to make distributions from the child's trust directly to the child's parent, custodian, or guardian. Unless the amount to be distributed is relatively small, the Office of the Children's Lawyer may

question the validity of such directions. As a general proposition, an estate trustee cannot delegate fiduciary obligations to someone else, although such a clause in a will appears to express the testator's intention that such delegation can occur. Subject to the limited permissive distributions pursuant to s. 51 of the *CLRA*, only an appointed trustee can possess and spend trust funds on behalf of the minor child.

It is suggested that if the parent wishes to permit the custodian or guardian to receive distributions from the estate trustee for the benefit of a minor child, the will should expressly appoint the custodian or guardian as a sub-trustee for such purpose, thus giving rise to all the obligations that flow from the appointment of a trustee. Otherwise, the estate trustee runs the risk of being found to be in breach of trust. (The custodian or guardian may be accountable in any event as a *de facto* trustee.)

Section 51 of the *CLRA* provides that where no guardian of a child's property has been appointed, the estate trustee may pay or deliver to the child's parent or custodian cash or personal property for the benefit of the minor child up to an all-inclusive maximum value of $10,000. According to s. 51(3), the estate trustee is discharged to the extent of such payment(s) or delivery of personal property. Pursuant to s. 51(4), the parent or custodian to whom the money or property is delivered has the responsibility of a guardian for the care and management of the money or personal property.

6. Will drafting considerations for testamentary appointments

It has become common practice in Ontario since October 1, 1982, for parents who are so inclined to make a testamentary appointment of

- a custodian for a minor child; and
- a guardian of such child's property.

A typical will provision might be as follows:

> In the event that both my spouse and I die during the minority of any child of ours, it is my wish and I so direct that ANDRE and CATHY BROOKS be appointed to have custody of such minor child(ren) and, to the extent that I am capable of so doing, that they be appointed as the guardians of such minor child(ren)'s property during said minority. I so appoint ANDRE and CATHY BROOKS as such.

Insofar as the testamentary custodial appointment is concerned, one might fairly ask how well such an appointment meshes with the terms contained in a testamentary trust for the minor children as established in the parent's will. The estate trustee will typically have rights and obligations with respect to the investment and maintenance of the assets settled on the testamentary trust. If the custodian and the estate trustee are not the same person (which will often be the case), the two of them will have to work together for the benefit and welfare of the minor children. Thus, in appointing estate trustees and custodians in a will, a parent should be satisfied, as much as possible, that the estate trustee and the custodian can work collaboratively.

Sometimes, the client will express a strong desire that a particular individual not be appointed as the permanent custodian for a minor child. In such a case, there is no reason not to include in the client's will an appropriately worded statement declaring this viewpoint, as it may serve to put on notice the court hearing the "unwanted" person's application for permanent custody that careful inquiries into his or her character and background may be warranted.

In order to assist in the process of substitute-parenting, it is not unusual for parents of minor children to put together a letter or memorandum to the appointed custodians and/or estate trustees, outlining the parents' wishes regarding specific facets of the children's care or upbringing. Although such letters or memoranda are not binding, they may go a long way towards assisting the custodian and the estate trustee in determining the decisions the parents might have made or wanted had they survived to raise their children themselves.

Chapter 36

Taxation at death and personal tax planning

1. Basic principles

1.1 What is subject to tax

The question that clients most frequently ask with regard to taxation at death is: are there any estate taxes or succession duties? The answer to that question, narrowly put, is "no." There is no Canadian tax on wealth or the value of an inheritance, as such. Canada instead taxes income.

That answer is not universally true. The United States, for example, levies an estate tax on the value of the capital of an estate. Canadians owning assets with a U.S. *situs* (such as real estate and securities traded on U.S. exchanges) may be subject to U.S. estate taxes on the value of those assets.

Despite the fact that Canada only taxes income, certain specific rules have the effect of casting the "income net" more widely in the year of death. Somewhat offsetting this is the fact there exist several special concessionary rules applicable only to taxation at death.

1.2 Creation of two taxpayers

When a person dies, income earned or deemed to be earned between the end of the last taxation year and death is included in the person's T1 tax return due in respect of the year of death. This so called "terminal" return captures income earned between January 1 and the date of death. In addition, the day after the taxpayer's death is the first day in the first fiscal period of a new taxpayer, the estate of the deceased, which is taxed in accordance with the principles applicable to the taxation of trusts and which files a special tax return known as a T3 trust return.

As a preliminary matter, therefore, the personal representative must determine whether a payment due in consequence of a taxpayer's death is or is not taxable. Next, he or she must decide whether the income is reportable in the terminal return or is taxed elsewhere. On top of that, he or she must ensure that returns for prior years that ought to have been filed, are filed.

1.3 Change to accrual basis

Living taxpayers are entitled to report income on a cash basis (subject to the obligation to report compounding interest from certain investments on an annual, accrual basis (*Income Tax Act* (*ITA*), s. 12(4)). However, in the year of death, income that was payable periodically is deemed to accrue to a taxpayer on a daily basis (*ITA*, s. 70(1)(a)). This has the effect of accelerating the taxation of income. For example, if a living taxpayer purchased a guaranteed investment certificate on September 1 to mature and pay interest the following February 1, he or she would ignore the income accruing through December 31 and report it all the next year. A taxpayer who died on December 1 would have to accrue the income from September 1 to December 1. The income eventually paid on February 1 would cover the whole six month period, but the estate would report for tax purposes only the income earned after December 1. Personal representatives often forget to make this subtraction.

1.4 Deemed realization

Death triggers a "deemed realization immediately before death" for tax purposes of such items as non-depreciable capital property (*ITA*, s. 70(5)), depreciable capital property, and RRSPs (*ITA*, s. 146(8.8)). The significance of this provision cannot be understated: it is the backdrop against which much estate planning, simple or complex, is conducted.

For example, in a simple case, if a taxpayer acquires a stock portfolio in 1975 for $10,000 and holds it until his or her death when it is worth $100,000, he or she will, in the interim, only have paid tax on the dividend income earned by the portfolio. On death, the portfolio is "deemed to be sold" for net proceeds of $90,000 (proceeds of $100,000 less cost of $10,000), 50% of which will be brought into income and taxed at a rate that will be determined when all sources of income are added together. Only 50% of a capital gain is taxable. The remaining 50% does not attract tax and need not be reported. If the taxpayer wishes his or her heirs to retain the whole portfolio, he or she will have to provide adequate liquidity from other sources. If he or she wishes to make a specific gift of the portfolio by will, he or she must be conscious that some other interest in his or her estate will be paying the tax burden that enables the gift to take effect.

While the deemed realization at death provision may trigger a capital loss in cases where the fair market value of the property at the time of death is less than the adjusted cost base of that asset to the taxpayer, it should be noted that a capital loss cannot be triggered as a result of the disposition or deemed disposition of personal use

property (i.e., property owned by the taxpayer that is used primarily for the personal use or enjoyment of the taxpayer and family, such as an automobile or furniture).

A taxpayer's death presumptively results in the deemed inclusion in his or her income in the terminal year of the unpaid balance of his or her RRSP, RRIF, or annuity purchased with the proceeds of an RRSP. Ironically, payments made from registered pension plans are taxed not on a deemed receipt basis but on a cash basis, with the result that they are taxable to the estate or its beneficiaries.

2. The position of the personal representative

The responsibility for addressing the tax consequence of a taxpayer's death is, logically enough, placed upon the personal representative (*ITA*, s. 150(3)). However, the *ITA* does not simply place the responsibility on the personal representative's shoulders; it imposes personal liability for failing to discharge it. The imposition of this personal liability is obviously an important consideration for a personal representative and is therefore worthy of some careful explanation.

Under provincial common and statute law, a creditor, including a creditor such as the Canada Revenue Agency (CRA), can pursue its claim against the beneficiary who has received funds from the estate since the right of a creditor to be paid in full takes priority over the right of a beneficiary to receive a gift. The *ITA* does not dilute this principle. The CRA is as free as any other creditor to seek payment from beneficiaries to the extent that they have benefitted from the estate in preference to creditors.

Provincial law also states that a personal representative can be held personally liable for creditors' claims if he or she has distributed property to beneficiaries when he or she knew or ought to have known of creditors' claims. It provides a scheme for the personal representative to follow if he or she wishes to avoid such a personal liability (*Trustee Act*, s. 53 (advertising for creditors)) and provides a further scheme for establishing priorities among creditors. Again, the CRA can avail itself of all of these rules.

The *ITA* gives the CRA a very substantial additional protection. It states that a personal representative, before distributing any property under his or her control, must obtain a certificate certifying that taxes, interest, and penalties have been paid in respect of the taxation year in which the distribution is made, in respect of a preceding taxation year, and in respect of a payment to the CRA for which the personal representative can "reasonably be expected to become liable" (*ITA*, s. 159(2)). Failure to obtain this clearance certificate is not a punishable offence akin to tax fraud, but it carries with it a risk. Where a personal representative distributes property without obtaining the clearance certificate, the personal representative becomes "personally liable for the payment of those amounts to the extent of the value of the property distributed" (*ITA*, s. 159(3)).

A clearance certificate is a document that is applied for by the personal representative after all the required tax returns for the period to be covered by the certificate have been assessed. The personal representative may apply for an interim clearance certificate (to the date of death) and/or a final clearance certificate (to the date of distribution). Mercifully, in respect of the final clearance certificate, the personal representative is not required to estimate how long it will take the CRA to issue the clearance certificate and to file a return with income estimated to that future date. Instead, when ready to effect the final winding-up of an estate and the distribution of all remaining assets to the beneficiaries (except for settling tax matters), he or she calculates income earned to a past date and undertakes to distribute the estate promptly upon receipt of that certificate. Income earned by the estate during the hiatus period between the date so selected and the time when the clearance certificate arrives, is regarded for tax purposes as earned by the personal representative as agent for the beneficiaries.

The effect of the personal liability provision is, crudely put, to terrorize personal representatives into ensuring that they do not overlook their obligation to file tax returns on behalf of an estate that they might otherwise be able to distribute without doing so and to provide the CRA with a direct source for the payment of tax.

If one were to take those provisions of the *ITA* at face value and were to be consulted by a personal representative who wished to avoid personal liability, one would be required to advise the personal representative to settle the deceased taxpayer's estate at a rate determined entirely by the speed of the assessment and audit process of the CRA; however, significant delays would occur before the estate was fully distributed. In short, it is theoretically attractive, but practically impossible, to administer an estate on this basis. Instead, most personal representatives, knowingly or unknowingly, assume the personal liability described above by making interim distributions and, if they are professionally advised, retain a reserve to meet and exceed anticipated taxes and do not distribute the reserve until the clearance certificate is in hand. As an alternative, if a personal representative is on good terms with the beneficiaries (and considers them to be solvent), he or she may be prepared to distribute the entire estate

prior to the receipt of a clearance certificate and to accept the undertaking of the beneficiaries to indemnify the personal representative to the extent that the personal representative is subsequently found to be liable for additional tax.

There is a separate reason to apply for a final clearance certificate. The CRA has the right to reassess a tax return at any time if there has been fraud or neglect, but otherwise for three years after the expiry of the normal annual assessment period (*ITA*, s. 152(4)). A personal representative will wish to have distributed the estate before the expiry of the period during which reassessment is a possibility but, especially if he or she is not a beneficiary, will not wish to carry the contingent risk of personal liability that might arise from any such reassessment. The final clearance certificate operates as a representation to the personal representative by the CRA that, notwithstanding that the deceased's tax returns might in the future be reassessed, no liability will attach to the personal representative from the reassessment. In practical terms, the issuance of a clearance certificate also provides the beneficiaries with a strong indication that the deceased's tax business will never be reopened. Jurisprudence has made it clear, however, that the issuance of a clearance certificate does not operate to prevent the CRA from reassessing a return after its issuance and seeking the taxes that are due from the beneficiaries.

None of the foregoing should lead the reader to the conclusion that it is either mandatory or appropriate in every case to obtain a final clearance certificate. An estate can be distributed without the certificate. A personal representative who is also the sole beneficiary of the estate has no particular reason to seek a discharge from personal liability in his or her capacity as a personal representative when he or she would remain personally liable in any event in his or her capacity as a beneficiary. The only purpose for obtaining a clearance certificate in that circumstance would be to obtain "virtual certainty" that no reassessment of the deceased's taxes will be conducted. Many, even most, taxpayers are content to run the risk of future reassessment because they are satisfied that the deceased's tax affairs are in good order. In addition, the request for a clearance certificate essentially operates as a request to the audit staff of the CRA to take a closer look for what the original assessment might have missed. In some circumstances, it may be better not to invite a taxing authority to take a second kick at the cat but rather (to mix metaphors) to let a sleeping dog lie.

3. Concessionary rules

3.1 Rollovers

The *ITA* stipulates that death will not cause a deemed realization of non-depreciable capital property or depreciable capital property in two circumstances:

- outright transfer to a spouse or transfer to a qualifying spousal trust; and
- inter-generational transfer of farm property.

Instead, in such situations, the transferee will acquire the property at the deceased's tax cost. This permits a deferral, but not an elimination, of the capital gain (and recaptured depreciation) until an actual or deemed realization in the hands of the transferee takes place. This is normally thought to be desirable on the basis that "taxes deferred are taxes denied." With respect to RRSPs, outright transfers to spouses also avoid a deemed disposition.

3.1.1 Transfer to spouse or qualifying spousal trust

If a taxpayer was resident in Canada immediately before the taxpayer's death and non-depreciable capital property or depreciable capital property after the death "and as a consequence thereof" has been transferred to the surviving spouse who was resident in Canada immediately before the death and the property becomes "indefeasibly vested" in the surviving spouse within 36 months of death, the deemed realization rule does not apply, but instead there is a "rollover" to the surviving spouse (*ITA*, s. 70(6)). No election is required in order to effect this result. It happens automatically by virtue of the fact that the deceased has a spouse.

The effect of the rollover rule is to allow the death of the first spouse to constitute a non-taxable event. The surviving spouse acquires the property at the deceased's tax cost and therefore eventually realizes a capital gain spanning the period of ownership of both the deceased and the surviving spouse, which is brought into income when the surviving spouse either disposes of the property by sale or is deemed to dispose of it by death.

The meaning of the word "spouse" has undergone an interesting evolution. It once meant, for all purposes of the *ITA*, only a married spouse. It was then extended to include common-law spouses for certain limited purposes. It was then extended as of January 1, 1993, to include common-law spouses for all purposes of the *ITA*.

The phrase "as a consequence thereof" has a defined meaning (*ITA*, s. 248(8); CRA, Interpretation Bulletin IT-305R4, "Testamentary Spouse Trusts"). It includes a transfer resulting from intestacy. It also includes a transfer resulting from a "disclaimer, release or

surrender" executed by a beneficiary other than the spouse—a document that has as its key element no direction as to the person to benefit thereby so that the interest is essentially "given back to the estate." It is the practice of the CRA to extend rollover treatment to a transfer of capital property that takes place pursuant to a court order pertaining to either dependants' relief or family property.

The concept of "indefeasibly vested" requires that the spouse acquire an absolute ownership interest that cannot be defeated by any future event. Agreements made by a deceased prior to his or her death can—often inadvertently—preclude indefeasible vesting and therefore prevent access to the rollover. For example, where a deceased person has bound his estate to sell property to a third party as a result of his or her death (as is commonly the case in shareholders' agreements), no spousal rollover can be obtained; although if the deceased has only granted an option, then it becomes a question of fact whether the property has been transferred to the spouse who subsequently sells the property, whether the property was sold by the estate, or whether the option was in fact exercised at all. It goes almost without saying that whether to attempt to preserve the rollover should be a primary decision in drafting contracts binding on a taxpayer's estate.

Insofar as rollovers to spousal trusts are concerned, it is not any trust to which the rollover applies; instead, the trust must have two key parameters (*ITA*, s. 70(6)(b)). A trust that has these parameters is usually referred to as a "qualifying spousal trust." First, the spouse must be entitled to receive all of the income of the trust that arises before the spouse's death. Second, no person except the spouse may obtain the use of any of the income or capital of the trust during the spouse's lifetime. These two conditions therefore pull in different directions. It is mandatory that the spouse receive all of the income derived from the trust, but it is not mandatory that the spouse receive any of the capital. It is only mandatory that if the trustees are given a discretion to encroach on the capital, they exercise that discretion only in favour of the spouse during his or her lifetime. These criteria would not be met if, for example, the terms of the spousal trust provide that if the surviving spouse remarries, the trust property then flows to a third party. Such a remarriage stipulation would prevent the trust from being a qualifying spousal trust.

A testator will often wish to establish a testamentary spousal trust so as to control the ultimate distribution of the trust capital. However, non-tax objectives (such as the desire to permit access to capital to persons other than the spouse during the spouse's lifetime) may be at odds with the required parameters of a qualifying spousal trust that the testator will have to adhere to in order to obtain a rollover. To solve this problem, a testator will occasionally create both a qualifying spousal trust and a "tainted" spousal trust and will give his or her personal representative the discretion to determine which assets are to be allocated to which trust. This practice is accepted by the CRA (Interpretation Bulletin IT-305R4 "Testamentary Spouse Trusts" at para. 8). It is not clear whether the CRA permits the discretion to establish the relative values of the trusts to be delegated to the personal representative, but it would be permitted as a matter of provincial law (*Re Nicholls*).

A taxpayer may have inadvertently tainted what would otherwise be a qualifying spousal trust by, for example, charging the trust with certain obligations, thereby putting capital in the hands of persons other than the spouse. The *ITA* provides relief in two respects. First, an otherwise qualifying spousal trust is deemed not to be tainted if it provides only for the payment of any estate or income taxes with respect to the trust property (*ITA*, s. 108(4)). Second, if the trust is otherwise tainted only because it provides for the payment of other specified debts, it sets out a procedure for "cleansing" the trust by allowing assets comprising part of the trust having sufficient value to pay those debts to be regarded as having been disposed of at fair market value and by allowing the remaining assets to be rolled over.

A qualifying spousal trust can be created as a consequence of the death of a taxpayer in the same manner as can an outright transfer and is subject to the same requirements of indefeasible vesting.

When property is transferred to a qualifying spousal trust, the property that was subject to the rollover becomes subject to tax when it is disposed of in fact by the trust and is subject to deemed realization when the surviving spouse dies or when, during the lifetime of the surviving spouse, the trust transfers the property to a person other than the spouse (*ITA*, s. 107(4)). If the property is retained until deemed realization on the death of the surviving spouse, the income deemed to be realized must be taxed within the trust. Where a spouse or a spousal trust acquires the ownership of property that was a deceased's principal residence, the recipient is deemed (*ITA*, s. 40(4)) to have owned the principal residence and designated it as such for the years in which the deceased so owned and designated the principal residence, thereby allowing the principal residence designation to run with the property rolled over.

3.1.2 Intergenerational transfer of farm property

A taxpayer may also on death transfer property used by the taxpayer or his or her spouse or child in the business of farming immediately before death to his or her child resident in Canada on a rollover basis, subject again to the 36-month indefeasible vesting rule. If farm property is transferred to a qualifying spousal trust, the farm rollover will apply on the death of the spouse so long as immediately before the spouse's death, the property was used in the business of farming and, as a consequence of the spouse's death, it has become vested indefeasibly in a resident child of the taxpayer (*ITA*, s. 70(9.1)).

3.1.3 Election to avoid the spousal rollover

It is also possible to elect that assets be subject to the deemed disposition rule even if a spousal rollover is available (*ITA*, s. 70(6.2)) and to make this election with respect to some, but not all, of the deceased's assets. An estate may wish to take this measure where it will have little negative impact on the deceased spouse (for example, he or she may have unused losses) and will have a positive impact (eventually) on the surviving spouse by increasing his or her cost base.

3.1.4 Registered retirement savings plans (RRSPs)

Just as with non-depreciable capital property and depreciable capital property, a spousal rollover is available for RRSPs. Any amount in respect of which the spouse (as opposed to the estate of the taxpayer) is the direct recipient by way of beneficiary designation is deemed to be income to the spouse and not the deceased. The taxpayer's spouse can then either include the proceeds of the RRSP in his or her income or, more likely, purchase an RRSP in his or her own name with the proceeds and thereby continue the tax deferral (*ITA*, s. 60(1)). The surviving spouse must be careful to make the RRSP contribution in, or in respect of, the same year as the income is deemed to have been received by redemption. If death occurs in November and redemption occurs in December, a spouse will want to make the contribution by February 28 in the next year.

Where the proceeds of an RRSP are receivable by an estate, the estate and the spouse may jointly elect that the amounts receivable by the estate are deemed as received by the spouse, thereby allowing the tax deferral to be preserved (*ITA*, ss. 146(8.2)(b) and (8.9)–(8.91)). In order for the personal representative and the spouse to be in a position to make this joint election, the spouse's beneficial interest in the estate must be sufficiently large that it is fair to say in the circumstances that all payments can reasonably be allocated to the spouse. This will be achieved not only where the spouse is named in the will as the person to whom the RRSP proceeds should be paid by the recipient personal representative, but also where the testate or intestate share of the spouse is large enough to accommodate their RRSP proceeds, where there is an authority to encroach on capital, where there is a disclaimer, or where there is a dependant's relief order. It does not, however, extend to circumstances in which there is a specific gift of the RRSP proceeds to some other person, the spouse is allocated only specific assets other than the RRSP proceeds, or the total gift to the spouse is less than the proceeds of the RRSP.

A different tax treatment is available to the extent that the proceeds of the RRSP are payable (either directly or by way of joint election similar to the spousal joint election) to a child or grandchild of the deceased who is, as a matter of fact, financially dependent upon the deceased for support (*ITA*, ss. 146(1) "refund of premiums" and (8.8)–(8.9)). In that case, the proceeds of the RRSP are included in the income of the child or grandchild recipient, who can purchase, if he or she is below the age of 18, an annuity payable until age 18 (*ITA*, s. 60(l)). If he or she is mentally or physically infirm, the deduction can be used for an RRSP contribution for the child or for the purchase of an RRSP annuity or RRIF.

At the planning stage, a taxpayer must be extremely careful in determining how to gift the proceeds of an RRSP. The taxpayer must also be aware the RRSP may have a value to the recipient that is different than its face value. If the taxpayer's death creates a deemed income inclusion in the taxpayer's terminal return and the RRSP is expressly gifted to a particular person, there will be a joint and several liability for the amount of tax resulting from the deemed income inclusion between the recipient and the estate (*ITA*, s. 160.2(1)); but at the end of the day, the recipient could probably receive indemnity from the estate. A taxpayer planning a gift must therefore be careful to understand to whom he or she wishes to gift the tax liability. It may well be that the recipient of the RRSP will get the RRSP funds and the estate (and the beneficiaries thereof) will bear the tax burden.

It appears that there is no requirement for a plan administrator to withhold tax for payment out from the plan that follows death (*ITA*, s. 153(1)(j); *Income Tax Regulations* (*ITR*), ss. 103(4) and (6)).

3.1.5 The taxation of an estate as a trust

As noted above, the death of a taxpayer will almost certainly compel the preparation of a T3 trust return to report the income earned by the estate after the

deceased's death and before the distribution of the estate to beneficiaries.

Expressed as a very general proposition, a trust is a conduit for income that it pays or is obliged to pay to its beneficiaries. There are important exceptions to this general rule. For example, an estate cannot allocate its capital gains to its non-resident beneficiaries; they have to be taxed within the trust. Therefore, in a routine situation where the estate was immediately distributable, the estate would calculate its income, allocate all of its income to the beneficiaries (by issuing a T3 supplementary slip), take a deduction from its income of the amounts so allocated, and file a return showing that there was no income generating tax. The sole function of the return would therefore be to demonstrate to the CRA that there had been no "leakage" of income from the tax system and to provide for continuity of accounting for that income.

The personal representative appears to be obliged, in principle, to file a return for income of the estate as a trust in any circumstance where the trust has income (*ITA*, s. 150(3); *ITR*, s. 204(1)). By its administrative policy, the CRA does not insist that the trust file a return in circumstances where the total taxable income of the estate does not exceed $500, no beneficiary's share in that taxable income exceeds $100, all of the income is taxable in the hands of the beneficiaries, and there are no non-resident beneficiaries. (This is a low threshold, given that the estate of any taxpayer who was in the workforce for any significant time will be in receipt of a Canada Pension Plan death benefit of the maximum $2,500.) The T3 Guide also contains the following statement:

> You may not have to file a return if the estate is distributed immediately after the person dies, or if the estate did not earn income before the distribution. In these cases, you should give each beneficiary a statement showing his or her share of the estate.

The statement supports the notion that the CRA is principally concerned that income not escape from the tax system simply because it is earned at the estate level, rather than with the formality of filing a return. In other words, where an estate has not earned income for any appreciable period and the personal representative can be confident that the beneficiaries' *pro rata* shares in the estate's income will be reported by them, he or she may well feel comfortable not filing a T3 return (and, presumably, not requesting a clearance certificate for any period postdating the deceased's death).

Even in the immediately distributable estate, there are opportunities for tax planning involving the use of a trust return, which are derived from the following principles:

- Testamentary trusts are taxed at graduated rates. (*Inter vivos* trusts are taxed at the top marginal rate.)
- A trust beneficiary is deemed not to have received income from a trust until the last day of the fiscal period of the trust, even though the income might have been paid to him or her in a previous calendar year.
- Testamentary trusts can choose the length of their own first fiscal period. (*Inter vivos* trust must operate on a calendar-year basis.)
- Trustees can elect to have income taxed at the trust level, even if the income was paid to the beneficiaries and the trust would otherwise allocate the income to the beneficiaries.

The residence status of a trustee or beneficiary can play havoc with the general rules for the taxation of trusts. A trust is taxed, generally speaking, on the basis of its residence, which is usually determined in turn by the residence of the trustee. For example, a deceased Canadian resident who has a sole beneficiary and estate trustee resident in the United States will be required to file a T1 terminal return, but not a T3 return, except with respect to "taxable Canadian property" (essentially, real estate). A personal representative also has to be careful to determine whether the trust income in question is allocable to the beneficiary or must be taxed in the trust and, if it is allocable, must remember to remit withholding tax on the amount allocated to the non-resident beneficiary.

3.1.6 The time to file tax returns

The due date for the terminal return depends upon the date of the deceased's death, as follows:

- Death prior to November: terminal return due by next following April 30 (or June 15th, if the deceased had business income). These are the same deadlines that exist for individuals alive throughout the tax year.
- Death in November or December: terminal return due six months from death (*ITA*, s. 150(1)).

There is also a specific rule in respect of the return for the year preceding the year of death (which the personal representative will often have to file if the deceased has been ill before death or has died early in the year):

- Death prior to May: prior year's return due six months after death.
- Death in May or after: prior year's return was due on April 30 in year of death and no extension is given (see *ITA*, s. 150(1)(b),(d)).

There is one extended deadline for the filing of the basic terminal return and a special deadline with respect to one of the elective T1 returns, as follows:

- Terminal return where qualifying spousal trust created: no late filing penalty until 18 months after death (interest runs from normal deadlines) (*ITA*, s. 70(7)(a)).
- Rights and things return: due by later of one year from death and 90 days after assessment of terminal return (*ITA*, s. 70(2). This extended filing deadline enables the personal representative to determine whether, based on the notice of assessment, any additional tax saving may be incurred by identifying rights and things and declaring them as part of a separate return).

The T3 return is due within 90 days after the expiry of the trust's year-end. The trust can choose its own first fiscal period, but in default of an express choice, it will end on the first anniversary of the taxpayer's death (*ITA*, s. 150(1)(c)).

An estate trustee is under no obligation to continue to make quarterly instalment payments (*ITA*, s. 156.1(3)).

3.1.7 The principal residence exemption

The principal residence exemption permits a taxpayer and his or her immediate family to own and occupy a residence that is capital property. Any capital gain on the actual or deemed disposition of the property is fully sheltered by the exemption.

However, only one residence per family per year can be designated. Since both a city residence and a cottage property qualify as a principal residence, it is important to make the most judicious use of the exemption so that the greatest gain is sheltered. For example, in recent years, many cottage properties have appreciated more than city homes and therefore deserve greater application of the annual designation.

When a principal residence is designated, the gain that otherwise arises is multiplied by a fraction and therefore watered down. The numerator of the fraction is "(post-1971) years designated, plus one". The denominator is "(post-1971) years owned." Because of the "plus one" built into the numerator, it will often be wise, where two residences are owned, to allocate at least one year of the designation to each property so that the "plus one" can be accessed twice.

The change in use of a principal residence (for example, from living in it to renting it out) triggers its deemed disposition. That deemed disposition can be deferred for up to four years by election. Where the cessation of occupation is on account of employer-required relocation and where the taxpayer eventually reoccupies the property, the four-year period continues indefinitely.

A principal residence includes a building and up to one-half hectare of land. More can be included if the taxpayer shows the excess is necessary for the use and enjoyment of the residence (for example, the excess may not be severable).

3.1.8 Income splitting and non-arm's length dispositions

Apart from these statutorily sanctioned breaks, much of estate planning can be characterized as an ongoing battle of wits between estate planners and those drafting tax legislation to engage in, or prevent, two techniques: income splitting and dispositions at less than fair market value.

Income splitting refers to the technique of shifting property from a high income taxpayer to a lower income taxpayer, and attempting to have the lower income taxpayer rather than the high income taxpayer report the income for tax purposes. Income splitting is expressly rendered nugatory in certain circumstances because of the attribution rules. First, where one spouse transfers or loans any property to the other on any basis other than a sale at fair market value, income and capital gains from the property are deemed to be income and capital gains to the transferor. Second, where one person transfers or loans any property to a minor person with whom he or she does not deal at arm's length, or a nephew or niece, any income (but not, interestingly, any capital gains) is deemed to be income of the transferor until the minor attains the age of majority.

One can therefore generally freely split income with one's adult children, but before doing so one has to take careful account of the property that is transferred. If it is cash, no problem will arise; but if it is capital property, a "deemed disposition at fair market value" (dealt with immediately below), which could have adverse tax consequences, will result.

Not surprisingly, there are rules to prevent indirect income splitting. A transfer or loan to a trust resulting in the payment of income to a trust beneficiary is treated as essentially equivalent to a transfer to the beneficiary. A transfer or loan to a corporation (other than a "small business corporation," which is a private corporation that uses substantially all its assets to earn active business income primarily in Canada), one of whose main purposes is to reduce the transferor's income and to benefit a spouse, non-arm's length minor, nephew, or niece owning at least 10% of the shares of the corporation, results in deemed attribution at a prescribed rate (*ITA*, s. 74.4).

In addition, where an individual transfers property to a trust and retains the capacity to benefit from the trust, all of the income and capital gains of the trust are attributed back to him or her (*ITA*, s. 75(2)).

Where there is a loan from one individual to any other non-arm's length individual and one of the main reasons for making the loan is the reduction or avoidance of tax, income from the loaned property is attributed back to the lender (*ITA*, s. 56(4.1)). Therefore, a parent who lends money to an adult child to pay off a mortgage will not be subject to attribution (because the loan produces no income). A parent who lends money to a child who invests it could be subject to attribution. In addition, if such a loan bears a below-market interest rate, a market interest rate will be deemed to exist.

Attribution does not apply in respect of transfers at fair market value or to loans at commercial interest rates or in respect of business income.

There are also a series of rules that deem dispositions at amounts that the parties would not normally choose to apply. If a transferor either gives property or sells it at less than fair market value to a person with whom he or she does not deal at arm's length, he or she is deemed to have disposed of it at fair market value (*ITA*, s. 69). The recipient who acquires the property as a gift is deemed to receive it at fair market value, while the recipient who pays below market consideration for the property is deemed to have acquired the property at that value. Therefore this puts him or her in a worse position than if he or she had received it by gift, because he or she is stuck with a below-market cost base. Between spouses, a presumptive rollover rule applies, but they can elect that the transfer take place at fair market value.

A taxpayer and a trust are deemed not to deal with each other at arm's length if the taxpayer or any person not dealing at arm's length with the taxpayer has a beneficial interest in the trust (*ITA*, s. 251(1)).

Chapter 37
Trusts and estate planning

1. Income tax definition of "spouse"

Subsection 248(1) of the *Income Tax Act* (*ITA*) introduces the term "common-law partner" of a taxpayer to mean a person who cohabits at that time in a conjugal relationship with the taxpayer and

- has so cohabited throughout the 12-month period that ends at that time; or
- is a parent of a child of whom the taxpayer is a parent.

This term "common-law partner" has been added throughout the *ITA* wherever the term "spouse" appears, to cover both common-law spouses and same-sex partners. As the income tax treatment afforded spouses and common-law partners is identical, any reference to "spouse" in this chapter should be read to include "common-law partner."

2. What is a trust?

The *ITA* does not define the word "trust" or provide any guidelines for establishing whether a trust exists. The trust concept derives from the English common law and has been defined in various ways by different authors. In general terms, a trust is an equitable obligation binding a person (who is called a trustee) to deal with property over which he or she has control (the trust property) for the benefit of persons (who are called the beneficiaries or "*cestuis que* trust"). The person who creates the trust is usually referred to as the settlor. A trust, unlike a corporation, is not a legal entity as such, but rather a relationship between the trustees and the beneficiaries. The essence of a trust is the separation of legal and beneficial ownership of property. An individual may act in more than one capacity, i.e., as settlor, trustee, and/or beneficiary of the trust.

A trust involves the vesting of property in a trustee for the benefit of a beneficiary (or beneficiaries) where the property is held in a fiduciary relationship. A trust may arise by the intention of the parties (express trusts) or by operation of law (e.g., presumptive, constructive, or resulting trusts). The trust has developed both as a device to hold property (and thereby creates substantive rights) and as a remedy. These dual aspects of a trust reflect its mixed origins in the courts of common law and equity. While estate planners must be aware that a sequence of events may cause a trust to arise by operation of law, we are more often concerned with express trusts that are deliberately established by an agreement in writing for a particular purpose. An express trust is a trust that is intentionally created by express declarations of the owner of the property (settlor). The two essential features of an express trust are that it creates a fiduciary relationship between the trustee and the beneficiary and it involves a transfer of property to the trustee. This chapter will address the relevance of express trusts to the estate planning process.

A trust, unlike a corporation, is not regarded by the law as a person capable of acquiring rights and obligations independently of those of the parties to the relationship. The treatment of the trust as an individual for income tax purposes should not obscure the fact that the trust is not a legal entity. Only the trustees, and not the trust as such, can enter into contracts, acquire the ownership of property, and incur liabilities. Fundamental to the trust relationship is the principle that the trustees are not agents of the beneficiaries. The trustees act as principals and not as agents in their transactions with third parties, subject to the fiduciary obligation that such powers of legal ownership of the assets in the trust fund must be exercised in accordance with the terms of the trust for the benefit of the beneficiaries.

The beneficiaries generally have no rights or powers against or over the trustees except to insist that the terms of the trust are performed in accordance with the provisions of the trust instrument. The trustees' primary obligation is to carry out the instructions of the settlor by exercising powers and performing obligations for the benefit of the objects (beneficiaries) of the trust.

One exception to the principle that the trustees are not agents of the beneficiaries is the bare trust; namely, a trust under which the trustees have no independent powers or discretions and are subject to the primary and overriding obligations to carry out the instructions of the beneficiaries. Bare trusts arise in commercial transactions where, for example, securities are registered in the name of a stockbroker or title to land is held by a nominee corporation to be dealt with subject to the instructions of the beneficiaries.

As a general rule, an express trust, to be effective and recognized, must have three essential characteristics (often referred to as the three certainties):

- The language of the settlor must be imperative; for an instrument to create an express trust, its language must disclose with sufficient certainty an intention to create a trust (Certainty of Words).

- The subject matter or trust property must be certain (Certainty of Subject Matter).
- The objects or persons intended to have the benefit of the trust must be certain—if a trust is to be valid, it must be possible to ascertain the intended beneficiaries (Certainty of Objects). If the beneficiaries are not specifically referred to by name, they may be referred to by class (e.g., "children"); however, the description of the class must be sufficiently precise to permit a determination as to whether any particular person is or is not a member of the class. However, if the trustee has discretion as to whom and in what proportions among a class he or she will distribute the trust property, the trustee need not be able to determine who all the possible beneficiaries are but only whether any particular beneficiary is within the class. One exception to the rule that the objects of a trust must be certain is in the case of a charitable trust—so long as the purpose of the trust is clearly charitable, it is not necessary that the mode, scheme, or method be certain in order for the trust to be valid. If the objects are uncertain, a *cy-près* scheme may be created by the court directing the disposition of the funds for a specific charitable purpose.

In summary, when establishing a trust, the settlor must make it clear that he or she intends to establish a trust, specifically describe the property that is to be the subject matter of the trust, and identify the beneficiaries beyond any doubt.

Trusts may be either revocable or irrevocable. A revocable trust is one that by its terms may be revoked or amended and the property comprising the trust assets returned to the settlor. An irrevocable trust is one that cannot be revoked or amended by the settlor.

3. Duties and responsibilities of trustees

The common law has established the basic duties and responsibilities of a trustee. In administering the assets of the trust, trustees are subject to the following fiduciary obligations:

- The duty of care: The common-law standard of care for a trustee is that which a reasonable and prudent business person would exercise in conducting his or her own affairs.
- The duty to act personally: A trustee cannot normally delegate his or her decision-making power. Although a trustee may seek advice, responsibility for the ultimate decision lies with the trustee.
- The duty to avoid conflict of interest and act solely for the benefit of the beneficiaries: A trustee must act solely in the best interests of the trust beneficiaries and avoid any conflict between his or her own interests and those of the beneficiaries. A trustee may not profit personally from the administration of the trust. In addition, a trustee must act impartially between different beneficiaries (often referred to as the "even hand" principle). Trustees must not favour one class of beneficiaries over another or one beneficiary of a class over another, but must treat all beneficiaries equally. For example, trustees must hold an even hand between the income and capital beneficiaries of a trust.

Legislation of the applicable jurisdiction of a trustee may alter the application of any of those basic duties, in some cases imposing higher standards and obligations. For example, the *Trustee Act* introduces a "prudent investor" rule to govern the manner in which a trustee can invest property under his or her administration. Furthermore, the applicable trust agreement may also, to some extent, impose different standards and obligations.

While these obligations or standards can be eroded to some extent by the specific provisions of the trust document, they cannot, because of the fiduciary position of the trustee, be excluded entirely. If the settlor or testator desires to provide the trustees with maximum flexibility, discretion, and protection in exercising powers of management, this can be accomplished by conferring powers that are expressed to be exercisable solely in accordance with the absolute discretion of trustees and by including express provisions that exculpate the trustees from liability for damage or loss suffered by the trust. However, in view of the fiduciary status of the trustee, it is possible that in certain situations, the terms of discretionary and limited exculpatory provisions may be regarded as repugnant to that status and void on that ground.

4. Uses of trusts in estate planning

The trust is the perfect estate planning vehicle, since it possesses several unique features that make it particularly suited to estate planning. The most important of these features are the separation of legal and beneficial ownership, the ability to create successive beneficial interests and thereby control the property over a considerable number of years, and the flexibility that can be provided by conferring a variety of discretionary powers that may affect the selection of beneficiaries, the types and timing of benefits to be enjoyed by them, and the investment and management of the trust property.

The following are some of the more common uses of trusts in estate planning:

- to provide for the maintenance and education of infants or other persons to whom it is desired to give the enjoyment of property without powers of control or management. The ability of the trustees to act as owners of the trust property in their transactions with third parties provides the most efficient legal vehicle for overcoming the

beneficiaries' legal and natural incapacities with respect to property.

- to provide a degree of financial independence for an adult child while postponing the time at which the child will obtain full management and control over the property.
- to provide for the care and maintenance of individuals who are unable, for medical or other reasons, to manage their own affairs.
- to provide for the care and maintenance of a spouse during his or her lifetime while controlling the disposition of the trust property on the spouse's death (e.g., to ensure protection for children of a former marriage).
- to implement legitimate tax-planning objectives such as income-splitting capital gains with minor beneficiaries.
- to provide for the education of children and/or grandchildren.

5. Taxation of trusts

5.1 Introduction

Sections 104–108 of the *ITA* address the taxation of trusts and their beneficiaries. Subsection 104(2) of the *ITA* establishes the fundamental principle with respect to the taxation of trusts and estates: it deems a trust or estate to be an "individual" for tax purposes. A testamentary trust (which includes an estate) that has been created by will and the estate of a taxpayer who has died intestate are both treated, for tax purposes, as trusts. As a result, *inter vivos* and testamentary trusts and estates are thereby made distinct taxable entities. For tax purposes, the estate of a deceased is separate and distinct from the deceased. The deceased is taxable on his or her income up to the day of death, and any income after that time is taxed separately as the estate's income. There is, however, one important and useful exception to this principle that permits the estate to transfer its capital losses and terminal losses incurred by it during its first taxation year against the deceased's income in the year of death (*ITA*, s. 164(6)). Since a trust or estate may own property or even carry on a business, it will be subject to income tax on the taxable income it derives from the property or earns from the business, including any taxable capital gain and recapture incurred on the sale of its capital or depreciable property.

A trust or estate is also a conduit for tax purposes in that it can flow income out to its beneficiaries. Such amounts constitute income to the beneficiary, and in order to ensure that the trust is not taxed on the same income, the *ITA* provides the trust with a deduction for all amounts flowed through to beneficiaries. There are two main circumstances in which a trust or estate may flow income through to its beneficiaries and claim a deduction:

- The trust or estate actually distributes the income to its beneficiaries.
- The income is "payable," although not actually paid, to the beneficiaries.

5.2 Residence

There are no provisions in the *ITA* for determining the residence of a trust or estate. Subsection 104(1) of the *ITA* does, however, state that a reference to a trust or estate in the *ITA* is to be read as a reference to the trustee, executor, or other legal representative "having ownership or control of the trust property," which suggests that the residence of the trustees is relevant. Residency is a question of fact to be determined according to the circumstances in each case. However, a trust is generally considered to reside where the trustee, executor, administrator, or other legal representative who exercises central management and control over the trust assets resides.

5.3 Taxation year

The taxation year of an *inter vivos* trust must always coincide with the calendar year (*ITA*, ss. 104(2) and 249(1)). For a testamentary trust or estate, the taxation year may (but need not) be the calendar year. It can be the period for which the accounts of the trust are ordinarily made up or, in the absence of an established practice, any period adopted by the trustees for that purpose provided the period does not exceed 12 months (*ITA*, s. 104(23)). The first taxation period of a testamentary trust will start on the day after the death of the taxpayer and end at any time within the next 12 months selected by the trustees. To achieve maximum deferral of tax, it is common for the fiscal year of a testamentary trust or estate to be based on the 12-month period following the day of the taxpayer's death, although for reasons of accounting convenience or timing of income a personal representative may wish to select some other fiscal period. A change in the taxation year of a testamentary trust may only be made with the concurrence of the Minister of National Revenue (MNR).

5.4 Filing requirements

Every person acting in a fiduciary capacity, such as an executor, trustee, or administrator, and having ownership or control of property on behalf of some other person must file a "trust income tax and information return" (T3 return).

The T3 return must be filed with the Canada Revenue Agency (CRA) within 90 days from the end of the trust's taxation year (*ITA*, s. 150(1)(c)). The T3 return reports

the trust's income and provides information to the CRA about distributions to beneficiaries. Beneficiaries of the trust or estate to whom income is paid or payable or who have made a preferred beneficiary election must be provided with T3 supplementary forms indicating the income that they are required to report on their own personal tax returns.

5.5 Rates of tax

A testamentary trust is subject to tax, under s. 117, at the same graduated rates as an individual. The rate of tax payable by an *inter vivos* trust, however, generally depends upon the date the trust was established. *Inter vivos* trusts established after June 17, 1971, are subject to a flat rate of tax equal to the highest marginal tax rate applicable to individuals (*ITA*, s. 122(1); CRA, Interpretation Bulletin IT-406R2, "Tax Payable by an Inter Vivos Trust"). Subsection 122(2) provides that an *inter vivos* trust, however, is taxed at the regular graduated rates where the trust

(a) was established before June 18, 1971;

(b) was resident in Canada on June 18, 1971, and without interruption thereafter until the end of the year;

(c) did not carry on any active business in the year;

(d) has not received any property by way of gift since June 18, 1971;

(e) has not, after June 18, 1971, incurred

(i) any debt; or

(ii) any other obligation to pay an amount

to, or guaranteed by, any person with whom any beneficiary of the trust was not dealing at arm's length; and

(f) has not received any property after December 17, 1999, where

(i) the property was received as a result of a transfer from another trust;

(ii) subsection (1) applied to a taxation year of the other trust that began before the property was so received; and

(iii) no change in the beneficial ownership of the property resulted from the transfer.

The failure to satisfy any one of these conditions will permanently taint a pre-June 18, 1971, *inter vivos* trust and result in its being subject to the highest marginal tax rate on every dollar of its taxable income. In order to preclude a taxpayer from creating multiple testamentary trusts, each of which would be entitled to the graduated tax rates, s. 104(2) of the *ITA* provides that where there are multiple trusts and substantially all of their properties have been received from one person and the income accrues or will ultimately accrue to the same beneficiary or group or class of beneficiaries, the MNR may combine all the income from all of the trusts and tax the trusts as if the income had been earned by one trust. In *Mitchell v. M.N.R.*, it was held, however, that the MNR could not consolidate four trusts, each of which had as its beneficiary a different child of the settlor.

5.6 Clearance certificates

Subsection 159(2) of the *ITA* provides that every administrator, executor, or trustee must obtain a clearance certificate from the CRA before distributing any property under his or her control. The certificate provides comfort that any taxes, interest, or penalties payable by the trust or estate have either been paid or security for payment has been accepted by the federal taxation authorities. Property that has been distributed without a clearance certificate renders the executor or trustee personally liable for any unpaid taxes, interest, or penalties of the trust or estate (*ITA*, s. 159(3)). Note, however, that the personal liability of a trustee, executor, or administrator is limited to the value of the property distributed to the beneficiaries. The legal representative must obtain a certificate with respect to all amounts

(a) for which the taxpayer is liable under the *ITA* in respect of the taxation year in which the distribution is made, or any preceding taxation year; and

(b) for the payment of which the responsible representative is or can reasonably be expected to become liable in his or her capacity as the responsible representative.

5.7 Classification of trusts

5.7.1 Testamentary trusts

A testamentary trust is defined in the *ITA* as a trust or estate that arises upon and in consequence of the death of an individual (*ITA*, s. 108(1)). It includes a trust created under the terms of a will or by an order of a court made pursuant to dependants' relief legislation. An *inter vivos* trust is defined in the *ITA* as a trust other than a testamentary trust.

5.7.2 Inter vivos trusts

After June 17, 1971, *inter vivos* trusts are subject to tax at the highest marginal tax rate, whereas testamentary trusts are taxed at the graduated rates applicable to individuals. At least theoretically, it may have been possible for a taxpayer to establish a testamentary trust to which property could have been contributed after his or her death by someone other than the taxpayer. The testamentary trust so created could then take advantage of the graduated rates of tax. To prevent this perceived abuse, the definition of a testamentary trust was

amended. For taxation years commencing after November 12, 1981, the following trusts are excluded from qualifying as testamentary trusts, thereby being converted into *inter vivos* trusts taxable at the highest tax rate:

- a trust created by a person other than the deceased;
- a trust created after November 12, 1981, if property has been contributed to the trust otherwise than by an individual on or after his death and as a consequence thereof; and
- a trust created before November 13, 1981, if
  - after June 28, 1982, property has been contributed to the trust otherwise than by an individual on or after his death and as a consequence thereof; or
  - the fair market value of property contributed to the trust by someone other than the deceased exceeds the fair market value of property contributed by the deceased on his death.

5.8 Qualifying spousal trusts

5.8.1 Testamentary spousal trusts

By virtue of ss. 70(5)–(5.2) of the *ITA*, taxes may be exigible on the death of a taxpayer owning capital property, depreciable property, eligible capital property, resource properties, and land included in the inventory of a business. Each of these properties is subject to a deemed disposition immediately before death at fair market value.

Where capital property or depreciable property are bequeathed to the deceased's spouse or to a qualifying spousal trust, a deferral of tax is available under s. 70(6) of the *ITA* unless the legal representative voluntarily elects, under s. 70(6.2), not to have the rollover apply. A personal representative might prefer to forego the rollover where, for example, the deceased had not fully utilized his or her lifetime capital gains exemption and it is available to offset some or all of the capital gain triggered or where the deceased had losses from previous years that could absorb any income arising upon a deemed disposition of his or her property at fair market value. The advantage is that, as a result of the legal representative of the deceased electing not to have the rollover apply, the beneficiaries would be considered to have acquired the deceased's property at its fair market value at the time of the deceased's death so that on a subsequent sale by the beneficiaries, they would pay less tax than if they were deemed to have acquired the property at the deceased's original tax cost. It is important to understand that, with very few exceptions, each time the *ITA* deems a disposition to have occurred at a certain value (whether adjusted cost base, undepreciated capital cost, or fair market value), it simultaneously deems the recipient to have acquired the relevant property at the same amount.

The requirements for qualification as a testamentary spousal trust, contained in s. 70(6) of the *ITA*, may be summarized as follows:

- The deceased must have been resident in Canada immediately before death.
- The trust must be resident in Canada immediately after the time the property vested indefeasibly in the trust.
- The spousal trust must be created by the taxpayer's will or by an order of a court made pursuant to dependants' relief legislation.
- The property must have been transferred or distributed on or after death and as a consequence thereof or as a consequence of a disclaimer, release, or surrender by a person who was a beneficiary under the deceased's will or intestacy. Subsection 248(8) expands the meaning of property transferred "as a consequence" of the death of a taxpayer to include a transfer under a will and a transfer as a result of a disclaimer, release, or surrender of a beneficiary under a taxpayer's will.
- The surviving spouse must be entitled to receive all of the income of the trust that arises during his or her lifetime. One problem with this requirement is that while the capital gains of a trust are regarded as "income" for tax purposes, under trust law they are generally treated as "capital," thereby accruing to the capital and not the income beneficiaries. Thus, the accrual by the trust of capital gains to someone other than the spouse would *prima facie* be fatal to the spousal trust qualifying for the rollover. To ensure that this does not become a trap for the unwary, s. 108(3) provides that, for the purpose of this requirement, the income of a trust is to be computed under trust law and without reference to the *ITA*. This means that, so long as the spouse is entitled to receive all amounts that would otherwise be regarded as income for trust accounting purposes, the trust will qualify as a spousal trust. Since the surviving spouse must be entitled to receive all the income of the trust for life, a clause in the will terminating the spouse's entitlement to the income in the event of remarriage will invalidate the trust as a qualifying spousal trust. Also, the trustees should not be permitted to accumulate income or sprinkle it among other beneficiaries.
- No person except the spouse may, during the surviving spouse's lifetime, receive or otherwise obtain the use of any of the income or capital of the trust. These criteria would not be met if, for example, the terms of the spousal trust provide that if the surviving spouse remarries, the trust property then flows to a third party. Such a remarriage clause would prevent the trust from being a qualifying spousal trust.

- The property must vest indefeasibly in the spousal trust within 36 months of the death of the testator.

5.8.2 Inter vivos spousal trusts

Where capital property of a taxpayer is transferred to a qualifying *inter vivos* spousal trust, s. 73(1) of the *ITA* permits the property to be transferred at its adjusted cost base if it is capital property, or its undepreciated capital cost if it is depreciable property of a prescribed class. Subsection 73(1) also permits the transferor to elect in his or her tax return for the year in which the property was transferred not to claim the rollover, in which case s. 69 will apply to deem the transfer or gift to take place at fair market value.

In order to qualify as an *inter vivos* spousal trust, the following requirements must be satisfied:

- Both the transferor and the trust must be resident in Canada when the property is transferred to the trust.
- The spouse must be entitled to receive all of the income of the trust that arises before his or her death.
- During the lifetime of the spouse, no other person may receive or otherwise obtain the use of any of the income or capital of the trust.

5.9 Transfers to a trust

With important exceptions described below, a transfer or gift of property to an *inter vivos* or testamentary trust is a disposition for tax purposes (*ITA*, s. 54). In this respect, the deemed disposition at fair market value rules of s. 69 of the *ITA* should be considered. Property that is acquired by a trust from a person with whom the trust does not deal at arm's length for a consideration exceeding the fair market value of the transferred property is deemed acquired by the trust at its fair market value (*ITA*, s. 69(1)(a)). The CRA generally presumes that the relationship between a settlor and a trust is a non-arm's length one, unless the facts indicate otherwise (CRA, Interpretation Bulletin IT-419R-2, "Meaning of Arm's Length"). Furthermore, s. 251(1) of the *ITA* provides that a taxpayer and a trust are deemed not to deal with each other at arm's length if the taxpayer, or any person not dealing at arm's length with the taxpayer, is beneficially interested in the trust. Where property is disposed of to a trust by a non-arms' length person for proceeds less than fair market value or by way of gift to the trust, there is a deemed realization at fair market value to the transferor. Where a trust acquires property by way of gift, bequest, or inheritance, the trust is regarded as acquiring the property at its fair market value (*ITA*, ss. 69(1)(b)–(c)).

5.9.1 No beneficial ownership change

Any transfer of property by virtue of which there is a change in legal ownership without any change in beneficial ownership is not a disposition (which means that it is not a taxable event) (*ITA*, s. 54).

5.9.2 Testamentary/inter vivos spousal trusts

A transfer of property to a qualifying *inter vivos* or testamentary spousal trust may be accomplished on a tax-free basis with the spousal trust acquiring capital property at the adjusted cost base and depreciable property at the undepreciated capital cost of the transferor (ss. 70(6) and 73).

5.9.3 Alter ego trusts and joint partner trusts — ss. 73(1.01)–(1.02)

A gift of assets to an alter ego trust will qualify for rollover treatment, thereby avoiding the triggering of tax on accrued gains. An alter ego trust is a trust created after 1999 by an individual at least 65 years of age. In an alter ego trust, the individual who gifts property to the trust must be entitled to receive all the income of the trust prior to the death of the individual and must be the only person able to receive income or capital of the trust prior to the death of the individual.

A gift of assets to a joint partner trust will also qualify for rollover treatment thereby avoiding the triggering of tax on accrued gains. A joint partner trust is also a trust created after 1999 by an individual at least 65 years of age. In a joint partner trust, until the death of the surviving spouse, both spouses (in whatever combination) must be entitled to receive all the income of the trust and must be the only persons entitled to receive the income or capital of the trust.

The alter ego and joint partner trusts may, in particular cases, provide a significant estate planning tool for individuals who wish to avoid probate taxes or the public disclosure of assets inherent in the probate process. As is the case with the qualifying spousal trust, the alter ego trust and the joint partner trust contemplate that the trust will provide for contingent beneficiaries who will be entitled to receive income and capital of the trust after the death of the individual or the surviving spouse (as the case may be). The assets in the trust would then effectively bypass probate, provided that the trust constitutes a true *inter vivos* trust.

The use of such trusts does not avoid the deemed disposition of assets on death provisions; the deemed disposition occurs at the same time as it would have occurred if no trust had been established. The alter ego trust is deemed to dispose of its assets on the death of the

individual who established the trust, whereas a joint partner trust is deemed to dispose of its assets on the death of the surviving spouse. Although the deemed disposition on death provisions are not avoided using these trusts, the 21-year deemed disposition of trust property does not apply to these trusts created for those 65 and older.

5.10 Trusts and attribution

Subsections 74.1(1) and 74.2(2) of the *ITA* contain the so-called attribution rules, which are designed to attribute back to the transferor any income or capital gains generated from property transferred at less than fair market value consideration or for no consideration to a spouse of the transferor and to attribute income (but not capital gains) on similar transfers to a non-arm's length minor. The attribution rules apply in similar fashion to loans at less than fair market value interest. The attribution rules do not apply to attribute to the transferor any income or loss or any taxable capital gains or allowable capital losses that relate to a period following the death of the transferor. As a result, these rules are not applicable to the testamentary situation.

Subsections 74.1(1)–(2) specifically refer to trusts and treat the rights of beneficiaries of a trust as property that has been transferred to them. For the purposes of these provisions, the transfer of property is regarded as occurring not between the settlor and the trust as an individual but, rather, through the trust to the beneficiaries. To effect this, s. 74.5(9) deems a loan or transfer to a trust in which a person is beneficially interested to be a loan or transfer to that person. A person is considered beneficially interested in the trust if he or she has a right, immediate or future, absolute or contingent or subject to discretion, to income or capital of the trust. Where an individual loans or transfers property for less than fair market value consideration to a trust of which his or her spouse or a non-arm's length minor is beneficially interested, attribution will apply unless the income is accumulated in the trust and taxed therein. Subsection 74.3(1) sets out the calculation for the amount of trust income that will be subject to attribution for purposes of ss. 74.1–74.2. In general terms, the income or loss that a spouse or non-arm's length minor actually receives from the trust or is deemed to receive from the trust under a preferred beneficiary election in respect of such property and substituted property, is deemed to be received by the individual who made the transfer or loan. Similarly, capital gains and losses that a spouse receives or is deemed to receive from the trust in respect of such property are deemed to be received by the individual who made the transfer or loan.

Where a person contributes property to a trust and that property or substituted property may revert to that person or pass to persons to be determined by him or her subsequently, s. 75(2) of the *ITA* provides that income or capital gains of the trust will be attributed for tax purposes to the settlor. This provision constitutes a significant tax disadvantage in most cases for the use of revocable *inter vivos* trusts. The terms of s. 75(2) are so widely drawn that its effective limits are unclear. For example, it is the CRA's position that s. 75(2) of the *ITA* would apply where an individual creates an irrevocable discretionary trust to which he or she contributes property and such individual is the sole trustee, even though the individual is not included in the predetermined list of discretionary beneficiaries (M.N.R. Administrative Interpretation 9202455 (February 27, 1992)).

5.11 Trust as a taxable entity

Since a trust or estate is deemed by the *ITA* to be an individual for tax purposes, it follows that it will compute its income under Division B of the *ITA* and will be allowed a deduction for all expenses incurred for the purpose of gaining or producing income from its business or property. For example, if a trust or estate borrows money in order to invest in bonds or shares, any interest paid or payable by the trust in respect of the borrowed funds will be deductible in calculating the income of the trust or estate. It should be stressed, however, that the trust or estate, like any ordinary taxpayer, is only permitted a deduction for expenses incurred for the purpose of gaining or producing income from a business or property. Expenditures of a trust or estate that are made in respect of the personal expenses of the beneficiaries are not deductible. Where a trust or estate suffers a business or property loss, the loss cannot be transferred to the beneficiaries. Instead, the normal rules for carrying such losses backward or forward apply to the trust or estate.

It should be noted that s. 122(1.1) of the *ITA* provides that *inter vivos* and testamentary trusts cannot claim the personal tax credits available to individuals.

Where a trust or estate is resident in Canada, it will be taxed on its income for a taxation year from all sources, whether inside or outside Canada, except to any of the following extents:

- Its income for the taxation year is actually paid to its beneficiaries.
- Its income is payable (although not actually paid) to its beneficiaries (s. 104(24) provides that an amount is considered to be payable when the beneficiary is entitled to enforce payment thereof) (Interpretation Bulletin IT-286R2, "Trusts—Amount Payable").

- "Preferred beneficiaries" elect to assume the tax liability for their share of the trust's income even though the income remains in the trust.
- A taxable benefit (other than a distribution or payment of capital) is conferred by the trust on its beneficiaries because the trust or estate paid for the upkeep, maintenance, or taxes on property used by the beneficiary.

These four amounts are treated as deductions from the income of a trust and are required to be included in the income of the beneficiaries concerned.

The definition of "preferred beneficiary" in s. 108(1) of the *ITA* is important in determining whether any beneficiary may make a preferred beneficiary election so as to include his or her share of the accumulating income of the trust in his or her income and permit the trust to deduct such amount when computing the trust's taxable income. A preferred beneficiary is a beneficiary resident in Canada who is

- the settlor of the trust;
- the spouse or former spouse of the settlor;
- a child, grandchild, or great grandchild of the settlor or the spouse of any such person; and
- an individual eligible for a disability tax credit or an adult beneficiary for whom a dependant tax credit can be claimed by another individual because of the beneficiary's mental or physical infirmity.

5.12 Taxation of beneficiaries

5.12.1 Income paid or payable to beneficiaries

The income of a trust or estate that is paid or payable to a beneficiary is taxed in the hands of that beneficiary (*ITA*, s. 104(13)). To ensure that it is not taxed on the same income, the trust or estate is allowed a deduction for an equivalent amount. An amount is considered to be payable to a beneficiary when the beneficiary is entitled in that year to enforce payment thereof (*ITA*, s. 104(24)). Where the trust is not a discretionary trust and the only reason that income is not payable to a beneficiary is that the beneficiary has not attained the age of 21, s. 104(18) states that the income is to be considered payable to the minor, thereby allowing a deduction to the trust and an income inclusion to the minor. Accordingly, a beneficiary will be required to pay tax on trust income that is not actually received so long as he or she has a legally enforceable right to the income. The beneficiary should not, of course, be taxed when he or she actually receives income that has already been notionally included in income because it was payable to him or her. To accomplish this, s. 104(13) provides that this income can be subsequently paid to the beneficiary tax free.

Where an amount is included in a beneficiary's income because it was paid or was payable by the trust or estate, the CRA considers the beneficiary to have earned the income on the last day of the taxation year of the trust (See s. 104(23) of the *ITA* and Interpretation Bulletin IT-342R, "Trusts—Income Payable to Beneficiaries"). For example, assume that a testamentary trust has a taxation year ending on January 31. On March 1, 2003, the testamentary trust pays the beneficiary $10,000 of trust income. The beneficiary will include the payment in his or her 2004 taxation year and report the income on his or her 2004 personal tax return that must be filed on or before April 30, 2005. The choice of a non-calendar year by a testamentary trust may result in a deferral of the beneficiary's tax liability for amounts paid or payable to him or her.

A distinction must be made between capital and income transactions of a trust. Most trusts distinguish between beneficiaries who are entitled to distributions from the capital of the trust and those who are entitled to distributions from the income of the trust. Income for trust purposes does not generally include capital gains; however, net income for tax purposes includes taxable capital gains. A situation can and often does arise in which a trust has separate capital and income beneficiaries and is required to pay the income out every year. As income for trust purposes does not normally include capital gains, the taxable portion of the capital gains cannot be paid out to the income beneficiaries and must remain behind to be taxed in the trust unless a preferred beneficiary election is made.

5.12.2 Subsection 104(13) designations

A trust can choose to retain income in the trust rather than report it in the hands of beneficiaries. The trust must be resident in Canada throughout the year, and this designation option applies only to income paid or payable to beneficiaries. The choice of retaining income in the trust for tax purposes is authorized by s. 104(13.1) of the *ITA* and is commonly referred to as a "104(13.1) designation." The designated amount is not deductible by the trust and is not taxable to the beneficiary. If taxable capital gains are included in the income to be kept in the trust, a similar designation can be made under s. 104(13.2). The beneficiary's taxable capital gains are reduced by the beneficiary's proportionate share of taxable capital gains retained in the trust.

There is no provision in the *ITA* to permit net capital losses of a trust to be passed through to the beneficiary. As a result, there is potential for such losses to be wasted. The s. 104(13.2) designation provides an opportunity to absorb these losses in the trust by allowing the trustee to deduct under s. 104(6) less than the full amount of

taxable capital gains that are payable to the beneficiaries. The undeducted capital gains are included in the trust's income, and the allowable capital loss or net capital loss carryforward can be used to offset such gains. The s. 104(13.2) designation deems taxable capital gains otherwise included in the beneficiaries' income under s. 104(21) not to be payable to the beneficiary.

5.13 21-year deemed disposition of trust property

5.13.1 General principles

Section 104 of the *ITA* prevents a trust from holding property for an indefinite period, thereby deferring the taxation of capital gains and recapture. Generally, subject to the exceptions described below, there is a deemed disposition and reacquisition by the trust of capital property every 21 years for notional proceeds equal to fair market value. Where the property owned by the trust has appreciated in value, consideration should therefore be given to distributing the trust property to the beneficiaries before the 21-year period has elapsed. Generally, this can be accomplished on a tax-free basis if the trust is a personal trust. The first deemed realization occurs 21 years after the creation of the trust, although trusts in existence on January 1, 1972, will have their first realization 21 years after such date.

In order to avoid the 21-year deemed disposition rules, the trust instrument should ensure that the trust assets can be distributed out to the beneficiaries before the 21-year realization, and generally, the roll out can be accomplished on a tax-deferred basis, provided the trust qualifies as a "personal trust" as described below.

A "personal trust" is defined in s. 248(1) of the *ITA* to mean

- a testamentary trust; or
- an *inter vivos* trust, no beneficial interest in which was acquired for consideration payable directly or indirectly to
  - the trust; or
  - any person who has made a contribution to the trust.

A trust that is not a personal trust is known informally as a "commercial trust."

5.13.2 Testamentary/inter vivos spousal trusts

Certain spousal trusts, however, may be deemed to dispose of their property at the date of the spouse's death. These spousal trusts must satisfy the basic requirements of a spousal trust, in that the spouse must be entitled to receive all of the income of the trust arising during his or her lifetime and no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust. In addition, these trusts must be created in either of the following ways:

- by the will of a taxpayer who died after December 31, 1971; or
- by a taxpayer during his lifetime (other than a pre-June 18, 1971, *inter vivos* trust taxed at the graduated rates applicable to individuals).

5.14 Henson trust

A "Henson trust" is the term often used to describe a discretionary trust designed to benefit a disabled individual in such a manner as to protect that disabled individual's entitlement to collect means-tested government benefits, such as benefits payable under the Ontario Disability Support Program. The important aspect of a Henson trust is that the trustees must have absolute discretion with respect to the allocation of income and capital to the disabled beneficiary (there may be several discretionary beneficiaries that include the disabled individual) so that the assets in the trust and income generated from the trust investments cannot be said to have vested in the disabled beneficiary. A properly drafted Henson trust will ensure that assets in the trust are not considered assets of the disabled individual for purposes of determining his or her eligibility for government means-tested disability support programs. The term "Henson trust" arises from a 1989 Ontario case that dealt with the issue (*Ontario (Director of Income Maintenance, Minister of Community & Social Services) v. Henson)*.

Chapter 38

The impact of the Family Law Act on estate administration

1. Introduction

With the enactment of Ontario's *Family Law Act* (*FLA*) in 1986, the administration of estates became vastly more complicated than it was formerly. Prior to its enactment, the lawyer was able to advise an estate trustee that the only statutory claim that could interfere with the testate or intestate distribution of the deceased's assets was one brought by a "dependant" under Part V of the *Succession Law Reform Act* (*SLRA*) on the grounds that the deceased had not made "adequate provision" for the claimant. With the passage of the *FLA*, the estate trustee must now also be concerned with a potential property claim by a surviving married spouse.

2. Definition of net family property (NFP)

In order to understand the nature of the surviving spouse's claim and how it affects the estate trustee's responsibilities and authority, one must have a solid grasp of the rules in Part I of the *FLA*. The key concept underlying those rules is that of "net family property" (NFP). NFP is defined in s. 4(1) of the *FLA*. Essentially, the NFP of a spouse is intended to be a measure of his or her increase in net worth during the marital relationship. Each spouse calculates his or her net worth as at the "valuation date" and also as at the date of marriage. The difference (which cannot be less than zero) is that spouse's NFP.

This description is, however, an over-simplification for several reasons:

- Certain property owned by a spouse on the valuation date does not form part of the calculation. Property falling into one of these categories has come to be referred to as "excluded property," although the term is rather misleading as it suggests that the property itself is somehow immune from any court order.
- The matrimonial home is accorded special treatment in calculating NFP. While the value of all other property owned by a spouse at the date of marriage constitutes a credit on the spouse's opening balance, the full value of a matrimonial home owned by that spouse at the date of marriage must be included in calculating his or her NFP if it is still a matrimonial home at the date of separation.
- By virtue of an expanded definition of "property" in s. 4(1) of the statute, certain categories of property that would not otherwise be thought of as being owned by a spouse are treated, for purposes of Part I of the *FLA*, as if they are in fact owned by the spouse. For example where a spouse is a trustee, either alone or with another person, of a trust that authorizes the trustee(s) to make distributions of trust capital to that spouse, the value of the trust property is treated as if he or she owned it. (However, even though property may be deemed to be owned by a spouse, it may still fall into the category of "excluded property.")

3. Exclusions from NFP

As noted above, certain property, despite being owned by a spouse on the valuation date, is—by its nature or its source—not included in calculating the spouse's NFP. The categories of so-called "excluded property" are described in s. 4(2) of the *FLA*.

The onus of proving entitlement to an exclusion rests with the person claiming it. Accordingly, it will be essential to maintain accurate and thorough records of the source of property and, where applicable, the transformation(s) it may have undergone between original receipt and valuation date. This may be problematic for the personal representative of the deceased spouse. However, the information gathering exercise will be aided by the statutory requirement that each party to an application under s. 7 of the *FLA* provide the other with the financial information necessary to permit calculation of NFP.

4. Valuation date

"Valuation date" is defined in s. 4(1) to mean the earliest of the following dates:

- the date the spouses separate and there is no reasonable prospect that they will resume cohabitation;
- the date a divorce is granted;
- the date the marriage is declared a nullity;
- the date one of the spouses commences an application based on s. 5(3) (improvident depletion) that is subsequently granted; and
- the date before the date on which one of the spouses dies, leaving the other spouse surviving.

Several comments are in order here:

- The valuation date in the case of the death of one spouse is not necessarily the day before that spouse's death. If, for example, the spouses have separated prior to the spouse's death, the valuation

date will be the date of separation. (For ease of reference, however, it will be assumed that the valuation date is the day before the deceased spouse's death, unless the context of the discussion indicates otherwise.)

- If both spouses die simultaneously, neither spouse's estate will have a claim against the estate of the other, since there will be no surviving spouse. Where both spouses die in circumstances rendering it uncertain which survived the other, neither of the spouses' respective personal representatives will be able to discharge the burden of establishing entitlement to an equalization claim (to be defined below).
- There is at least one reason why the drafters chose the day before the date of death rather than the date of death. There was a concern that if the date of death were specified, the value of a deceased spouse's interest in property owned in joint tenancy with a third party would, by virtue of the third party's right of survivorship, be excluded from the deceased spouse's NFP. This concern over the economic "windfall" to the surviving spouse has been alleviated for two reasons:
  - As noted below, the *Family Statute Law Amendment Act, 2009* (*FSLAA*) has expanded the obligation of the surviving spouse to set off against his or her equalization entitlement the value of property acquired on the death of the deceased spouse by right of survivorship.
  - In its 2010 decision in *Ranking (Litigation Guardian) v. Ranking Estate*, the Ontario Court of Appeal has declared that the surviving spouse's set-off obligation for property held between the spouses as joint tenants was always a part of the *FLA*.

  (The choice of the day before death is not without its own problems, as will be discussed later in this chapter.)
- With the valuation date being the day before the deceased spouse's death, proceeds of any insurance policy on his or her life will not yet be payable. Accordingly, even though any cash surrender value attributable to the policies on the day before the insured spouse's death will be included in the owner spouse's NFP, the policy proceeds would not appear to be included in the NFP calculation of either spouse. (Some elaboration on this latter point appears at "Life insurance on the deceased spouse's life," below.)

5. The equalization claim

Only deaths on or after March 1, 1986, will give rise to a right in the surviving spouse to make an equalization claim (*FLA*, s. 70(1)(b)). Subsection 5(2) of the *FLA* provides that when a spouse dies, if the NFP of the deceased spouse exceeds the NFP of the surviving spouse, the latter is entitled to one-half the difference between them. The court may award an amount that is more or less than one-half that difference if, having regard to six factors enumerated in s. 5(6), it would be unconscionable to do otherwise

Earlier jurisprudence from Ontario's appellate court suggested that the courts could do no more than award 100% of the difference in the parties NFPs to the spouse with the lower NFP. However, in the 2007 decision in *Von Czieslik v. Ayuso*, a different panel of Ontario's appellate justices held that a court has the authority to award an amount up to 100% of the value of the NFP of the spouse who has the higher NFP to the spouse with the lower NFP.

Unlike the entitlement under s. 5(1) or (3), the entitlement under s. 5(2) is "one-way" only. That is to say, if the surviving spouse has the larger NFP, the deceased spouse's estate will have no claim against the surviving spouse. However, the surviving spouse may be obliged to repay the estate any "overpayment" he or she receives in the form of insurance proceeds or lump-sum payments from a pension or similar plan. This "set-off" or "credit" mechanism has been expanded pursuant to the *FSLAA* to include "property or a portion of property to which the surviving spouse becomes entitled by right of survivorship or otherwise on the death of the deceased spouse."

6. Elections

Unless the deceased spouse's will expressly provides that the surviving spouse can have his or her entitlement under the will in addition to his or her entitlement under s. 5(2), the surviving spouse is put to an election. He or she may claim either the entitlement under the will or an equalization payment, but not both (*FLA*, s. 6(1)). Similarly, where there is no will, the surviving spouse must choose between the entitlement according to the *SLRA* and the equalization claim (*FLA*, s. 6(2)). Finally, on a partial intestacy, the choice must be made between entitlement under the will and the provincial intestacy rules on the one hand, and the equalization claim on the other hand (*FLA*, s. 6(3)).

6.1 How, when, and where is the election filed

The election must be filed within six months of the death of the deceased spouse (*FLA*, s. 6(10)), unless an application is granted for an order to extend the time to file (*FLA*, s. 2(8)). The election must be in the prescribed form and must be filed at the office of the Estate Registrar for Ontario in Toronto (*FLA*, s. 6(10)). This office should be distinguished from that of the Superior Court of Justice for the geographical area in which the deceased spouse was domiciled at the date of death. If

the surviving spouse fails to file the election within the six-month period, he or she is deemed to have elected to take under the will or under the *SLRA* or both, as the case may be, unless the court, on application, orders otherwise (*FLA*, s. 6(11)).

6.2 Who can make the election?

There is case law holding that a validly executed and subsisting continuing power of attorney will entitle the named attorney to file the election on behalf of the surviving spouse as grantor of the power. The Public Guardian and Trustee who acts as statutory guardian of property of a surviving spouse pursuant to a certificate issued under s. 54(4) the *Mental Health Act* would appear to have the necessary authority to make the election, as would a mentally incompetent surviving spouse's guardian of property appointed under s. 15(k) of the old *Mental Incompetency Act*. The *Substitute Decisions Act, 1992* creates two new types of surrogate: a "statutory guardian of property" and a "court-appointed guardian of property." It would appear that, in principle, either of these surrogates would have the authority to elect on behalf of a surviving spouse, subject to any restrictions imposed either by the surviving spouse in the relevant empowering document or by court order.

What about the personal representative(s) of the surviving spouse who dies within the six-month limitation period without having elected? Can the personal representative(s) file an election and make application for an equalization payment? The answer appears to be no. (See *Rondberg Estate v. Rondberg Estate*.)

For the time being, it remains an open question as to whether a trustee-in-bankruptcy has the power to elect on behalf of a bankrupt surviving spouse. It is likely just a matter of time before this issue is litigated.

6.3 Can the election be revoked?

There is nothing in the *FLA* to suggest that an election, once filed with the office of the Estate Registrar for Ontario, is revocable. There are several conflicting decisions on the point. The most recent one is *Iasenza v. Iasenza Estate*, which held that the court has a residual discretion to authorize revocation of an election in restrictive circumstances where the interests of justice so require and where it is warranted by a balancing of interests of the affected parties. Nonetheless, until the issue is clarified by an appellate court, prudence would dictate that if one is acting for a surviving spouse, the election, once filed, ought to be treated as irrevocable. On that basis, a surviving spouse should make every effort to determine his or her entitlement under the *FLA* prior to making a decision as to which way to elect. Of course, where the surviving spouse would receive the whole of the deceased spouse's estate, whether according to the will or the intestacy rules, there is obviously no point in electing in favour of an equalization claim.

It will be important for the surviving spouse to establish his or her entitlements arising on the death of the deceased spouse, including (i) certain insurance proceeds; (ii) survivorship benefits under pension plans and similar plans; and (iii) entitlements arising by right of survivorship or otherwise. As will be explained below, a spouse electing in favour of an equalization claim could lose these benefits, along with entitlement under the will or on intestacy.

A caution should also be given to the surviving spouse who makes his or her decision on the basis of a will in respect of which no certificate of appointment of estate trustee with a will has been issued. If ultimately the will being propounded is found to be invalid, the surviving spouse may well find that the election should have been made the other way. The prudent course of action would be to defer the filing of the election until after the certificate of appointment of estate trustee with a will has been issued. Where there is difficulty in locating a will or there is litigation over the validity of a will, it would be appropriate to apply for an extension of time for filing the election beyond the six-month period following the deceased spouse's death (*FLA*, s. 2(8)).

Of course, there will be instances where a certificate of appointment of estate trustee with a will (formerly "letters probate") is issued and a later will surfaces after the election is filed. Similarly, there will be instances where a will is found after a certificate of appointment of estate trustee without a will (formerly "letters of administration") is issued. In such instances, there will be problems in determining the rights of the surviving spouse who has already filed an election and who wishes to change his or her mind on the basis of the subsequently discovered will.

As noted earlier, where a spouse files no election within the statutory six-month period, the *FLA* deems him or her to have elected to take under the will or on intestacy, as the case may be, unless the court, on application, orders otherwise (*FLA*, s. 6(11)). In this instance at least, the court will have jurisdiction to reverse the (deemed) election, although it must be left to future jurisprudence to establish the bounds within which that discretion will be exercised.

7. Effect of election

7.1 Electing under the will or on intestacy

If the surviving spouse elects, or is deemed to have elected, to take under the will or on intestacy, as the case may be, his or her entitlement arising on the death of the deceased spouse will be unaffected (*FLA*, s. 6(4)). In addition to benefits under the will or on intestacy, a surviving spouse will receive all insurance proceeds from policies on the deceased's life naming him or her as beneficiary, as well as any death or survivorship benefits under pension plans or similar plans in which he or she is so named (*FLA*, s. 6(4)). Furthermore, the right of survivorship associated with any property jointly owned by the spouses will be operative in the normal manner (*FLA*, s. 6(4)).

7.2 Electing to make an equalization claim

Things change dramatically if the surviving spouse elects to take under the *FLA*. Unless the deceased spouse has otherwise expressly indicated in a written designation, will, or other written instrument that the benefits under the will are in addition to those available under s. 5(2) of the *FLA*, an election to take under the *FLA* will result in the following:

- the forfeiture by the surviving spouse of all entitlement under the will; and
- the interpretation of the will as if the surviving spouse had predeceased the testator (*FLA*, s. 6(8)).

7.2.1 Effect on executorship

Suppose the deceased spouse's will appoints the surviving spouse as executor, whether alone or together with another or others. As just noted, the surviving spouse's election in favour of an equalization claim results in the will being interpreted as if he or she had predeceased the testator. Until a few years ago, the effect of that election on the surviving spouse's appointment as estate trustee was uncertain. On the one hand, giving s. 6(8) a plain reading would suggest that the surviving spouse could not take the appointment since he or she would be considered to have predeceased the testator for all purposes of the will. The contrary argument is made by contrasting the wording of this provision with that of s. 17(2) of the *SLRA*. The latter provision describes the impact of the dissolution of the testator's marriage after the date of the will. Like s. 6(8) of the *FLA*, s. 17(2) also states that, absent a contrary intention contained in the will, the will is to be construed as if the former spouse had predeceased the testator. However, it goes on to provide expressly that the surviving spouse's appointment as executor is revoked. Since no such language is contained in s. 6(8) of the *FLA*, it may be argued that the surviving spouse who elects in favour of equalization may continue to act as executor.

Somewhat surprisingly, this issue, although recognized almost immediately after the enactment of the *FLA*, took almost 13 years to be settled by jurisprudence. In the case of *Reid Martin v. Reid*, it was held that s. 6(8) of the *FLA* should be given its plain meaning, with the result that the surviving spouse who, on the facts, had elected in favour of equalization could not act as executor. The contrary argument set out above was expressly addressed but rejected. However, in answering one question, the *Reid Martin* decision has raised other practice issues that must be addressed.

First, can one draft around s. 6(8) if the client wishes to see his or her spouse retain the office of executor in the face of an equalization claim, even though he or she forfeits the other will entitlements? Can one, for example, simply state that the surviving spouse's appointment is to be effective whether or not he or she elects in favour of an equalization claim? Subsection 6(8) provides only one way around its application. As noted above, the will must provide that the surviving spouse is to receive his or her entitlements under the will in addition to the entitlement under s. 5(2) of the *FLA*. Thus, in order to preserve the surviving spouse's right to act as an executor, but not his or her entitlement to any bequests under the will, one must make any such bequests expressly conditional upon the surviving spouse's election in favour of equalization, while also providing that such bequests are to be in addition to the equalization entitlement!

Second, how does one address the issue of forfeiture of office by the surviving spouse as a matter of estate administration? Because of s. 17(2) of the *SLRA*, the application for a certificate of appointment asks whether the testator was divorced after the date of the will. As a result of the *Reid Martin* decision, the application form was amended, with effect from March 1, 2000, to ask also whether the applicant has elected in favour of equalization.

Of course, that will not deal with the case where the surviving spouse applies for a certificate before deciding whether to elect in favour of an equalization claim. This should not be thought of as being merely of theoretical concern. Consider the following example. A wife makes her will under which her husband is appointed as one of three executors and under which he is given a life interest in the residuary estate (with the remainder interest to be held in trust for the children of the marriage). A week before her sudden death, the wife entered into an agreement for the sale of a condominium apartment, with closing scheduled for a date that is six weeks after her death. At her death, the wife owned all the shares of a

corporation that carried on a worldwide business. Calculation of the wife's NFP requires putting a value on her shares, but a proper valuation of the corporation cannot be completed until well after the closing date for the sale of the condominium. Yet the sale of the condominium cannot conclude without the executors' procuring a certificate of appointment.

As a result, a further practice issue must be addressed. By what procedure does one seek revocation of the testamentary grant to the surviving spouse who subsequently elects in favour of equalization? Since that election disentitles the surviving spouse to act as estate trustee, it would seem appropriate that someone—a co-executor, an alternate executor, or if neither is named, anyone who wishes to obtain a certificate of appointment of estate trustee—make an application to have the surviving spouse removed as estate trustee pursuant to the mechanism set out in s. 37 of the *Trustee Act*.

7.2.2 Effect on intestacy

Where there is an intestacy, either partial or total, the election in favour of an equalization claim will result in the surviving spouse's forfeiture of his or her entitlement under Part II of the *SLRA* (*FLA*, s. 6(9)). On a partial intestacy, even if the will of the deceased spouse provides that the benefits under the will are to be in addition to the surviving spouse's equalization claim, that statement would not appear to avoid the latter's forfeiture of entitlement under Part II of the *SLRA*. Note that on an intestacy, the *SLRA* does not necessarily govern a surviving spouse's entitlement to property situated outside Ontario. The law of the *situs* governs succession to immovable property as dictated by conflict of laws rules. Accordingly, unless the laws of the jurisdiction in which immovable property is situate require that Ontario law be applied, the surviving spouse who elects in favour of an equalization claim may nonetheless be able to claim certain assets located outside Ontario. This is clearly an unfair and probably unintended result since the NFP of the deceased spouse is calculated on the basis of his or her worldwide assets. (As will be observed below, this unfairness may have been eliminated as a result of amendments to the *FLA* effected by the *FSLAA*.)

7.2.3 Effect on dependant's relief claims

The surviving spouse who elects to make an equalization claim does not forfeit any entitlement under Part V of the *SLRA* (dependant's relief provisions). It is, of course, to be expected that any claim for support under Part V of the *SLRA* will be heard after the equalization claim is settled. It is interesting to note the interrelationship between Part V of the *SLRA* and Part I of the *FLA*. Section 58 of the *SLRA* requires, as a pre-condition of a dependant's entitlement to support, that the deceased spouse, whether dying testate or intestate, not have made adequate provision for the dependant.

Consider, for example, a deceased spouse who has bequeathed a life interest in the whole of his or her estate to the surviving spouse. The surviving spouse has opted for an equalization payment, with the result that he or she receives nothing under the will. In such a case, where the surviving spouse has, by his or her own hand, forfeited the life interest, can it fairly be said that the deceased spouse did not make adequate provision for the surviving spouse?

Of course, this issue may not be significant where the surviving spouse's equalization claim is substantially in excess of his or her entitlement under the will. In such instance, once the equalization payment is determined, it is unlikely that a court would find it necessary to make any award under Part V of the *SLRA*. However, where a surviving spouse's election to make an equalization claim turns out to be a serious mistake, the Part V claim could be contested on this basis. On the other hand, s. 58(4) of the *SLRA* states:

> The adequacy of provision for support . . . shall be determined as of the date of hearing of the application.

This would suggest that the court determination will proceed just as if the surviving spouse had been left nothing under the deceased spouse's will.

7.2.4 Effect on insurance, pension, or similar plan benefits and other entitlements arising on the death of the spouse

The election to make an equalization claim will result in other adverse consequences to the surviving spouse. Unless the deceased spouse has otherwise designated in writing, such an election will require the surviving spouse to set off against the equalization claim

- any benefits to which he or she is entitled as a named beneficiary of the proceeds of any policy of insurance owned by the deceased spouse on his or her life, as well as the proceeds of any group policy under which the deceased spouse is a member;
- any benefits to which he or she is entitled as a named beneficiary of a lump-sum payment provided for under a pension or similar plan on the death of the deceased spouse (*FLA*, s. 6(6)); and
- the value of any property or a portion of any property to which he or she becomes entitled by right of survivorship or otherwise on the death of the deceased spouse.

Broadly speaking, the set-off obligations are intended to prevent certain "windfalls" to the surviving spouse that would otherwise accrue to him or her because they arise

after the valuation date and would thereby be excluded from the calculation of his or her net family property.

While the *FSLAA* has clearly eliminated the windfall formerly available as a result of property owned by the spouses as joint tenants, it remains to be seen how broadly the courts will cast the net created by the words "or otherwise on the death of the deceased spouse."

One clue as to how those words will be judicially construed can be found in newly amended s. 6(7). That provision refers to "entitlement to the property or portion of property [that] was established by or on behalf of a third person." Evidently, the surviving spouse may have to account for entitlements to which the deceased spouse was never entitled and over which he or she never had any control.

Consider the following scenario. The deceased spouse and his or her parent die in a common accident. The parent's will leaves his or her entire estate to the deceased spouse, but the will was drafted so that the anti-lapse provision of the *SLRA* is engaged. The deceased spouse has no surviving children. In that case, the surviving spouse would become entitled to the parent's entire estate. Unless the parent or the deceased spouse has provided otherwise, either by a will or by some other written instrument, the surviving spouse must set off against the equalization claim the value of the parent's estate to which he or she became entitled under s. 31 of the *SLRA*.

Furthermore, a plain reading of the words "or otherwise on the death of the deceased spouse" would lead one to the following conclusions:

- All of the previously existing categories of property required to be set off against the surviving spouse's equalization claim may now be redundant.
- In the case of an individually owned insurance contract on the life of the deceased spouse, ownership of the contract may now be irrelevant.
- RRSP and RRIF money payable to a surviving spouse may have to be set off against the equalization claim, whether or not they could be said to be "similar" to a pension plan.
- Although a surviving spouse who elects in favour of equalization does not forfeit any intestate entitlements arising as a consequence of the application of "foreign" laws, he or she may nonetheless be required to set off those entitlements against the equalization claim.
- The surviving spouse may now be required to account for survivor pension benefits paid on a periodic basis (likely through a present-value exercise to achieve a single figure).

If such benefits have already been received by the surviving spouse and are, in the aggregate, in excess of the equalization claim as finally determined, the estate of the deceased spouse may sue for the repayment of the excess (*FLA*, s. 6(7)).

8. Priority of equalization claim

The equalization claim has priority over

- gifts made under the will, unless made for valuable consideration;
- a person's right to a share of the estate under Part II of the *SLRA*; and
- orders made against the estate under Part V of the *SLRA*, except orders in favour of a child of the deceased spouse (*FLA*, s. 6(12)).

Gifts under a will that have been made in accordance with a contract entered into by the deceased spouse in good faith and for valuable consideration will take priority over the equalization claim, except to the extent that the value of the gift, in the court's opinion, exceeds the consideration (*FLA*, s. 6(13)). While the value of the gift would appear to be determined at the time of the deceased spouse's death, it would seem more appropriate for a court to value the consideration as of the time the bargain was made.

Although the computation of the surviving spouse's claim requires the deduction of the debts and liabilities of the deceased spouse at the valuation date (one day before death), the equalization claim does not necessarily stand behind all of those debts and liabilities. Presumably, the claim ranks behind those of any secured creditors and those that are preferred by law. Where it stands in relation to the claims of unsecured creditors is uncertain.

9. Restrictions on distribution of estate

When a spouse dies, no distributions can be made out of the estate during the six-month period immediately following the deceased spouse's death without

- the surviving spouse's written consent; or
- court authorization (*FLA*, s. 6(14)).

Where the personal representative receives notice that an application has been made under Part I of the *FLA*, no distributions can be made out of the estate without

- the applicant's written consent; or
- court authorization (*FLA*, s. 6(15)).

Reasonable advances to dependants of the deceased spouse for their support are permitted, notwithstanding the prohibitions referred to above (*FLA*, s. 6(17)).

Where the court extends the time for a spouse's application based on s. 5(2), any property distributed by

the personal representative before the date of the order and without notice of the application is not brought into the calculation of the deceased spouse's NFP (*FLA*, s. 6(16)).

The precise meaning of not bringing such property into the calculation of the deceased spouse's NFP is unclear. Does it, in effect, create an additional category of excluded property? Does it have an impact on the order of distribution of assets out of the estate after the six-month prohibition expires?

Furthermore, does this provision put an onus on the personal representative to make distributions as soon as possible after the expiry of the moratorium? It is arguable that this provision has shortened the executor's year to only six months. After all, if the surviving spouse fails to elect and bring an application under s. 7 within the six-month period, any distributions (out of non-excluded property) will decrease the amount of the equalization claim to the advantage of the beneficiaries under the will, if any, or the rightful heirs on an intestacy. If all other legal obligations have been fulfilled, it may well be that the personal representative would be liable for failing to make a speedy distribution as soon as possible after the expiry of the six-month prohibition period in order to reduce the value of the equalization claim by the surviving spouse.

The surviving spouse's filed election to make an equalization claim does not constitute constructive notice to the personal representative, who is under no obligation to inform himself or herself of the election. Accordingly, a surviving spouse must block distributions by the personal representative and bring an application under s. 7 on or before the expiry of the statutory six-month period or apply for a court order to suspend administration of the estate (*FLA*, s. 6(20)). The latter step will be appropriate where the surviving spouse requires more time to decide whether to make an equalization claim.

10. Liability of personal representative

A personal representative who makes distributions out of the estate in contravention of the *FLA* provisions referred to above will be liable, up to the amount distributed in breach, for the amount of any shortfall in the estate assets available to satisfy the equalization claim (*FLA*, s. 6(19)).

The personal representative may be tempted to ignore the six-month moratorium on distributions out of the estate in two separate situations:

- The surviving spouse has entered into a domestic contract with the deceased spouse, waiving his or her right to make an equalization claim.
- The will leaves the deceased spouse's entire estate to the surviving spouse, or the benefits to the surviving spouse under the will are stated to be in addition to his or her rights under s. 5 of the *FLA*.

However, the following caveats are offered to the personal representative with respect to the scenarios noted above:

- The domestic contract may be set aside under one or more criteria set out in the *FLA* (ss. 55(1) and 56(4)).
- The will may be found to be invalid (for example, on the basis of mental incapacity of the testator, undue influence, or the failure to observe the formalities of execution).

11. Exchange of financial information

On an application under s. 7 of the *FLA*, each party is required to serve on the other and file with the court a statement, verified by oath or statutory declaration, disclosing particulars of debts and liabilities as of

- the date of marriage;
- the valuation date; and
- the date of the statement.

Also, any exclusions or deductions claimed in calculating NFP must be particularized. Finally, information respecting dispositions of property during the two years preceding the making of the statement or during marriage, whichever period is shorter, is required (*FLA*, s. 8).

With respect to the last-mentioned requirement, there are no clawback provisions in the *FLA*. Once property has been disposed of prior to the valuation date, there is nothing in the *FLA* that permits tracing of the property into the hands of third parties. This does not preclude the court's finding that the apparent disposition is a mere sham and the third party is simply holding the property as a bare trustee for the disposing spouse. Moreover, in *Stone v. Stone*, the Ontario Court of Appeal declared that the transfer of property by a spouse for the purpose of defeating an equalization claim arising after his or her death is at risk of being set aside under Ontario's *Fraudulent Conveyances Act*.

Where a transaction is legally effective to transfer beneficial ownership to the third party and cannot be undone as a fraudulent conveyance, the only remedy a court would appear to have is an order for unequal division of NFP. (As alluded to earlier, the Ontario Court of Appeal declared in *Von Czieslik v. Ayuso* that a court has the authority to award an amount up to 100% of the value of the NFP of the spouse who has the higher NFP to the spouse with the lower NFP.)

12. Court orders

The court's powers to enforce the equalization order are extensive (*FLA*, s. 9). The court may order

- money to be paid;
- security to be given;
- payment to be deferred for, or made in instalments over, a period of up to 10 years;
- transfer of property *in specie*; or
- partition and sale of property.

Where deferred or instalment payments are ordered, subsequent variation orders are permitted where the court is satisfied there has been a material change in the circumstances of the paying spouse (but the amount of the equalization payment previously determined cannot be varied) (*FLA*, s. 9(3)).

The court is directed to avoid orders that would require or result in the sale of an operating business or farm or that would seriously impair its operation, unless there is no reasonable alternative method for satisfying the award (*FLA*, s. 11(1)). To comply with this directive, the court may

- order that one spouse pay to the other a share of the profits from the business or farm; or
- for an incorporated business or farm, order that one spouse transfer or cause the corporation to issue from the treasury to the other spouse shares in the corporation (*FLA*, s. 11(2)).

An order against a spouse to issue treasury shares from the corporation in satisfaction of the other spouse's equalization claim is fraught with difficulties:

- Most corporate law statutes require that treasury shares be issued only for money or past services. In this case, the corporation is not receiving anything for the treasury shares ordered to be issued.
- The paying spouse may not have the authority to issue shares from the treasury without the consent of the other shareholders.
- Even if the shareholder has sufficient votes to authorize the issuance of treasury shares (assuming he or she is not otherwise restricted by a shareholders' agreement), any other shareholder will see the value of his or her shareholdings diluted.
- Similarly, where shares have been pledged to a third party, the value of that security will be diminished.
- Adverse income tax consequences may arise by virtue of such an order.

The court may restrain a spouse from depleting his or her property and may make orders for the possession, delivering up, safekeeping, and preservation of the property (*FLA*, s. 12).

13. The matrimonial home

Special provisions are made for matrimonial homes on the death of an owner spouse. First, where a matrimonial home is owned by a spouse in joint tenancy with a third party, the joint tenancy is deemed to have been severed immediately before death (*FLA*, s. 26(1)). This treatment is to be contrasted with that accorded to all other property owned in joint tenancy, which passes to the surviving joint tenant(s) by operation of law.

The deemed severance provision ensures that a one-half interest in the matrimonial home will remain in the deceased spouse's estate to satisfy the equalization claim of the surviving spouse. Note, however, that this provision is contained in Part II of the *FLA* (the matrimonial home) and not in Part I (family property). Apparently, the primary intent of the deemed severance is to preserve the surviving spouse's right to retain possession of the matrimonial home against the deceased spouse's estate, rent-free, for a 60-day period following the death of the deceased spouse, as provided in s. 26(2). Were there no deemed severance, the estate of the deceased spouse would hold no remaining interest against which the right to retain possession could be asserted.

The deemed severance operates automatically, even if the surviving spouse elects to take under the will or on intestacy, as the case may be. It seems a rather extreme provision if the primary intent is to preserve the surviving spouse's right to possession for a temporary period. A better approach might have been to deem the right of survivorship to be inoperative for the requisite 60-day period.

14. Particular issues respecting NFP calculations and set-offs

The choice of the day before death as the valuation date for a marital relationship ending with the death of one spouse gives rise to problems in calculating the deceased spouse's NFP. Similar problems will arise on account of the surviving spouse's obligation under s. 6(6) of the *FLA* to account for benefits received as a consequence of the deceased spouse's death.

14.1 Calculating the deceased spouse's NFP

There are several issues that arise in the calculation of the deceased spouse's NFP where the valuation date is one day before the death:

- How do you deal with life insurance on the deceased spouse's life?
- Are estate administration expenses (e.g., funeral and burial costs, estate administration tax, professional fees, and estate trustee fees)

considered to be debts and liabilities to be deducted in calculating NFP?

- How do you account for income tax liabilities that arise on that death?

14.1.1 Life insurance on the deceased spouse's life

Where there is life insurance in place on the deceased spouse's life, the insurance money does not become payable until after the valuation date. Accordingly, that insurance money should not be included in calculating the deceased spouse's NFP. This was the view taken in the Ontario decision *Patton v. Roach*, where three debts owing to a credit union by the deceased spouse were, despite being life-insured, given full credit as deductions in calculating the deceased spouse's NFP. Kozak J. refused to recognize the fact that, from an economic viewpoint, the estate suffered no loss as a result of the liabilities in question. A similar view was more recently taken in *Weatherdon-Oliver v. Oliver Estate*.

The Saskatchewan Queen's Bench took the other view in *Paterson v. Remedios*, where the insured spouse was known, at the time of the hearing, to be near death from a terminal illness. The court clearly took that fact into account, as well as accepting an agreed statement of facts that included a description of several avenues open to the spouse—for example, cash advances, living benefits, securing a bank loan—that would have allowed him to derive actual cash from the policy before his death. In the result, the court included approximately one-half of the face amount of the insurance in valuing the spouse's assets.

At present, commercial trading in life insurance contracts is illegal in Ontario. Should such transactions be permitted in future, it will provide a strong basis on which to impute value to a term policy on an insured spouse who is known to be suffering from a terminal condition on the valuation date.

Unless the insurance is of the term variety, it will also have a cash surrender value (CSV). Assuming the spouse whose life is insured is also the owner of the insurance contract, the CSV, being available to him or her right up to the instant before death, should be included in calculating his or her NFP. (Sometimes a court will get mixed up on the distinction between the CSV of a policy and the insurance proceeds payable on death. The decision of Steinberg J. in the Ontario case of *Foffano v. Foffano* is a good example of this.)

14.1.2 Estate administration expenses

Just a few years after the *FLA* came into force, Hogg J. held in *Re Ward* that a number of estate administration expenses, including executor's compensation, legal fees, and disbursements, were deductible in calculating the deceased spouse's NFP, despite the fact that they did not arise until after the valuation date. No reasons were given by Hogg J.

In *Bobyk v. Bobyk Estate*, the court reached the opposite conclusion, but did give reasons. Kurisko J. rejected the claimed deduction for a number of administration expenses, including funeral expenses, fees and disbursements claimed by the executor, legal accounts, probate fees (as estate administration tax was formerly known), accounting fees, and property taxes. His rationale was simple: none of these liabilities existed on the valuation date.

The most recent decision on this issue was *Szuflita v. Szuflita Estate*. In that case, Whitten J. expressly endorsed the view of Kurisko J. in *Bobyk* and rejected the claims for estate administration expenses, which included funeral expenses, legal fees and disbursements, a reserve for future legal expenses, and executor's compensation.

14.1.3 Income taxes at death

While there has been very little jurisprudence dealing with claims arising on the death of a spouse, there are a great many cases dealing with claims arising on marriage breakdown. A frequently litigated issue is whether, for the purpose of computing a spouse's NFP, property owned by him or her should be valued at its after-tax amount in the spouse's hands. In the first few years under the *FLA*, cases were all over the map on this point, some suggesting that income tax costs of disposition should be taken into account (with or without a discount for the likelihood of the disposition taking place relatively soon), while others suggested that in the absence of a clear indication that property would be sold by the owner spouse, no tax costs should be taken into account, on the grounds that such a calculation was too speculative.

Where the valuation date is one day before the death of the deceased spouse, the argument that income tax costs should be taken into account is more compelling than in the case of marriage breakdown. This is so because the *Income Tax Act* (*ITA*) deems the deceased spouse immediately before death to have

- disposed of all of his or her capital property at fair market value; and
- collapsed all of his or her RRSPs and RRIFs.

Accordingly, there is really nothing speculative about when the owner spouse may incur the tax costs of disposing of capital property or of collapsing RRSPs or RRIFs or, for that matter, about the quantum. That

rationale has been applied in both *Rivett v. Rivett Estate* and in *Bobyk* to allow a deduction for income taxes arising on death in calculating the deceased spouse's NFP.

(Interestingly, in *Marchese v. Marchese*, which involved a separation scenario, the Ontario Court of Appeal refused to overturn the trial judge's decision to allow the husband to claim a deduction for the discounted value of the income taxes that would arise on his death on a deemed disposition of his shares of a private corporation. The trial judge accepted the husband's evidence of his shortened life expectancy due to an existing medical condition, as well as the likelihood that he would not dispose of his shares during his lifetime.)

Should the calculation of the deceased spouse's NFP assume optimal tax planning? It has been held, for example, that (in the context of a marriage ending in separation) the owner spouse should take into account one-half of his or her available lifetime capital gains deduction in order to minimize the notional tax costs of disposition.

14.2 The surviving spouse's set-off

Where the valuation date is one day before the death of the deceased spouse, property held jointly with a right of survivorship poses a problem. Specifically, while the spouses' respective equal interests in that property will offset each other for the purpose of calculating NFPs, the surviving spouse will become the sole owner of the entire property. This clearly unfair result has now been eliminated with the enactment of the *FSLAA*. (although, as already noted above, in the *Ranking* decision, predating the enactment of the *FSLAA*, the Ontario Court of Appeal ruled that a surviving spouse was obligated to set off the windfall against his or her equalization entitlement). The equalization calculation does not change, but the surviving spouse is required to account for the increase in his or her fractional interest in the jointly owned property arising from the death of the other spouse.

That accounting requires (i) a valuation of the increase in that fractional interest; and (ii) a reduction for any contingent tax liability in respect thereof. That reduction would arise if there were any income tax liability accruing to the surviving spouse on a disposition of that increase in the fractional interest. An example will illustrate.

Suppose that the spouses had owned a parking lot as joint tenants that they had jointly purchased for $100,000 and that, at the time of the first spouse's death, was valued at $300,000. As a result of the death of one spouse, the surviving spouse's interest in the property would have increased by $150,000. Were the property sold very shortly after that death, the surviving spouse would realize a capital gain.

The quantum of that capital gain would depend on whether, on the filing of the deceased spouse's terminal return, his or her personal representatives took advantage of the inter-spousal rollover pursuant to s. 70(6) of the *ITA*. If so, the surviving spouse's capital gain on the sale of the parking lot would be equal to $200,000, being the full increase in the value of the property beyond its original adjusted cost base. One-half of that capital gain—$100,000—would be attributable to the deceased spouse's 50% interest in the parking lot. Since only one-half of a capital gain is taxable, that would mean that the surviving spouse would have to bring into his or her own income $50,000 on account of the sale of the one-half interest in the property accruing to him or her as a result of the deceased spouse's death.

Presumably, the surviving spouse's reduction in the amount of the set-off would be the incremental tax liability accruing to him or her on account of that $50,000 income inclusion. This would entail a calculation of the surviving spouse's tax liability: first, with the $50,000 income inclusion, and second, without the income inclusion.

The obvious question that will eventually confront the courts is how to assess the impact of the surviving spouse's decision not to dispose of the property acquired on the deceased spouse's death. Suppose, for example, the surviving spouse in the above example did not sell the parking lot but held onto it for its income-producing potential. One might be inclined to argue, as in the separation scenario, that there should be no deduction for income tax costs of disposition if, on the *Sengmueller* principle, the tax liability is so speculative that it can be safely ignored. However, given that the statute now expressly mandates a deduction from the amount of the set-off for "any contingent tax liability" associated with the property, it is more likely that the only dispute will be over the quantum of the discount.

The obligation to reduce the amount of the surviving spouse's set-off obligation for any contingent tax liability applies to every entitlement accruing to him or her as a result of the deceased spouse's death. So, for example, if a surviving spouse is designated as a beneficiary of the deceased spouse's RRSP or RRIF, there will not necessarily be a dollar-for-dollar offset for the value of that registered plan. (This assumes, by the way, that the phrase "similar plan" in s. 6(6)(b) of the *FLA* encompasses RRSPs and RRIFs or, as noted earlier, that the *FSLAA* has drawn them into the set-off calculation in any event.) However, we can expect the same arguments to arise over the appropriate discount to be applied to the

tax liability that will arise when the surviving spouse either makes withdrawals from the registered plan or dies (assuming, in the latter event, that no spousal rollover is available to him or her).

15. Other income tax issues

In addition to the manner in which income taxes affect the computation of a spouse's NFP, there are other important income tax issues that must be addressed:

- Where capital property is transferred to a surviving spouse in satisfaction of an equalization claim, does such a transfer qualify for "rollover" treatment under s. 70(6) of the *ITA*? If so, how does that tax deferral affect the computation of the deceased spouse's NFP?
- Where a court orders that the surviving spouse is to have a life interest in capital property owned by the deceased spouse, does such a transfer qualify for rollover treatment under s. 248(9.1) of the *ITA*, on the basis that the life interest is a "testamentary spousal trust"?
- Where a surviving spouse files an election to make an equalization claim, any life interest left to him or her under the deceased spouse's will is collapsed. This will result in an acceleration of taxes and a shortening of the time period within which to file the tax return for the deceased spouse's year of death. If the surviving spouse obtains an order for a late filing of an election to make an equalization claim, interest and late filing penalties will arise under the *ITA*. Who should bear the burden of those added costs?

15.1 Transfers of property in satisfaction of an equalization claim

Suppose a court orders that the capital property of the deceased spouse is to be transferred to the surviving spouse absolutely in satisfaction of the latter's equalization claim. In order to determine whether the property can roll over to the surviving spouse at the deceased spouse's tax cost pursuant to s. 70(6) of the *ITA*, the key issue to be determined is whether that transfer can be characterized as having been made as a consequence of the death of the deceased spouse. Subsection 248(23.1) of the *ITA* answers this question in the affirmative for a transfer of capital property made "as a consequence of the laws of a province relating to spouses' ... interests in respect of property as a result of marriage."

That *ITA* provision is unclear as to whether a property transfer made pursuant to a settlement without a court order will qualify for rollover treatment. However, the most recent pronouncement from the Canada Revenue Agency (CRA) is that the rollover will be available if the surviving spouse files an election in favour of equalization within the time frame set out in the *FLA*, whether the ultimate transfer of property takes place by court order or by agreement between the surviving spouse and the deceased spouse's personal representative(s).

If it is necessary to take into account the income tax liability that arises by virtue of the deceased spouse's death in calculating his or her NFP, an unusual calculation appears to be required to determine the NFP, the amount of the equalization claim, and the deceased spouse's ultimate tax liability. Assuming for simplicity that the deceased spouse had a nil net worth at marriage, the steps would proceed as follows:

(1) Calculate the value of deceased's estate.

(2) Deduct the taxes owing to determine deceased's NFP.

(3) Calculate surviving spouse's equalization claim.

(4) Assume a transfer to the surviving spouse of capital property having a value equal to equalization claim.

(5) Re-calculate taxes owing after taking into account rollover of capital property transferred.

(6) Deduct revised taxes owing to obtain deceased's revised NFP.

(7) Go to step 3.

Fortunately, this iterative procedure will converge to give an accurate figure for the equalization claim and for the deceased spouse's taxes.

15.2 Transfers of a life interest

To satisfy the criteria of s. 248(9.1) of the *ITA*, the court order must be one made pursuant to the law of a province that "provides for the relief or support of dependants." The issue reduces to whether the "law" referred to is the *FLA* as a whole or whether it is restricted to Part I thereof. If the latter, it is arguable that the law has nothing to do with support, but only property rights. However, the CRA has opined that the "law" referred to is the law as a whole and that the rollover will apply.

16. Duty owed to the surviving spouse

There is some doubt as to the precise nature of the personal representative's duty to advise the surviving spouse. If the estate trustee owes a duty only to the estate and its beneficiaries, the estate trustee should make no mention to the surviving spouse of the potential rights he or she may have under the *FLA*. If, on the other hand, a duty is owed to the surviving spouse, how far does that duty extend?

In the recent Superior Court of Justice decision in *Webster v. Webster Estate*, the surviving spouse missed

the six-month period within which to file an election for an equalization of NFP. In an application to extend the time to elect, it was argued that the personal representatives of the deceased husband's estate had a duty to advise the surviving spouse of her entitlement to make an equalization claim. Although Robertson J. rejected this argument, the facts were somewhat unusual. The surviving spouse and her son were two of the four estate trustees, and the court had made a representation order that the son act on his mother's behalf for the purpose of bringing the application (she having become mentally incapable due to advancing Alzheimer's.) Moreover, even though the son became aware of the equalization claim within two months of the death, inexplicably he took no steps to pursue the claim for a further seven months. For those reasons, the *Webster* case is unlikely to carry much weight on the specific issue of the duty owed by an estate trustee to the surviving spouse. The issue is undoubtedly going to arise again—and on cleaner facts—between a personal representative and

- an angry widow(er); or
- an irate group of beneficiaries or next-of-kin.

It is submitted that the personal representative should not simply treat the surviving spouse as a creditor of the estate. Rather, the personal representative should advise the surviving spouse that he or she may have rights under the *FLA*, suggest that independent counsel be retained to explain those rights, and stress the importance of doing so in a timely manner so as to preserve those rights. To do more would put the personal representative on tenuous ground *vis-à-vis* his or her duty to uphold the will and act in the best interests of the beneficiaries of the estate.

17. A solicitor's checklist

The following checklist is intended to suggest the significant areas of inquiry that a solicitor must consider in acting for a personal representative, where a surviving spouse has made, or is contemplating making, an equalization claim under the *FLA*.

(1) Where the surviving spouse is named as a personal representative under a will, determine what steps should be taken to avoid or address the inherent conflict of interest for the spouse and for the lawyer.

(2) Determine whether an election to take under the *FLA* is permitted:

(a) Confirm that the deceased spouse died on or after March 1, 1986.

(b) Ascertain that the spouses had their last common habitual residence, if any, in Ontario.

(c) Examine any domestic contract to which the deceased was a party to see whether the surviving spouse has waived any right to make an equalization claim.

(d) Determine whether a previous claim under s. 5(3) (improvident depletion) has been made successfully by either spouse, barring the surviving spouse from making a claim under s. 5(2).

(e) Determine whether the six-month deadline for filing an election and a notice of application has expired.

(3) Consider the impact of an equalization claim on the surviving spouse's entitlement to

– the proceeds of any policies of insurance (group or individual) on the deceased spouse's life;

– any lump-sum benefits under any pension or similar plan arising on the death of the deceased spouse; and

– the value of any property or of a portion of any property to which he or she becomes entitled by right of survivorship or otherwise on the death of the deceased spouse.

This will require investigating whether, in relation to any of these entitlements, the deceased spouse—or, in the case of entitlements established by, or on behalf of, a third party in the last-mentioned category, the third party—made a written designation that such entitlement was to be in addition to any equalization claim (*FLA*, s. 6(6)). Be prepared to claim from the surviving spouse the amount, if any, by which the aggregate of all such set-offs exceeds the equalization claim as finally determined.

(4) Determine the impact of an equalization claim on the surviving spouse's rights to property comprising the estate:

(a) Ascertain whether the deceased spouse's will contained an express provision that the surviving spouse was entitled to the will benefits in addition to his or her equalization claim (*FLA*, s. 6(5)).

(b) Determine whether any property was held by both spouses as joint tenants (ensuring that the issues of resulting and constructive trust are canvassed), entitling the surviving spouse to claim the property, whether or not an equalization claim is made.

(c) Determine whether there is either a partial or total intestacy with respect to immovable property situated in a jurisdiction other than Ontario. If so, succession to such property may be governed not by the *SLRA* but by the laws of that other jurisdiction, in which case the surviving spouse may be entitled to that property whether or not an equalization claim is made. (In this regard, see the argument

posed in "Effect on insurance, pension, or similar plan benefits and other entitlements arising on the death of the spouse," above, that such an entitlement may nonetheless have to be set off against the equalization claim.)

(5) Determine the valuation date:

(a) Where a marriage ends in the death of one spouse, the valuation date will usually, though not necessarily, be the day before the death of the deceased spouse. Bearing in mind that the valuation date is defined to be the earliest of several specified events, it is clear that where the marital relationship has ended in separation, the date of separation (assuming there is no reasonable prospect of resumption of cohabitation) will be the valuation date, notwithstanding that the claim is one brought under s. 5(2), rather than under s. 5(1), of the *FLA*.

(b) If the valuation date is determined to be the date of separation, consideration should be given as to whether the events leading up to the final separation may give rise to some uncertainty over the valuation date. That is, it will be a question of fact whether any particular event of separation was made without any reasonable prospect of resumption of cohabitation.

(6) Take steps to determine the value of the equalization claim:

(a) Consider whether it is necessary (or, for that matter, economically viable) to obtain professional valuations for specific property and obtain proper instructions in this regard.

(b) Consider resulting and constructive trust arguments.

(c) Determine whether there are facts or circumstances that may give rise to a finding of unconscionability, thus justifying an unequal division of NFPs (whether in favour of the surviving spouse or in favour of the estate). In light of the Ontario Court of Appeal decision in *Serra v. Serra*, this should include an assessment as to whether any relevant facts might permit the court to take into account changes in the value of property subsequent to the valuation date.

(d) Consider if there have been any fraudulent transfers of property by the deceased spouse to defeat the surviving spouse's equalization claim.

(e) Determine whether any entitlements that accrue to the surviving spouse as a result of the deceased spouse's death must be set off against his or her equalization claim under s. 6(6) of the *FLA*.

Chapter 39
Administration of estates

1. Estate trustee's and lawyer's duties

1.1 Who does what

It is the lawyer's function to advise the estate trustee of his or her duties and obligations. Consequently, the lawyer must be familiar with the various steps required to administer an estate. At the outset, it is most important that the lawyer outline to the estate trustee his or her duties, as well as the duties of the lawyer. If two or more persons are acting as estate trustees, the lawyer takes instructions from all of the estate trustees. If one of the estate trustees instructs the lawyer, the others must consent prior to the lawyer's acting on those instructions.

Various types of estate trustees may retain the lawyer, and therefore the lawyer will be called upon to perform varying functions. The lawyer's function where there is a corporate estate trustee differs significantly from his or her function where there is a lay estate trustee. The corporate estate trustee will perform most of the functions of an estate trustee, such as preparing the inventory of the estate, insuring and collecting assets, recording and keeping accounts, and preparing tax or trust returns. Consequently, the corporate estate trustee will request the lawyer to perform only the legal administration. The lay estate trustee may call upon the lawyer for assistance in all of his or her functions. Somewhere in between is the "average estate trustee."

One of the key principles that the lawyer ought to communicate to the estate trustee is the duty to act personally and not through an agent. That is not to say that the estate trustee must personally perform all aspects of the administration. Clearly there will be some tasks that he or she is unqualified—either legally or practically—to perform.

Broadly speaking, there is no prohibition against delegating to an agent the authority to carry out a mere administrative task (e.g., the preparation of tax or trust returns) in order to implement a decision made by the estate trustee who requires that task to be carried out.

Where matters involving the exercise of discretion are concerned, the estate trustee must, as a general rule, act personally. So, for example, the estate trustee must decide when to realize an original estate asset and the price at which it should be sold. Decisions as to whether and when to exercise discretion granted by the will to make distributions of trust income or trust capital to a trust beneficiary cannot be delegated to another. There is an exception to this non-delegation principle in the case of investment management of estate assets. Ontario's *Trustee Act* expressly authorizes a trustee (including an estate trustee) to retain an agent as investment manager. However, there are very specific rules contained in that statute that circumscribe the authority to hire an agent.

1.1.1 General immediate concerns

Locating a will for the deceased is one of the first considerations on the part of the members of the family, estate trustee, and/or the lawyer (who may not have been involved in the preparation of the will). It is prudent for a lawyer who prepares wills to review the obituaries in the local newspapers to determine whether a deceased client may have made a will that has been left with the lawyer. The question then arises as to whether a lawyer is entitled or obliged to contact the family regarding the will. Perhaps this is something that should be done only if there are special instructions in the will. Otherwise, it is up to the members of the family to contact the lawyer regarding the estate.

How should the lawyer who is in possession of an original will of a deceased person respond to a request to release the original will to someone who is not named as estate trustee? Such a scenario may arise where there is no named estate trustee who is alive, willing, and able to act as estate trustee. A recent decision by Brown J. in *Hope v. Martin* has provided an answer to this question. In that case, the lawyer insisted on a court order to release the original will, citing solicitor-client privilege and the duty of confidentiality to the client. Brown J. held that neither of these was a bar to releasing the will to the person who intended to apply for a certificate of appointment of estate trustee with a will. Privilege, he said, was a non-issue where the interests of the party seeking the information are the same as those of the client who retained the solicitor in the first place. As to the duty of confidentiality, he opined that a deceased person who has made a will must have intended that it be acted upon and thereby has implicitly consented to disclosure of what would otherwise be confidential to the appropriate person in order that the client's intention could be fulfilled. Only where a lawyer in possession of the will is faced with conflicting demands over entitlement to the will should a court order be required.

A search must be made for the most recent will among the deceased's documents, in his or her safe deposit box,

with the deceased's family members, with any lawyers who may have previously acted for the deceased, or at the Estates Office where the deceased may have deposited an original will.

1.1.2 Advising the estate trustee

The estate trustee named in a will usually contacts the lawyer, who must advise as to the terms of the will and any special instructions, duties, and responsibilities that the estate trustee is required to undertake. The lawyer should advise the estate trustee with respect to his or her entitlement to compensation for administering the estate, taking into account any provisions respecting compensation that may be set out in the will. The estate trustee must be advised about matters that require immediate attention, including the applicability of limitation periods, notification of the relatives and beneficiaries, disposition of perishable assets, and provisions for the immediate needs of dependants. The lawyer must advise the estate trustee that any funeral or burial instructions contained in the will are not legally binding and that the estate trustee has full authority to determine the place and manner of burial.

As a general rule, where two or more persons are appointed to the office of estate trustee, they should jointly retain and instruct the lawyer. However, even in the case of a will that permits decisions to be made otherwise than unanimously, the lawyer should take reasonable steps to ensure that all of the estate trustees are made aware of the fact and nature of his or her retainer, as well as any significant instructions received in connection with the administration of the estate.

1.1.3 Funeral arrangements

Where someone other than the estate trustee has contracted with the funeral home for the funeral arrangements, the estate is answerable only for so much of the cost as an estate trustee might reasonably pay in the circumstances. Proper funeral expenses are payable out of the property of the deceased in priority to any other charges, but the estate trustee will be allowed only a reasonable amount in the circumstances, having regard, *inter alia*, to the size of the estate and the deceased's station in life. Many of these principles are applicable to an intestate situation as well.

1.1.4 Parts of the body

The lawyer must advise the estate trustee of any special instructions regarding the donation of organs or use of the body. The *Trillium Gift of Life Network Act* governs donation of parts or the whole of the body. It specifies that the consent of a deceased donor is required for use of tissue and that the deceased's family cannot override such consent.

1.1.5 Communication with persons entitled to benefit

The lawyer must advise the estate trustee to communicate with the persons mentioned in the will or the heirs on an intestacy about the possible benefits they are to receive. Where a person intends to apply for a certificate of appointment of estate trustee, he or she must file with the court an affidavit confirming that all persons entitled to share in the estate distribution have been served with a notice that an application for a certificate of appointment of estate trustee is being made. In some cases, it may also be necessary to serve the Children's Lawyer or the Public Guardian and Trustee.

Where there is a will but the estate trustee does not intend to apply for a certificate of appointment of estate trustee, it is still advisable to communicate with the beneficiaries. Maintaining such open lines of communication will minimize anger, frustration, suspicion, and hostility among those persons and may engender less contention

- during the estate trustee's day-to-day administration of the estate; and
- when the estate trustee is ready to account for his or her administration and claim compensation.

1.2 Security of assets and determination of assets

At the outset of the administration of the estate, the lawyer must advise the estate trustee of his or her responsibilities to determine, secure, and protect the assets. It is necessary to investigate and become familiar with all of the private dealings of the deceased in order to become aware of any assets. Any perishable assets must be disposed of immediately, and all other assets must be taken under the protection of the estate trustee and adequate insurance arrangements made for their security. As soon as possible, the adequacy of insurance on real property should be determined and corrective measures taken, if required. If there is any vacant real estate, arrangements must be made for its protection and supervision, and the necessary vacancy permit endorsement must be issued through the insurance company.

Where the lawyer who is acting for the estate did not prepare the will for the deceased, it is wise to contact the lawyer who drew up the will and determine whether that lawyer has any information respecting the deceased's assets. In addition, members of the family may know

where the deceased carried on business and kept papers and assets.

Any cash, securities, other valuable papers, jewellery, property deeds, mortgages, insurance policies, and other title papers and documents should be taken from the deceased's place of business or residence and placed in the custody of the estate trustee.

Where there is a private business in which the deceased was the controlling or operating force, the lawyer should advise the estate trustee to either arrange for competent management to continue the business operations or attend to its immediate termination. It may be that the deceased left instructions about the business operation. A search for any specific instructions should be undertaken, and where practicable, these instructions should be followed, although the instructions may not be legally binding unless they are part of a contractual buy/sell, shareholders' agreement, or partnership agreement.

In determining the assets of the estate, it is especially important to review the working copies of the previous income tax returns that the deceased may have filed. From the information obtained, more detailed investigations may be made.

Full particulars should be recorded of any securities contained in the safe deposit box, including serial numbers, principal amount, interest rates, dates of payment, maturity and issue dates, exact name of the deceased in which the securities are registered and the name of the transfer agent, if any. The objective is to obtain as much accurate information as possible, so that the lawyer will be able to prepare the necessary inventory and future documents to deal with the transfer or redemption of the securities.

The lawyer should advise the estate trustee to arrange for the collection of future income from all securities or, if so instructed, should do it personally. This is usually done by advising the interest- or dividend-disbursing agents to forward future cheques to the estate trustee or to an account opened in the name of the estate.

1.2.1 Moneys on deposit

The estate trustee should determine cash on deposit at banks, trust companies, investment firms, credit unions, and other depositories. The proper procedure is for a lay estate trustee to write to each of these institutions requesting full particulars. The response can be used to prepare all future documentation such as the inventory, accounts, income tax returns, and transfer documents. When the institution is contacted at this preliminary stage, inquiry should be made as to any other assets that the institution may be holding, have in safekeeping, or be aware that the deceased held solely in his or her name or jointly with any other person. The estate trustee should open a bank account in the name of the estate.

1.2.2 Household contents and personal effects

Household goods, objects of art, collections, furniture, automobiles, jewellery, and other personal effects must be listed and appraisals or valuations obtained.

1.2.3 Insurance policies

Information as to any insurance policies on the life of the deceased should be obtained and particulars recorded. The estate trustee is responsible only for proceeds of insurance on the life of the deceased that are payable to the estate. (Policy proceeds payable to a named beneficiary are often dealt with directly by the beneficiary, since the proceeds do not form part of the estate.) If the estate is entitled to the proceeds, the proceeds can initially be deposited into an estate bank account. Sometimes, the estate trustee will ask the lawyer to deal with these matters. In that case, the lawyer should notify the insurer in writing of the death of the life insured and request particulars of the policy, including the face amount, accumulating dividends, particulars as to any outstanding loans, and the manner and means for release of the proceeds.

1.2.4 Employee benefits

The deceased's former employer, if any, should be contacted to determine if any payments of salary and other benefits, such as sick leave, are owing and what death benefits might be expected under personal or group insurance plans, pension plans, stock options, or profit-sharing plans. There may also be medical or health insurance benefits that can assist the estate in settling claims. The lawyer should advise the estate trustee to obtain full particulars (or attend to that matter directly if so instructed by the estate trustee). At that time, information as to the amount of earnings for the year to the date of death should be obtained, along with any income tax, pension, or other deductions that would facilitate future filing of the necessary income tax returns.

1.2.5 Business interests

Any business interests should be investigated and, where necessary, valuation of the business interest obtained. Reviews of buy-sell agreements, shareholders' agreements, etc., are to be undertaken, since they may not be reflected in, or may be contradictory to, provisions of a will.

1.2.6 Annuity contracts, pensions

There may be annuities pursuant to which payments were being made and that may have a guarantee period. If so, there may be additional payments to be made to other members of the family or to the estate.

As a result of employment (or past employment), there may be certain pensions or superannuation benefits that are payable. Full particulars should be obtained regarding what is actually owing and what future payments may be made to other members of the family or to the estate.

If the deceased had been contributing to the Canada Pension Plan, there may be survivor benefits payable. If so, an application should be made by the survivors. The estate trustee is responsible for making the application for the death benefit under the Canada Pension Plan.

1.2.7 Armed forces benefit

The benefits payable under the *Canadian Forces Superannuation Act* or other pension benefits through the armed forces should be investigated, particularly for veterans. Currently, such inquiries are made to the Director Canadian Forces Pensions Services. It is necessary to request in writing the requirements for their release and the tax treatment of those benefits.

1.2.8 Foreign social security benefits

If the deceased was a national of some other country, his or her estate or surviving family members or both may be entitled to benefits. These should be investigated on a timely basis, since there may be limitation periods at play.

1.2.9 Real estate

The estate trustee should be advised to investigate whether there are any interests in real property. This may include a principal residence, city investment property, commercial or apartment buildings, rural vacation or recreational property, farms, vacant lands, or other real property. A qualified person must obtain valuations in the form of a written opinion. The existing loans, mortgages, taxes, and any other encumbrances must be determined.

1.2.10 Mortgage investments

The current value must be determined. Arrangements must be made for insurance coverage to be continued in the name of the estate and for the continued collection of future payments.

1.2.11 Interest in other estates and trusts

The deceased may have been receiving or may be entitled to receive benefits from another member of the family pursuant to a will or to an *inter vivos* trust. If so, it is necessary to determine whether these benefits will continue in the future or whether they are terminated upon death. There may be property passing upon death that does not form part of the estate but that might involve the estate in certain tax issues (income tax or inheritance taxes in other jurisdictions).

1.2.12 Jointly held property

Subject to arguments of resulting or constructive trust, real estate, bank accounts, and securities held by the deceased and another as joint tenants with a right of survivorship do not form part of the estate. (According to the Supreme Court of Canada decision in *Pecore v. Pecore*, there is a rebuttable presumption of a resulting trust in the case of a transfer by a parent to an adult child, the onus being on the child to rebut that presumption. This contrasts with the rebuttable presumption of advancement in the case of a transfer from a parent to a minor child.)

There is an exception where joint tenants die at the same time or in circumstances rendering it uncertain which of them survived the other or others. In such cases, they are deemed to have held the property as tenants in common. Notwithstanding that ownership of property has been registered or recorded as a joint ownership with another or others (with a right of survivorship), the impact of the death of one joint owner may still leave beneficial ownership of some or all of the property in the estate of the deceased joint owner. The interest of the deceased joint owner may be 50% of the value, 100% of the value, or some different percentage, depending upon the deceased's actual contribution to the initial acquisition and the intention of the parties when title was taken or transferred into joint names or evidence of a subsequent gift appears. (In *Pecore*, it was held that a person may create a third type of joint bank account or joint investment account. In such cases, the person intends to make a gift of the right of survivorship to the other joint account holder, while retaining the ownership of the funds in the joint account during the person's lifetime.)

Whatever the percentage interest remaining in the estate of the deceased, the fact of the joint ownership should be duly noted, since the deceased's former interest will be deemed to undergo a disposition at death at fair market value, and the tax arising from such deemed disposition will be a debt of the estate.

1.2.13 RRSPs, RRIFs, TFSAs, and RESPs

A registered retirement savings plan (RRSP), registered retirement income fund (RRIF), or tax-free savings account (TFSA) may be an asset of the estate or may pass outside of the estate. Naming a designated beneficiary other than the estate will cause the RRSP, RRIF, or TFSA to pass outside the estate directly to the designated beneficiary, thereby excluding its value for the purpose of calculating estate administration tax. For RRIFs and TFSAs, a further possible exclusion from the estate and from the estate administration tax calculation may be effected—by appointment of a successor annuitant in the case of a RRIF, or by appointment of a successor holder in the case of a TFSA. (While such appointments are permitted for RRIFs and TFSAs that are either insurance based or governed by a declaration of trust, it is doubtful, having regard to the language used in Part III of the *SLRA*, that they are available for a depositary RRIF or TFSA.)

In so far as RRSPs and RRIFs are concerned, where the deceased has designated as beneficiary

- a surviving legal spouse or common-law partner as defined in the *Income Tax Act*; or
- a surviving, financially dependent child or grandchild.

for income tax purposes, the estate trustee may nonetheless designate all or any part of the amount of the RRSP or RRIF to be included in the deceased's income in the year of death. The balance of the tax liability and the RRSP or RRIF itself passes to the beneficiary designated by the deceased.

A designated beneficiary of a RRSP or RRIF is entitled to receive the gross value of the plan or fund at the date of death. However, he or she will be jointly and severally liable with the estate for the additional income tax payable as a result of the income inclusion in the deceased's terminal year. Nonetheless, the estate trustee must report the income for the deceased's year of death and pay the tax arising from it.

Contributions the deceased made during his or her lifetime to a Registered Education Savings Plans (RESP) belong to his or her estate, while income derived from those contributions and any Canada Education Savings Grants paid into the RESP belong to the beneficiary or beneficiaries under the plan. By making a contribution to the RESP, the estate trustee will step into the shoes of the deceased as the "subscriber" of the plan. If the deceased left a will, it should be reviewed to see if it contains any directions to make continuing contributions to the RESP.

1.3 Preparation of inventory

Once information about the extent of the deceased's assets has been obtained, it is necessary to itemize the assets in an inventory or valuation. This enables the estate trustee to complete the application for a certificate of appointment of estate trustee. The inventory also forms the basis of future preparation of the accounts by the estate trustee and the basis for the completion of income tax returns.

In this regard, it is important again to distinguish between a corporate estate trustee and a lay estate trustee. The corporate estate trustee provides the lawyer with the inventory, which is then used in the necessary application for a grant. Usually the lay estate trustee requests the lawyer to assist with the determination of the valuation of assets, and the lawyer may therefore wish to undertake investigative procedures so as to be aware of all particulars for the preparation of the inventory.

It is recommended that when the lawyer is called upon to prepare the inventory, the lawyer should list all assets in the inventory in order to verify that all assets have been dealt with, whether they are jointly owned, pass by way of contract or designation to a beneficiary, or are in the sole name of the deceased. The lawyer and the estate trustee would then have a record of all assets that have been investigated, whether or not they are needed for the application for a certificate of appointment of estate trustee. By use of separate columns, the value for probate purposes is distinguished from the value of assets that pass by survivorship. All of this information may then be available and useful when assisting with the preparation of estate accounts or the income tax returns.

2. Certificate of appointment of estate trustee

2.1 Purpose

In a properly drafted will, there is an estate trustee or trustees named who will have the right to deal with the assets in the estate immediately upon death, since the estate trustee's authority arises from the will itself. On an intestacy, there is no person who can act immediately upon the death. Someone must apply to the Ontario Superior Court of Justice to be appointed estate trustee, called an "estate trustee without a will." In the latter case, the estate trustee's authority comes only from the court order (called a certificate of appointment of estate trustee without a will).

2.2 Types of appointment

There are several different types of appointment that may be obtained from the Ontario Superior Court of Justice.

They are described in the Ontario *Rules of Civil Procedure* (*Rules*). The type of appointment varies with the circumstances surrounding the deceased's estate. The different appointments listed below are generally obtained in the respective circumstances described therein:

- *Certificate of appointment of estate trustee with a will*, where there is a valid will and named estate trustees who are able and willing to act: This also includes the appointment of a trustee where there is a will, but no named estate trustee is alive, able, and willing to act (see r. 74.04 and Forms 74.4 and 74.5).
- *Certificate of appointment of estate trustee without a will*, where there is no will (see r. 74.05 and Forms 74.14–74.15).
- *Certificate of appointment of foreign estate trustee's nominee as estate trustee without a will*, where a foreign estate trustee nominates an estate trustee to administer assets in Ontario (see r. 74.05.1 and Form 74.20.1).
- *Certificate of appointment of succeeding estate trustee with a will*, where a second supplemental grant is required, such as on the happening of an event that requires the addition of another named estate trustee under the will: This also includes the appointment of an estate trustee to replace the estate trustees initially named in the will, where all estate trustees have died intestate themselves (see r. 74.06 and Form 74.21).
- *Certificate of appointment of succeeding estate trustee without a will*, where an administrator of an estate dies leaving assets unadministered (see r. 74.07 and Form 74.24).
- *Confirmation of resealing of appointment of estate trustee*, where a grant has been given by a Commonwealth court outside Ontario: The grant may be "resealed" by the Ontario Superior Court of Justice of the county in which the deceased had assets (see r. 74.08 and Form 74.27).
- *Certificate of ancillary appointment of estate trustee with a will*, where a non-Commonwealth court had given a grant: An ancillary grant in Ontario is required to administer assets situated in Ontario (see r. 74.09 and Form 74.27).
- *Certificate of appointment of estate trustee during litigation*, a grant that is made in order to preserve assets of an estate where an action has been commenced that contests the validity of the will (see r. 74.10 and Form 74.30).
- *Litigation administrator*, where an action is commenced against the deceased's estate and there is no estate trustee: The court will appoint a litigation administrator to enable the action to continue (see r. 9.02).

2.3 Appointment of estate trustee with a will

A certificate of appointment of estate trustee with a will may be issued out of the Ontario Superior Court of Justice of the county in which the testator has a fixed place of abode at the time of death or, if the testator resided outside of Ontario, in the county where the deceased held property at the time of death.

A certificate of appointment of estate trustee with a will is a document under the seal of the proper court that certifies that the will, a copy of which is annexed, was duly proved and registered in the court and that administration of the property of the testator was duly committed by the court to the estate trustees whose names and descriptions are set out in the document.

The certificate is the only evidence recognizable by a court of the trustee's authority to deal with the property of the deceased. The certificate is not the foundation of the estate trustee's title, but only the authentic evidence of it. The personal property vests in the trustee from the moment of the testator's death (*Estates Administration Act*, s. 2). Therefore, the estate trustee has the authority to deal with the deceased's property before the issuance of the certificate.

Although the authority of the estate trustee(s) appointed by a deceased person's will flows from the will itself, there are a number of circumstances in which an application for a certificate of appointment of estate trustee will be made by the person(s) so appointed:

- The nature of the assets or the position of third parties having control over assets or the record of title to them requires the certificate.
- It is desired to have the protection afforded by the *Trustee Act* to anyone acting on the authority of a certificate.
- There is contention over the validity of the document that purports to be the deceased's will.

Also, where there is no person named in the will as estate trustee who is alive, competent, and willing to accept the appointment as estate trustee, an application for a certificate of appointment will likewise be required. Although the *Estates Act* contains a prohibition in such circumstances against the issuance of a certificate of appointment of estate trustee to a person who is not resident in Ontario, an endorsement was issued by the then administrative judge for the Toronto Estates List in 2010 in *Re Estate William Armstrong* asserting that this prohibition is not absolute and that, in appropriate circumstances, a court may approve the issuance of a certificate of appointment of estate trustee to a person who is not a resident of Ontario.

A renunciation is required from any person who, although named in the will as estate trustee and being thereby entitled to apply for a certificate, chooses not to act.

A certificate of appointment of estate trustee with a will will be granted if these documents are in order. Rule 74.14 provides that the registrar of the court can sign the necessary court order without reference to a judge, provided the documents filed are complete. Otherwise the application is to be referred to a judge for a determination.

Where a certificate of appointment of estate trustee with a will has been issued to two or more persons and one of them dies, the surviving estate trustee(s) will require a court document to demonstrate to third parties the authority of the surviving estate trustee(s) to carry on with the administration of the estate. Although not stipulated in the *Rules*, there is a widespread practice for the court, upon being notified of the death of one of the estate trustees, to issue a "court status certificate," which confirms the authority of the surviving estate trustee(s) to continue with the administration of the estate. However, where the will provides for the appointment of a named person to fill the vacancy in the office of estate trustee that has arisen by virtue of the death of an originally appointed estate trustee, it will be necessary for the surviving estate trustee(s), together with the replacement estate trustee, to apply for a certificate of appointment of succeeding estate trustee with a will.

2.4 Appointment of estate trustee without a will

When a person dies intestate, the administration of the estate (including its distribution in accordance with Part II of the *Succession Law Reform Act* (*SLRA*)) is carried out by the person or persons appointed by the Ontario Superior Court of Justice as estate trustee(s). Just as a certificate of appointment of estate trustee with a will is conclusive evidence of the validity of the will, a certificate of appointment of estate trustee without a will is conclusive evidence that the person(s) to whom the certificate was granted has (have) a right to it, which right cannot be questioned in collateral proceedings. While a certificate of appointment of estate trustee with a will relates back to the death of the testator, there is no retroactive effect to the certificate of appointment of estate trustee without a will.

The order of preference of the persons entitled to apply for a certificate of appointment of estate trustee without a will is set out below. Where death occurs after March 31, 1978, all terms describing the relationship include those that may be traced through persons born outside marriage:

- married spouse of the deceased or the person with whom the deceased was living in a conjugal relationship outside marriage (including a same-sex partner) immediately before death;
- children of the deceased;
- grandchildren of the deceased if no child is living; and
- great-grandchildren of the deceased if no child or grandchild is living and so on, if there is a lineal descendant.

Descendants are preferred over ascendants even when the latter are closer in relationship:

- the father of the deceased who leaves no issue;
- the mother of the deceased who leaves neither issue nor father;
- the sibling(s) of the deceased who dies without issue, father, or mother;
- the grandparent or grandparents of the deceased who dies without issue, parent, or sibling;
- the uncles, aunts, nephews, nieces, and great-grandparents of the deceased who dies without issue, parent, sibling, or grandparent;
- collateral relatives of more remote degrees, those of equal degree having an equal right; and
- where there are no next-of-kin resident in Ontario, the Public Guardian and Trustee (see *Crown Administration of Estates Act*, s. 2).

Here too, the *Estates Act* prohibits the issuance of a certificate of appointment of estate trustee without a will to a person who is not resident in Ontario. See, however, *Re Estate William Armstrong*, referred to above.

A certificate may be issued to a creditor of the deceased where there is no next-of-kin resident in Ontario willing and able to make the application. For such application to be made, the appointment of a creditor must be necessary in order that the deceased's debts can be collected.

Those having a prior right to apply must be cited or must renounce before a certificate will be issued to anyone having a lesser degree of kinship to the deceased. The persons entitled to a certificate may consent to an application by another person or persons or by a trust company.

Where there are several persons standing in the same degree of kindred, the practice of the court is to select one or more of such persons in its discretion. The primary objective governing the court's discretion is the interest of the estate. If there is no material objection on one hand, or reason for preference on the other, the court

will put the administration in the hands of that person from among such kindred to whom the majority of persons interested in the estate are desirous of entrusting the estate. Where an applicant's own interest and his or her duty as estate trustee would conflict, causing possible prejudice to the estate, at least to an appreciable degree, this constitutes a material objection to the grant sought, and another of the next-of-kin ought to be preferred.

The material to be filed on an application for a certificate of appointment of estate trustee without a will is set out in r. 74.05(1), and for the certificate of appointment to be issued, in Form 74.20. Rule 74.14 allows the court registrar to issue the certificate if the material filed with the application is complete. If, in the opinion of the registrar, the application material is not complete, the matter is referred to a judge for determination.

2.5 Certificate of appointment of estate trustee during litigation

This type of certificate of appointment is issued where an action is commenced touching upon the validity of the will or an appointment of an estate trustee is sought to be revoked. The certificate is issued in order to preserve the assets of the estate pending the outcome of the litigation.

Such an estate trustee has all the rights and powers of any other estate trustee except for the authority to distribute the estate. The estate trustee is deemed to be an officer of the court and is immediately subject to its control and direction.

The duties of the estate trustee continue until the action or the appeal, if one is commenced, is finally disposed of. The office of the estate trustee ceases at the final determination of the litigation, at which time the estate trustee must proceed to pass accounts and distribute assets of the estate according to the finding of the court.

Ordinarily, the court will not appoint one of the parties to the litigation to act as estate trustee during litigation unless the appointment has the consent of all parties concerned.

An application for the appointment of an estate trustee during litigation is made by way of notice of motion to the court in which the action touching upon the will has been commenced. Generally, affidavit evidence is filed in support of the motion, setting out the necessity for the order and the nature of the pending action, the value of the assets in the estate, and the nomination of a person or trust company to act as estate trustee. The consent of the proposed estate trustee and each of the beneficiaries should, if possible, be filed in support of the motion.

Once an order is obtained, an application for a certificate of appointment of estate trustee during litigation is then made to the Ontario Superior Court of Justice that would have had jurisdiction if the deceased had died intestate. The estate trustee may be required to post an administration bond, the amount of which may be fixed by the judge who makes the appointment.

2.6 Litigation administrator

Subsection 38(2) of the *Trustee Act* provides that, except in cases of libel and slander, an action in tort may be maintained against the estate trustee of the person who committed, or is by law liable for, the wrong. Where no certificate of appointment of estate trustee has been issued within six months following the date of death, the plaintiff may apply to the court for an order appointing a litigation administrator to represent the estate so that the action may be properly commenced. The order appointing the estate trustee should be confined to the proposed action referred to in the application. Any subsequent judgment in favour of, or against, the litigation administrator is deemed to be a judgment against the deceased and has no effect on the litigation administrator personally.

2.7 Estate administration tax

Before the Ontario Superior Court of Justice issues a certificate, the estate administration tax must be paid. At the present time, this tax is calculated at the rate of $5 per thousand for the first $50,000 of estate value, and $15 per thousand for estate value over $50,000. Rule 74.13 requires the tax to be paid at the time of the application for a certificate of appointment. The exception is found at r. 74.13(2). In that case, the applicant must file an affidavit as to the estimated value, and the tax is based on the estimate. In addition, the applicant must give an undertaking to file a sworn statement as to the value of the estate and to pay the tax within six months. (If there is any doubt at all as to the value of certain property comprising the estate, the application should indicate that the value of the personal property or real property, as the case may be, is an estimate, and the undertaking noted above should be filed. There is anecdotal evidence to suggest that the court office may otherwise refuse to grant a request for a refund in the event that the actual value as subsequently determined turns out to be lower than the original declared value.) Often, the lawyer can obtain the necessary funds to pay the tax from the financial institution by advising that it is necessary to have the amount paid before the court issues the certificate of appointment of estate trustee. In most instances, the financial institutions are co-operative.

Assets passing on survivorship, real estate situated outside of Ontario, and insurance proceeds or registered

funds passing to a named beneficiary or assigned for value are not included when calculating the value of assets for the purpose of estate administration tax. The taxes are payable, as a general rule, on the gross value of all other assets passing under the will or on an intestacy. The one exception to that rule is that a deduction is available for "the actual value of any encumbrance on real property that is included in the property of the deceased person" (*Estates Administration Tax Act, 1998*, s. 1 "value of the estate").

Suppose, for example, a deceased has a home with a fair market value of $450,000 at the time of death. Suppose further that at that time there is a mortgage registered against title that secures an unpaid balance of $200,000. The value to be included in the calculation of estate administration tax on account of that property is only $250,000.

Note that the deduction is available only in respect of the "actual value" of the encumbrance. Suppose in the previous example that the deceased had given a mortgage to a financial institution to secure a line of credit up to a maximum of $200,000. If, at the time of death, the unused portion of the line of credit stood at $150,000, the deduction available in calculating estate administration tax owing would be only $50,000.

If the application is for an ancillary appointment or resealing of appointment, only the value of the assets in Ontario is included when calculating the tax amount. Where there are multiple wills and the one being submitted for probate governs only some of the estate assets, the estate administration tax is calculated based only on the value of those assets governed by that will.

2.7.1 Reassessments by Minister of Revenue

As a consequence of amendments made in 2011 to the *Estate Administration Tax Act, 1998* by Bill 173, the *Better Tomorrow for Ontario Act (Budget Measures)*, 2011, the Minister of Revenue now has the authority to assess or reassess an estate for additional estate administration tax owing. Although the Minister has already acquired that "audit and verification" function, it will be considerably aided by a new obligation to provide more detailed information about the estate that will be imposed upon each person who applies on or after January 1, 2013 (or such later date as may be prescribed by the Minister of Finance) for a certificate of appointment of estate trustee. The form and content of that additional information, as well as the time frame within which it must be provided, will be prescribed by the Minister of Finance at some point before the new information obligation arises. It appears unlikely that this new obligation will slow down the normal process for issuance of a certificate of appointment of estate trustee.

The normal period of time within which the Minister of Revenue may assess or reassess an estate for additional estate administration tax is four years from the date on which the certificate of appointment of estate trustee was issued. The period of time is open-ended—being whatever the Minister considers to be reasonable—where the applicant fails to provide the required additional information within the time prescribed, or where any person has "made a misrepresentation that is attributable to neglect, carelessness or wilful default, or has committed any fraud in supplying any information regarding an estate or in omitting to disclose any information regarding the estate."

The estate trustee is entitled to challenge an assessment for additional estate administration tax and, if the Minister of Revenue confirms the assessment, to appeal the assessment to the Superior Court of Justice. In considering whether to challenge the assessment and how far to pursue it, the estate trustee will have to consider whether the cost of challenging the assessment will be reasonable, having regard to the quantum assessed. And, of course, the estate trustee will want to ensure that he or she will have access to sufficient estate assets to fund any challenge.

In contrast to the (re)assessment mechanism found in the *Income Tax Act*, there is no provision for the estate trustee to apply for a clearance certificate. It remains to be seen whether the lack of a clearance certificate mechanism will cause an estate trustee to delay the distribution of an estate until after the normal period of time within which an assessment or reassessment may be made.

Every person commits an offence who fails to provide the additional information within the time prescribed or who "makes or assists in making a statement that, at the time and in light of the circumstances under which it was made, is false or misleading in respect of any fact, or that omits to state any fact the omission of which makes the statement false or misleading." There is a due diligence defence available where a person "did not know that the statement or omission was false or misleading and in the exercise of reasonable diligence could not have known that the statement or omission was false or misleading." A person who is guilty of an offence is liable to (i) a fine up to twice the amount of estate administration tax owing, (ii) imprisonment for up to two years, or (iii) both fine and imprisonment.

During review of Bill 173 at the committee stage, the Ontario government asserted that the estate trustee

would not be personally liable for estate administration tax. (This was the rationale for voting down a proposed amendment to establish a clearance certificate mechanism.) In theory, where the Minister issues an assessment for additional estate administration tax after the estate has been distributed, collection of the tax owing must be sought from the persons to whom the estate was distributed. However, it is a general principle of estate administration that an estate trustee must pay, or make provision for, the estate's creditors before distributing the estate to the persons entitled. On that basis, might there not be exposure to liability where the estate trustee makes an expeditious distribution of estate assets—either before providing the Minister of Revenue with the required information or even after providing it but before the Minister has had a reasonable opportunity to consider an assessment for additional estate administration tax owing?

It has always been an obligation of the lawyer who acts for the applicant for a certificate of appointment of estate trustee to be satisfied that the client is not swearing a false affidavit with regard to the estate values. However, as a result of this new obligation imposed upon the applicant, the lawyer should ensure that the client is aware of

- the new assessment powers of the Minister of Revenue; and
- the penalties that can be imposed for failing to provide the Minister with the required information on a timely basis or for making a false or misleading statement in doing so.

It is particularly important that the client recognize that any fines imposed will not be recoverable from the estate if they were unreasonably incurred. The lawyer should also be mindful of the penalties, since they can be imposed upon any person who "assists" in the making of a false or misleading statement.

2.8 Other formalities

2.8.1 Bequest to witness

Section 12 of the *SLRA* states that a bequest to a witness or spouse of a witness is void, unless the court is satisfied that neither the witness nor the spouse exercised any improper or undue influence upon the testator. Where a beneficiary or a spouse of a beneficiary witnesses the will, the court can require (see Form 74.40) the beneficiary or the spouse to satisfy the court that the beneficiary or spouse did not unduly influence the testator (r. 74.15(1)(f)). If a bequest is found to be void because a beneficiary or spouse is a witness, that fact is required to be noted on the certificate of appointment (r. 74.12(5)).

2.8.2 Bequests to former spouse

Subsection 17(2) of the *SLRA* provides that, except where a contrary intention appears by the will, where the testator makes a will and thereafter his or her marriage is terminated by judgment absolute of divorce, all testamentary gifts to the former spouse under the will, as well as his or her appointment as estate trustee, if any, are revoked. In such instances, r. 74.15(1)(g) provides for an order requiring a former spouse to take part in the determination of the validity of the appointment of the former spouse as estate trustee and of the testamentary gifts. As with bequests to a witness or spouse of a witness, a finding that the former spouse is likewise disentitled is noted on the certificate of appointment.

2.9 Security bonds

The court will require security to be posted—unless persuaded that special circumstances warrant its being dispensed with—whenever an applicant for a certificate of appointment of estate trustee with a will is neither a resident of Ontario nor a resident of any other Commonwealth jurisdiction. This is true even in any of the following circumstances:

- The applicant is seeking a certificate of appointment of estate trustee with a will by virtue of having been appointed in the will.
- There is an Ontario resident named as a co-estate trustee.
- The testator has declared he or she does not wish any security to be provided.

2.9.1 Application for bond

Subrule 74.11(1) sets out the particulars associated with bonds and provides Form 74.32 as the form of bond from an insurance or guaranty company and Form 74.33 for one or more personal sureties. If the bond is a personal bond, usually two individuals bind themselves, along with the applicant, to the judge of the Ontario Superior Court of Justice. Normally, the total penalty in the bond is twice the value of the assets in the estate being administered (*Estates Act*, s. 37). However, the general practice is that where the bond is obtained from a licensed insurer, the amount of the bond need be equal only to the value of the assets in the estate being administered. Where a trust company is appointed as estate trustee, no security is required, unless a court orders otherwise (*Loan and Trust Corporations Act*, s. 175(4)).

2.9.2 Dispensing with or reducing bond

Subrule 74.11(1) provides that a court may dispense with the necessity of a bond or reduce the amount of penalty on the bond at the outset or at any later time in the

administration of the estate. To obtain an order at the outset dispensing with the necessity of a bond, an affidavit by the estate trustee must be filed with the other documentation included in the application process. The affidavit should recite the circumstances of the case that the estate trustee submits would justify dispensing with the bond. As well, those entitled to the estate must consent to the waiver of a bond.

A similar procedure is followed throughout the administration of the estate when a major portion of the assets has been disposed of or distributed and it is therefore not necessary to have the bond with such a large amount (*Estates Act*, s. 37(2)).

A bond is not required where

- the administration is a result of an intestacy;
- it is granted to the surviving spouse of the deceased;
- the net value of the estate is two hundred thousand dollars ($200,000) or less for the purposes of the *SLRA*; and
- an affidavit of debts is filed with the application for administration (*Estates Act*, s. 36).

2.9.3 Surrender of bond

In all of the situations where an estate trustee is required to post security, when the administration is ended, the bondsmen must be released from the obligation. The court itself does not cancel the bond but only surrenders it up for cancellation (*Estates Act*, s. 42). The procedure for cancellation of a bond is set out in s. 43 of the *Estates Act*.

3. Asset administration

3.1 Securities

The estate trustee should ascertain that the securities are under his or her care and control. This may be a matter of removing them from the deceased's safe deposit box to another location or making certain with the depository that the safe deposit box is put into the estate trustee's name alone and that only he or she has access to the box. It is also wise to advise the estate trustee to transfer security certificates from investment firms and other institutions to the estate trustee's own safekeeping facility. If the securities are to be an asset of the estate, it is necessary to advise the estate trustee that these securities or investment accounts should be registered in the estate trustee's name, and this requires a transmission. If the securities are to be sold, as is often the conclusion after an investment review, or if the money is needed to pay debts and provide cash bequests, a transfer is also needed requiring a transmission. If foreign assets are held, the lawyer must investigate the requirements of the foreign jurisdiction. It is the lawyer's responsibility to prepare all the necessary documentation to complete such transfers or dispositions.

In instances where there are marketable bonds or debentures (distinguished from Canada Savings Bonds, guaranteed investment certificates, and term deposits) or marketable stock, it is necessary to have a power of attorney executed or the certificate endorsed. The endorsement may be printed on the back of the security document itself. A suggested alternative is to complete a separate power of attorney, since it is necessary for the estate trustee to attend at an institution to guarantee the signatures to the satisfaction of the stock exchange. In the event the endorsement is on the back of the security and the estate trustee did not complete it accurately, having it then amended to the satisfaction of the transfer agent dealing with the stock may be difficult. If the separate document is completed and a mistake occurs, it allows the lawyer to redo the document or complete the amendments accordingly without defacing the security itself. The safekeeping of the security itself is enhanced as well.

3.1.1 Transfer requirements for Ontario companies: stocks and bonds

The following documents are required for either a transfer or a sale:

- original certificate of appointment, which the lawyer must request to be returned after comparison with a notarial copy: In practice, the transfer agents do not require the original certificate but will accept notarial copies, which simplifies the disposition of the estate when there are many securities to be dealt with and various transfer agents.
- declaration of transmission completed by the estate trustee to deal with either stocks or bonds (forms may be obtained from stationers).
- transfer form or power of attorney or the certificate endorsed by the estate trustee as his or her name appears exactly in the certificate of appointment, in full and with no initials: The document must have the signature of the estate trustee guaranteed by an institution acceptable to the transfer agent.

3.1.2 Transfer requirements for Quebec companies

The same requirements must be met as for Ontario companies, although some companies still require statements as to whether any beneficiaries are Quebec residents.

3.1.3 Securities in foreign jurisdiction

When securities have a *situs* in a foreign jurisdiction, the lawyer should write to the company or the transfer agent

to seek the necessary requirements to complete the transfer or redemption of the security. This is necessary because practices change from time to time. It is advisable for the lawyer to complete the requirements as soon as possible after obtaining the documentation so that no undue delay in the administration will occur.

3.1.4 Additional considerations

The following additional matters should be noted when dealing with bonds or stock:

- For a transfer in the U.S.A., a court-certified copy and a notarially certified copy of the certificate of appointment are required (the lawyer should request the return of the court copy). A court certificate dated within the past six months and stating that the estate trustees are still authorized to act is also required. A further requirement is a resolution from the institution that guarantees the signature covering their signing officers, signed under seal and certified to be in full force and effect at the date of delivery of the security. An undated resolution is not acceptable. In addition to this, the American transfer agent will normally require proof that the deceased was not resident in the United States and that the assets, apart from the securities being dealt with, did not exceed the exemption level for the payment of U.S. estate tax. Otherwise, a U.S. estate tax consent would be required before the transfer can occur. (Although the exemption level was increased over recent years to a peak of $3.5 million in 2009, the estate tax was repealed for deaths occurring in 2010. The U.S. Congress reinstated estate taxes for 2011 and 2012, with an exemption level of $5 million for 2011 and $5.12 million for 2012. At this point, it is not known what changes may be made to the estate tax rules for 2013 and beyond.) Non-resident aliens have a pro-rated access to the exemption, based on the proportion that the value of U.S. *situs* assets bears to the value of world-wide assets.
- Stock registered in the name of a limited company should be endorsed under seal, and a copy of the resolution covering the signing officers, signed under seal and certified "to be in full force and effect as of this date," must accompany this document. Also, the signing officers must be named in the resolution (e.g., John Smith, President).
- Where shares are registered in the name of a minor, the requirements for transferring the shares are many and complicated. It is advisable for the lawyer to contact the Children's Lawyer about the requirements. In Ontario, a court order would have to be obtained to complete the transfer.
- All securities must be put in bearer or negotiable form before an order to sell is placed. This is usually done by way of the declaration of transmission, which requests the transfer agent to transfer the securities into the names of the estate trustees and to sell them immediately thereafter, and by completion of the transfer form (power of attorney), which is left in blank as to the transferee.

3.2 Real estate

Where the testamentary document directs a sale or where a sale becomes necessary, the residence and other real property, such as a farm, summer residence, commercial or apartment buildings, should be sold or conveyed. It is generally necessary to apply for a certificate of appointment of estate trustee with a will when the main asset is real estate that has been devised in the will, unless the property is in the registry system. In land titles, a transmission application must be made and a certificate of appointment of estate trustee is necessary for properties having a value in excess of $50,000. The Province of Ontario is in the process of converting all properties in the registry system to the land titles system. Administratively, the government will permit a first dealing with a property so converted as if the registry system were still applicable. With registry system property, the estate trustee named in the will can consider transferring the title to the devisee or beneficiary by registering the following documents pursuant to s. 53 of the *Registry Act*:

- the original will or notarial copy of the will;
- a statement by a person well acquainted with the testator attesting to the testator's handwriting and signature (or in the case only of a formal will, a statement by one of the subscribing witnesses to the will, proving the due execution thereof by the testator) or a notarial copy of such a statement; and
- evidence of the death of the testator, which may be any one of
  - a statement as to the testator's date of death, made by anyone having personal knowledge of that fact or a notarial copy of such a statement;
  - a death certificate under the *Vital Statistics Act* or a notarial copy of the certificate;
  - a funeral director's death certificate or a notarial copy of such a certificate;
  - a court order made under the *Declarations of Death Act, 2002* declaring that the testator has died and that is not limited under s. 2(6) of that *Act* to specified purposes other than dealing with the testator's estate or a notarial copy of such a court order.

4. Debts

4.1 Ascertaining debts

The lawyer should advise the estate trustee to determine what debts or claims (e.g., under the *Family Law Act*) or liabilities are outstanding. When an estate is being administered under the terms of a will, the estate trustee must be aware of all debts that may be outstanding.

4.2 Notice to creditors and others

The estate trustee should publish a proper advertisement for creditors' claims before any debts or legacies are paid or, in the case of an intestacy, before any distribution is made.

4.2.1 Effect of advertisement

Section 53 of the *Trustee Act* provides that where an estate trustee has given notice, i.e., where he or she has advertised, with court approval, he or she may distribute the assets in the estate at the expiration of the time specified in the notice or the last of such notices for sending in claims against the estate. The estate trustee is not liable for any person's claim that has not been received at the time of distribution.

The *Trustee Act* refers only to the liability of the estate trustee and not to the liability of the beneficiary. If a creditor with a valid claim appears after the estate trustee distributes to a beneficiary, the claim can be successfully asserted against the beneficiary or beneficiaries, as long as the claim is brought within the statutory limitation period. The advertisement for creditors does not, in and of itself, extinguish any debts.

A prudent estate trustee should advertise for creditors as soon as possible after the deceased's death, and when notice of any claim has been received, the estate trustee ought not to proceed to pay the legatees without making due provision for all legitimate claims of which notice has been received (*Re Kay, Mosley v. Kay*).

Unless an advertisement for creditors' claims has been published as required by the *Trustee Act*, no distribution of an intestate's estate should be made until the expiration of one year after the death. If the distribution is made, the beneficiaries (or heirs) are bound to refund amounts received to pay creditors' claims.

4.2.2 Form of advertisement

In drafting an advertisement for creditors, as far as possible, one should follow the words of the *Trustee Act*. In addition to calling for claims against the estate, the advertisement should state the effect of non-compliance would be the exclusion of persons failing to comply from participation in the estate to be divided. An example of the type of notice that is used in many jurisdictions is set out below:

> **Notice to Creditors and Others**
>
> All claims against the estate of _____, late of the City of _____, in the County of
>
> _____, who died on or about the ____ day of January, _____, must be filed with the undersigned not later than _____.
>
> Thereafter, the undersigned will distribute the assets of the estate having regard only to the claims then filed.
>
> DATED this ____ day of March, ____
>
> FRANK DOE, 111 Main Street,_____, Ontario, by his lawyers, MESSRS. SMITH AND SMITH
>
> 89 Back Street_____, Ontario N5Z 2K4

4.2.3 Where published

The advertisement should be published in the locality in which the deceased lived or carried on a business at the date of death. Some cases have indicated that where the deceased is a merchant, the creditors from outside of the deceased's community would not see a notice published in a local newspaper. For this reason it has been suggested that in such cases, a notice should also be published in the *Ontario Gazette*.

4.2.4 Frequency of publication

Generally, three insertions and a month's notice should be given from the first publication and the time fixed for distribution. Another case has held that three weeks' notice was insufficient. The custom followed in most jurisdictions is that of publishing the notice once a week for three successive weeks.

4.2.5 When advertising essential

Where there is an administration bond, a notice to creditors should always be published. Where there is no bond, a notice should be published if the Ontario Superior Court of Justice must pass the accounts or if the deceased was active in business. The estate trustee's liability is one of the main factors to be considered in determining whether to publish an advertisement for creditors.

4.3 Settlement of debts

It is necessary for the estate trustee to determine whether the claims submitted are valid. The lawyer will advise the estate trustee, and if the claim cannot be settled, the lawyer should explain the procedures under the *Estates Act* (ss. 44–45), such as the contestation of a claim and the alternative approach of requiring that the claimant commence an action in the normal manner.

The Canada Revenue Agency (CRA) is very often a major creditor, both with regard to taxes owing at the date of death and taxes arising as a consequence of that death. Note the references to tax arising from jointly held properties and from registered funds.

4.4 Application of assets to settle debts (priorities)

4.4.1 Insolvent estates

In the case of an insolvent estate, "the contest is between creditors *inter se* as to priority in which their debts are to be paid" (Lord Simonds, *Halsbury's Laws of England*, at para. 666). In case of a deficiency of assets, debts are to rank *pari passu* (subject to the prior claims of any secured creditors) (*Trustee Act*, s. 50). According to the Ontario Divisional Court in *Wright v. Canada*, the federal Crown prerogative puts the Minister of National Revenue ahead of most unsecured creditors. However, the provincial Crown stands in the same position as all other unsecured creditors (*Trustee Act*, s. 50).

4.4.2 Solvent estates

Where the estate is solvent, the creditors are paid in full, and the contest is between the beneficiaries *inter se*, first, as to the order in which resort is to be had to the various parts of the estate for payment of the debts and liabilities, and second, what parts of the estate are charged with payment of the pecuniary legacies and in what order (Lord Simonds, *Halsbury's Laws of England*, at para. 666).

5. Distribution

The following items will address those matters common to both outright distribution estates and continuing estates. Again, caution is in order in relation to claims under the *Family Law Act*.

5.1 Estate trustee's year

At common law, the estate trustee is allowed one year from the testator's death to call in the assets and settle the affairs of the estate. All investments that are not proper to retain should be realized within the year. At the end of the year, it is presumed that the estate has been reduced into possession, and interest then starts accruing. The estate trustee is entitled to withhold payment of legacies during the first year after the death of the deceased, even though the will indicates that unless inconvenient, payment should be made sooner.

The estate trustee's year does not apply to the payment of debts. The estate trustee is liable to be sued for payment of debts the moment after the testator's death.

5.2 Administrator's year

It has been held that an administrator cannot be compelled to make a distribution within the first year after the death of the deceased. As well, the *Estates Administration Act* provides that in an intestate estate, subject to the provisions of the *Trustee Act* (s. 53) dealing with the liability of the estate trustee to creditors, in the absence of an advertisement for creditors, no distribution is to be made until after the first anniversary of the death of the deceased.

5.3 Succession Law Reform Act as a code for distribution of intestate or partially intestate estate

5.3.1 Spouse and no issue

The code deals first with the closest next-of-kin, who is considered to be the spouse. Under s. 44 of the *SLRA*, if the spouse survives and there are no issue surviving, the spouse is entitled to the entire estate. "Spouse" for distribution purposes means a legally married spouse.

5.3.2 Spouse and issue

(a) Spouse's preferential share

Under the *SLRA*, a legal spouse is entitled to a "preferential share," currently fixed by regulation at $200,000. It is calculated only on the assets in the deceased's estate and therefore does not encompass any jointly owned assets or assets that pass to a beneficiary by contract (e.g., life insurance) or by designation (e.g., RRSPs, RRIFs, and TFSAs). The preferential share itself is calculated only after any debts and liabilities have been deducted (*SLRA*, s. 45(4)).

The spouse is entitled to the preferential share according to the following rules:

- If the net value of the estate is less than the preferential share, the entire estate passes to the spouse, whether or not there were surviving issue (*SLRA*, s. 45(1)).
- If the net value of the estate is greater than the preferential share, the preferential share passes to the spouse (*SLRA*, s. 45(2)).
- If there is a partial intestacy (i.e., when the will does not dispose of all of the property of the deceased), the benefits received by the spouse under the terms of the will are taken into account in computing the preferential share (*SLRA*, s. 45(3)(a)).

(b) Balance of estate

After the spouse has received his or her preferential share, the balance, if any, of the estate, is shared between the spouse and issue according to the following rules:

- Where there is only one child surviving, the balance of the estate is shared equally between the spouse and the child (*SLRA*, s. 46(1)).
- Where there are two or more children, the spouse takes one-third of the balance of the estate and the rest is divided equally among the children (*SLRA*, s. 46(2)).

If a child has predeceased an intestate or partially intestate parent, the portion that would otherwise pass to the child, had the child survived the intestate parent, will not fail if the deceased child has left issue. The spouse's share remains the same as if the child had survived the deceased intestate parent (*SLRA*, s. 46(3)).

The issue of an intestate person are dealt with by representation on a *per stirpes* basis, subject to the rights of the spouse of the intestate (*SLRA*, ss. 47(1), (2)). The spouse of the deceased child does not share in the distribution. This may be contrasted with the situation where a gift is left to a child in a will, no contrary intention is set out in the will, and the child predeceases the testator. In that case, the spouse of the deceased child would be entitled to the gift (*SLRA*, s. 31).

5.3.3 Issue and no spouse

Where there is no spouse but one or more issue (the deceased's descendants of any degree), the estate will be distributed on a modified *per stirpes* basis. For example, if at least one child is living, the estate will be distributed equally among the children, with the issue of any predeceased child standing in that child's place. However, if the deceased has no spouse, no surviving children, but surviving grandchildren, the estate will be distributed equally among the grandchildren, with the issue of any predeceased grandchild standing in that grandchild's place. Under a pure *per stirpes* regime, the share of each grandchild would be dependent on how many children his/her parent had.

5.3.4 No spouse and no issue

If there is neither spouse nor issue and one or both parents are surviving, the parents or parent will receive the entire estate, and if both parents are alive it will pass to them equally (*SLRA*, s. 47(3)).

5.3.5 No spouse, no issue, and no parents

If there is no spouse, no issue, and no parents surviving, the estate will pass equally among the siblings. If one of the siblings has predeceased, leaving a surviving child or children, the child or children will take the share to which the deceased sibling would have been entitled if he or she had survived, and if more than one child, in equal shares (*SLRA*, s. 47(4)).

5.3.6 No immediate family

At this point in the chain of the next-of-kin, the representative share ends. Where there is no spouse, no issue, no parents, and no siblings, the estate passes to all of the nephews and nieces, who will share equally, *per capita* (*SLRA*, s. 47(5)).

5.3.7 Next-of-kin

If none of the above survives, the nearest next-of-kin of equal degree will share *per capita*, as set out in the table of consanguinity (*SLRA*, ss. 47(6), (8)).

5.3.8 No next-of-kin

When there are no next-of-kin, the estate becomes the property of the Crown (*SLRA*, s. 47(8)).

5.4 Persons born out of wedlock

Since March 1978, persons born inside marriage and those born outside marriage are entitled to share equally in an estate, whether on an intestacy or under a will made after March 31, 1978, with no contrary intention expressed therein (*SLRA*, s. 1(1); *Children's Law Reform Act*, s. 1(1)). Accordingly, any words identifying a class of persons such as "children," "issue," "cousins," etc., will be deemed to include such persons who were born outside of marriage or those who claim through a person born outside marriage, as well as those born within marriage (*SLRA*, s. 1(2)).

For example, the word "cousin" would include not only a person born outside marriage to an aunt or uncle, but also the child, whether born inside or outside marriage, of an aunt or uncle who was born outside marriage.

When drafted, the legislation did not provide for a time limit after which property could not be traced by persons born outside marriage. At the present time, there is no time limit prescribed. However, there is a limitation on tracing in s. 24(3) of the *Estates Administration Act*. That limitation states that where there is neither a presumption nor a court finding of the parentage of a person born outside marriage until after the death of the deceased, only property that is distributed after the estate trustee has actual notice of

- an application to establish the parentage; or
- the facts giving rise to the presumption of parentage

can be traced by the child born outside marriage.

5.4.1 Reasonable inquiries

An estate trustee is not liable for failing to distribute property to a person born outside marriage or a person claiming through such person if the estate trustee makes reasonable inquiries about that person and searches the records of the Registrar General relating to parentage (*Estates Administration Act*, ss. 24(1)–(2)). The legislation does not define "reasonable inquiries," and there is no definitive guidance in case law. In the meantime, the lawyer representing the estate trustee is left with the task of deciding how many questions and people must be asked to protect the estate trustee from

liability. Where one tries to determine, for example, who is a cousin of the testator, it is presumably necessary to inquire about children born outside marriage of each of the four grandparents and each aunt and uncle "whether born outside marriage or not," as well as those who are now covered by the word "cousin."

It is useful to begin by making inquiries of the members of the family who would be expected to know who were in the family, specifically asking whether there is any knowledge of children born out of wedlock. If the family know of no children born out of wedlock and have no reason to believe that there are any, it may be that the estate trustee has made all the reasonable inquiries that are necessary. However, the scope of the term "reasonable inquiries" has likely expanded in the age of the Internet and the development of ancestry databases, since the cost of conducting family history searches has come down dramatically as a result. (A useful exposition on such search tools and techniques can be found in Monique Charlebois' article, "The Estate Trustee's Duty to Search for Heirs," 23 E.T.P.J. 209.)

The inquiries that are being made should be made by the estate trustee unless he or she directs the lawyer to do so. This may be a matter of diplomacy as to how it is handled.

5.4.2 Searches at the Registrar General's Office

Subsection 14(1) of the *Children's Law Reform Act* states that the clerk or registrar of every court in Ontario shall furnish the Registrar General with a statement respecting each court confirmation or finding of parentage. Subsection 14(2) provides that upon application and payment of a prescribed fee, any person may inspect an order or judgment filed under this provision and obtain a certified copy from the Registrar General.

In certain circumstances, it may be necessary to advertise in a newspaper in all localities in which the heirs and beneficiaries were last known to reside. In addition to this, the advisability of advertising in some form of nationally or internationally distributed newspaper should be considered.

5.4.3 Judicial determination

If these inquiries fail to locate the missing heirs and it is felt that insufficient "reasonable inquiries" have been made, an application under the *Rules* to the Ontario Superior Court of Justice may be made.

If an estate trustee has found a person who he or she believes may be a child born out of wedlock, even though there is no presumption under the provisions of the *Children's Law Reform Act* (s. 8) (with the result that there could be no declaratory order if the father of the child is deceased), it would be unwise for the estate trustee to exclude this person from a distribution without the benefit of a court order so directing. The estate trustee may be personally liable to a person who can prove a relationship if that representative has distributed the estate before being satisfied the potential claimant is not a beneficiary.

5.5 Other considerations affecting testate distributions

5.5.1 Lapsed devise

Unless a contrary intention appears in the will, where a devise or bequest is made to a child, grandchild, or sibling of the testator who predeceases the testator and leaves a spouse or issue surviving the testator, the devise or bequest does not lapse but takes effect as if it had been made directly to the persons among whom, and in the shares in which, the estate of that person would have been divisible if that person had died intestate, without any debts, immediately after the death of the testator, with no preferential share being given to his or her spouse (*SLRA*, s. 31).

5.5.2 Mortgage on land

Unless a contrary intention is contained in a will, where an interest in land is bequeathed, the land passes subject to any mortgage thereon. The person receiving the gift is not entitled to have the mortgage discharged out of the personalty of the estate (*SLRA*, s. 32).

5.5.3 Interest on legacies

Subject to certain exceptions, the general rule is that where no special time is fixed for the payment of a legacy, it carries interest only from the expiration of one year from the testator's death. To this rule there are, however, exceptions—e.g., where a discretion as to time of payment is vested in an estate trustee by the testator. However, it has been established that expressions such as "as soon as possible," "not to be payable until six months after my death" do not alter the date from which interest will run.

5.5.4 Ademption of legacies

Where there is a specific legacy and the subject matter does not remain *in specie* or does not remain the property of the testator at his death, the legacy is said to have adeemed (i.e., the subject matter having disappeared from the testator's estate, the gift cannot be made). The case law has established, however, that a bequest of specific property may still take effect if it has merely changed its form. As well, the *Substitute Decisions Act, 1992* provides an anti-ademption rule that

applies where property that is the subject of a specific bequest in the will of an incapable person has been disposed of by that person's attorney pursuant to the authority under a continuing power of attorney. In that case, the intended beneficiary will be entitled, absent a contrary intention contained in the will, to receive from the residue of the estate the equivalent of a corresponding right in the proceeds of disposition of the property, without interest.

5.5.5 Abatement of legacies

The general rule is that all general legacies abate rateably. Priority will not be established by the mere fact that the will contains a direction that the legacy is to be paid "immediately" or "out of the first moneys" or that the words "in the first place," "in the second place," etc., are attached to the legacies. To establish priority there must be an indication that the testator contemplated the possibility that the assets might be deficient and provided for the order of payment in that event.

A residuary legatee has no right to call upon a particular general legacy to abate. The whole estate not specifically given must be exhausted before general legatees can be obliged to contribute anything out of their bequests.

5.6 Receipts/releases

5.6.1 Legacies

(a) Cash legacies

With regard to cash legacies, it is a common practice among estates practitioners to require a release from the intended legatee prior to payment. As a practical matter, however, a receipt (in the form of a cancelled cheque or otherwise) that evidences proof of full payment ought to be sufficient protection for the estate trustee. However, where, as a result of an abatement, the amount of the cash legacy to be paid is less than the amount set out in the will, it is conceivable that the legatee will allege either that

- the particular legacy ought not, according to the application of proper legal principles, to have been subject to abatement; or
- but for the estate trustee's unreasonable acts or omissions in administering the estate, there would have been no abatement or the amount of the abatement would have been smaller.

In such circumstances, it is understandable that the estate trustee may wish to have the beneficiary's release before making payment. However, there is Ontario jurisprudence (*Brighter v. Brighter Estate*; *Rooney Estate v. Stewart Estate*) clearly stating that holding up payment to a beneficiary until the beneficiary signs a release is improper.

(b) Non-cash legacies

Where a specific asset is directed to be conveyed to a beneficiary, it is advisable to obtain from the beneficiary in advance an acknowledgment that the asset intended to be conveyed is the one described in the will as the subject of the bequest.

(c) Legacies for minors

The estate trustee must be advised that he or she is not discharged by paying the legacy to a minor, since the minor is unable to give a receipt unless the testamentary document specifically provides that the minor's receipt shall be a sufficient discharge. Similarly, the estate trustee is not discharged by paying or transferring the legacy to the minor's parent or other relative, unless permitted to do so by the will or by statute. Where the estate trustee is seeking a release (for any of the reasons indicated earlier), neither the minor nor his or her parent (unless he or she has been appointed a guardian of the minor's property) can give it.

(d) Final distributions

It is common practice among estates practitioners, prior to making a final distribution, to require a release from each of the residuary beneficiaries. However, as already noted above, Ontario courts have been highly critical of this practice, since it effectively seeks to hold a beneficiary hostage "in order to extort from a beneficiary an approval or release of the executor's performance of duties as trustee, or the executor's compensation or fee." In any event, the estate trustee should expect that request to be met by a demand for some form of accounting, whether in court form or at some lesser level. The preceding comments respecting releases for distributions to a minor are equally applicable here.

6. Tax returns in administration of an estate

6.1 Basic requirements

Income tax returns must be filed. The lawyer must advise the estate trustee as to the payment of income taxes or other duties. It is the estate trustee's responsibility to file, within a period of six months from the date of death, all income tax returns not filed prior to the date of death. The estate trustee is also responsible for filing a terminal or final income tax return from the beginning of the year of the testator's death to the date of death. The deadline for this filing is the later of

- April 30th following the date of death; and
- six months from the date of death.

It may also be necessary for income tax returns to be filed subsequent to the date of death.

A deceased who was a GST or HST registrant would have been obliged to file returns and pay any GST or HST owing. The estate trustee is similarly obligated to see to the fulfillment of these obligations.

It is the lawyer's responsibility to advise the estate trustee of these obligations and to clarify whether the returns will be prepared by

- an accountant;
- the estate trustee; or
- the lawyer.

The income tax rules regarding a deceased taxpayer can present both tax traps and "post-mortem" tax planning opportunities. Unless the estate trustee or the lawyer is highly knowledgeable about those tax rules, it would be prudent for the lawyer to recommend to the estate trustee that an outside professional with significant income tax knowledge and expertise be consulted.

In some instances, it may be necessary to file foreign tax returns.

Unless the estate trustee is also the sole beneficiary, the lawyer should advise the estate trustee to obtain the necessary clearance certificate prior to finalizing the estate, since the estate trustee is personally liable for taxes owing to the extent that, as a result of estate distributions, there are insufficient estate assets remaining to pay any income taxes owing.

7. Accounting

The lawyer must advise the estate trustee (and this is usually done at the outset of the administration of the estate) of the responsibility to keep accurate accounts of the assets in the estate. It is advisable to have sufficient records kept so that a passing of accounts can be prepared very easily if the estate trustee is requested to do so. The problems encountered in reconstructing accounts after a long administration—or, in some cases, even in a short administration—can be time consuming and frustrating.

7.1 Requirements of accounting

The estate trustee must be scrupulous in ensuring that estate funds are maintained completely separate from his or her own funds. There are many methods that can be used to maintain proper accounts for the estate. A complete set of separate ledger books for the estate may be established, with each receipt or disbursement being recorded in these books. If such an approach is used, receipts and disbursements of a revenue nature can quite easily be recorded separately from receipts and disbursements of a capital nature. However, if the estate is an outright capital distribution, it is not as important to keep capital entries separate from revenue entries. While such a distinction is necessary for purposes of filing income tax returns, it is not important to beneficiaries who are entitled to their share of all of the estate, whether capital or income earned. In that situation, it may be acceptable simply to record all receipts and disbursements on one ledger sheet or in the passbook for the estate bank account. However, where there is a division of interest as, for example, between a life tenant and a remainderman, it is crucial that separate accounts for capital and revenue be maintained and that disbursements be correctly allocated between the capital accounts and revenue accounts.

7.2 Statements for beneficiaries

A full accounting of the estate administration should be prepared and submitted to the beneficiaries or heirs for their approval. Where required or where the beneficiaries or heirs themselves do not consent, the accounts should be submitted in accordance with the procedure necessary for the passing of accounts before the Ontario Superior Court of Justice. After approval by the beneficiaries or heirs or after the audit on the passing of accounts, a final distribution of the balance of the assets to the beneficiaries should be arranged and releases from further liabilities obtained. The lawyer should advise the estate trustee in all these matters and give whatever assistance is requested.

The final distribution cannot be made until the necessary clearance certificate has been obtained from the CRA regarding income tax and, where applicable, GST or HST. The estate trustee should be advised to hold certain moneys to protect against further liability, since it is the estate trustee who would be responsible for such a tax liability and not the beneficiaries or heirs of the estate. With the consent of the beneficiaries or heirs, the reserve funds may be held in a non-interest bearing account to stop the estate from earning more interest so the final income tax can be calculated. If interest is earned on the reserve account, it should be allocated to the beneficiaries as though the funds were held on an agency basis for the benefit of the beneficiaries.

Arrangements to surrender any existing administration bond should be made.

7.3 Passing accounts

"Passing of accounts" (sometimes referred to as an "audit of accounts" or "approval of accounts") refers to the presentation of formal accounts to the beneficiaries and the court, which are examined by the court and

- approved or "passed" in the form as presented;

- amended by court order and passed in amended form; or
- not passed because the court is not satisfied with the accounts or some aspect of the administration of the estate reflected in the accounts.

7.3.1 When is it necessary to pass accounts?

Although there is no requirement at law that an estate trustee pass his or her accounts, he or she is required by law to maintain estate accounts. However, an estate trustee may voluntarily have the accounts audited by the court or may be compelled to have them audited.

An estate trustee may have his or her actions approved in only one of two ways. The accounts can be presented to the beneficiaries who may then approve the accounting and discharge the estate trustee. However, if any beneficiaries with interests, vested or contingent, suffer some form of legal incapacity, e.g., a minor, mentally incapable person, unascertained class, etc., the approval cannot be obtained from all of the beneficiaries. If that is the case or if there is hostility and one or more of the beneficiaries will not approve the accounts, the estate trustee's only recourse is to present the accounts to the court for audit.

Generally, it is considered that accounts of an ongoing trusteeship should be approved by the beneficiaries or, if necessary, audited by the court every three to five years. Accounts should be passed if an estate trustee has administered an ongoing estate for such period or if the administration has been completed and the approval of all beneficiaries with an interest in the estate cannot be obtained.

7.3.2 Application to pass accounts

The application must contain basic information, including full particulars of the deceased, the date of the certificate of appointment of estate trustee, the period covered by the accounts, compensation claimed, and the persons who are entitled to an interest in the estate. The basic form of the application is a notice of application filed by the estate trustee. Rule 74.17 sets out the form of the accounts to be submitted for audit. The material to be filed is set out in r. 74.18 of the *Rules*.

Subrule 74.18(3) requires serving (i) the notice, and (ii) a copy of a draft of the judgment sought, upon each person who has a contingent or vested interest in the estate. Service is required to be by regular mail. The time for service is 45 days for persons in Ontario and 60 days for persons outside of Ontario.

Subrule 74.18(6) provides that the court may appoint a person to represent any person with a financial interest in the estate who is under a disability or is unknown if the Public Guardian and Trustee or Children's Lawyer is not already authorized to represent the person's interest and there is no guardian or other person already appointed to represent those interests.

7.3.3 Disposition on the passing of accounts

Generally, the practice on hearings for a passing of accounts has been fairly informal. If there are facts at issue or there are a great number of matters arising from the accounts that are in dispute, the estate trustee can be required by the other parties to give *viva voce* evidence under oath. Counsel for the estate trustee is entitled to examine the estate trustee in chief. The estate trustee is then subject to cross-examination in the usual manner by the parties who take issue with the accounts. As in other proceedings, the court may render its decision immediately or may reserve to consider the matter.

If the matter in dispute is particularly complex or if there are numerous relevant factual issues relating to the area of dispute that are difficult to resolve, the court may direct a trial of the issue or issues (*Estates Act*, s. 49(4)). Generally, this will involve the court's making an order declaring the issue or issues to be tried and the parties who will participate, ordering that there be examinations for discovery and production of documents and specifying when the matter will proceed to trial. In those jurisdictions where contentious estate matters are subject to mandatory mediation, the order for directions will include the requirement that the issues in dispute be mediated, unless the court makes an order exempting the dispute from mediation.

Proceedings will usually conclude with a determination by the court, by either agreement or adjudication, as to the total amount of each of the accounts submitted by the estate trustee, e.g., capital receipts, capital disbursements, etc. It will then be left to counsel to prepare a draft order, approved by all those in attendance upon the passing of accounts, and submit the approved order to the court to be signed and entered.

Subsection 10(1) of the *Estates Act* states that any party taking part in proceedings may appeal to the Divisional Court from any order or judgment of the Ontario Superior Court of Justice.

It is open to a person to file a statement of submission of rights to the court in response to a statement of claim or on a motion or application for directions (r. 75.07.1). In that event, the person is not a party to the proceeding and is entitled only to notification of the time and place of the hearing and a copy of the judgment disposing of the matter. By filing a statement of submission of rights

to the court, the person is neither entitled to costs nor liable for costs. However, a judgment on consent following a settlement may not be given without either the written consent of that person or an affidavit by a lawyer of record in the proceeding attesting to service of the notice of the settlement upon the person and that no rejection of the settlement has been filed within the time required by the *Rules*.

7.3.4 Estate trustee's compensation

The statutory basis for fees charged by estate trustees is found in s. 61 of the *Trustee Act*.

(a) Court-recognized tariff

A "court-recognized" tariff (sometimes referred to as the "usual percentages" approach) has evolved for estate trustees' compensation. This is not a legislated tariff but has developed as a guideline or yardstick to which reference is made in most cases of claims to estate trustees' compensation. It is subject to increase or decrease in appropriate circumstances and may be disregarded altogether, since another approach—for example, fees on the basis of docketed time—may be adopted by the court in particular circumstances. This tariff applies percentages to the various sections of the accounts and is expressed as follows:

- 2½ % of the total capital receipts (i.e., original assets realized);
- 2½ % of the total capital disbursements;
- 2½ % of the total revenue receipts;
- 2½ % of the total revenue disbursements;
- annual "care and management" fee of 2/5 of 1% of the average annual market value of the capital of the estate or trust.

The estate trustee is not allowed the percentage with respect to capital disbursements until that capital has been paid out (as, for example, to satisfy a debt) or distributed. If original assets are maintained and eventually distributed *in specie*, it is only upon the *in specie* distribution that the fees pertaining to capital disbursements can be claimed.

The care and management fee is generally available only where it is a trust estate that is to be held for a number of years. However, this fee may be applicable to an outright distribution if the distribution could not occur for a very significant period of time—due, for example, to litigation affecting the estate. That said, in a 2007 decision of the Superior Court of Justice, *Re Archibald (Estate)*, the estate trustee's claim for a care and management fee was dismissed on the basis that such a claim requires "special circumstances." In the view of Perell J., the "transactional" component of the percentages approach "already provides a predictable way to measure a *quantum meruit* compensation for the wide range of duties performed by executors including the management of the estate's assets." In his view, absent special circumstances, payment of a care and management fee would constitute "double-counting."

Counsel for the estate trustee should not expect that all that is necessary for the client to obtain compensation pursuant to the tariff is to set out the calculations and submit the statement of compensation with the accounts to be passed. Nor should beneficiaries simply accept a compensation claim because it is consistent with the "tariff." In fact, developments in the courts of many jurisdictions suggest they are increasingly looking to evidence to substantiate the quantum of compensation claimed by the estate trustee.

These forms of evidence include time dockets or estimated time logs, length of the administration, complexity of the estate, results obtained, the skill and ability shown, and the care and responsibility needed—factors that have for many years been the primary determinants of the award of legal fees on the taxation of a lawyer's account.

Although the percentages used in the tariff are based upon the realization, distribution, and management of the estate, the resulting compensation is to cover all services that the estate trustee has performed. It is intended to be remuneration for all work done and not merely the particular acts of realization and distribution. The compensation relates to ascertaining and gathering in the assets, valuation of assets, preparation of inventory, application for probate or issuance of a certificate of appointment of estate trustee, payment of debts and legacies, maintaining the accounts, meetings and reports to beneficiaries, etc. (The cases are somewhat uneven as to whether the cost of preparing income tax and trust returns should come out of the estate trustee's compensation. A corporate estate trustee is more likely to have such a rule applied against it; a lay estate trustee, less likely.)

(b) Special compensation

If an estate has been particularly complex or there have been specific assets or circumstances of the estate that have required the estate trustee to expend a greater amount of time and effort, the estate trustee should consider requesting a fee above the tariff, which has come to be known as a "special fee." At the passing of accounts, the claimant should be prepared to provide the court with full particulars of the basis for that claim. The form of evidence that could be adduced would include

- a memo of the extra services performed;

- time sheets, dockets, or estimated time log;
- affidavits in support of the claim; and
- witnesses to provide *viva voce* evidence.

Two common circumstances in which estate trustees may be inclined to ask for a special fee would be the following:

- Among the estate assets there were business interests such as interests in a private corporation or a partnership interest that had to be administered by the estate trustee.
- The estate has been involved in litigious matters in relation to which the estate trustee has had to instruct counsel and make decisions on behalf of the estate.

(c) Setting the compensation by will or by agreement

Subsection 61(5) of the *Trustee Act* provides that the instrument itself may fix the allowance to be paid to the estate trustee. While this practice is not common to wills, frequently the compensation for trustees under *inter vivos* trusts will be established in the trust agreement. In recent years, it has become quite common for corporate trustees who are asked to agree to be named as estate trustee of a will to request that a compensation agreement be signed. The agreement may be proposed because the estate is expected to be too small to result in an appropriate fee by the application of the "usual percentages" approach and, therefore, the estate trustee wants to be assured of an adequate minimum fee. If a compensation agreement is entered into, it is normally referred to in the will.

(d) Charging the trustee's compensation against the estate

Where there are income and capital beneficiaries, the method of charging the compensation against the estate becomes very important. If a tariff approach is utilized, the compensation granted that is applicable to capital is usually charged against the capital account, and the compensation awarded in relation to revenue is charged against the revenue account. With respect to the care and management fee, the general approach has been to charge the fee 2/3 to capital and 1/3 to revenue. However, that allocation may be significantly changed at the discretion of the court. For example, if the life tenant is in financial need, the court may be quite receptive to a submission that the whole (or most) of the care and management fee be charged against capital.

(e) Pre-taking of compensation

There has been much written about and many judicial decisions touching upon on the question of whether an estate trustee is entitled to take compensation before a passing of accounts and in the absence of approval on the part of all beneficiaries representing 100% of the interests in the estate.

Much of the Ontario law has been based on the decision in *Re Knoch*, a 1982 decision by Dymond J. of the Surrogate Court. What is interesting about that decision is that it dealt with the propriety of pre-taking compensation by an administrator *pendente lite* (now referred to as an estate trustee during litigation). The Surrogate Court took particular note that the source of entitlement to compensation for an administrator *pendent lite* was not s. 61 of the *Trustee Act*. Rather, it was to be found in what was then s. 53 of the *Surrogate Court Act*, which stated that "such administrator shall receive out of the property of the deceased such reasonable remuneration as the court considers proper." Ultimately, the Surrogate Court accepted the submissions of counsel for one of the objecting beneficiaries that pre-taking by the administrator *pendente lite* was not proper. Dymond J. went on to declare, "In my view, although it is not essential to this decision, the same reasoning applies to a trustee or other personal representative with the exceptions already mentioned."

Ironically, despite the fact that this statement in *Re Knoch* was clearly *obiter dicta*, it has been cited by judges in countless later cases as the jurisprudential basis in Ontario for the general prohibition against pre-taking of compensation by an estate trustee. (In relatively recent jurisprudence, *Re William George King Trust* appears to be an isolated instance where the pre-taking of compensation by a trustee was approved. However, this decision was expressly considered and not followed in a subsequent decision, *Re Flaska Estate,* and newer cases have returned to a more traditional prohibition against pre-taking in any form.) An estate trustee who pre-takes compensation that exceeds the amount ultimately approved by the court will be ordered to repay the estate with interest.

(f) Lawyer also acting as estate trustee

It is not uncommon for a lawyer to be named as an estate trustee and, as a result, to act both as estate trustee and as lawyer for the estate. (Legally speaking, there is no such thing as a lawyer for the estate. The lawyer's client is the estate trustee, and it is to him or her, and not to the beneficiaries, that the lawyer reports.) The question then becomes whether the lawyer is entitled to charge both full estate trustee's fees and lawyer's fees.

Subsection 61(4) of the *Trustee Act* seems to give support to the proposition that the lawyer is not disentitled from charging both fees in this situation. As well, wills commonly so provide.

The general prohibition against pre-taking compensation does not apply to legal fees charged by a lawyer/estate trustee. For that reason, the lawyer should take care to distinguish lawyer's work from estate trustee's work and charge for the former separately.

(g) Lawyers' fees

There is no tariff for the calculation of lawyers' fees in the administration of an estate. Guidelines that may be published by various county and district law associations are merely guidelines. Lawyers' fees in the administration of an estate must be determined as any other legal accounts being based upon the considerations given to all legal fees, which include the time spent, skill involved, and results obtained.

It is usual practice that, in the course of estate administration, a lawyer will prepare the account, whether interim or final, and submit it to the estate trustee for consideration. If the estate trustee considers the account to be reasonable, the account will generally be paid out of the estate, subject to approval by the court in the event that a passing of accounts is necessary. Subrule 74.18(13) provides that the court may assess or refer to an assessment officer any lawyer's account for a lawyer employed by the estate trustee.

There is a tariff applicable to the lawyer's fees to be allowed on a passing of accounts without a hearing. Subrule 74.18(10) states that the costs so awarded are to be assessed according to Tariff C. Tariff C bases the cost assessment on the aggregate value of the capital and revenue receipts and sets a maximum cost assessment at $5,000 for receipts of $3,000,000 or more. This fee applies to the estate trustee's lawyer. Costs awarded to counsel for beneficiaries is one-half that awarded to the estate trustee, except for the Children's Lawyer and the Public Guardian and Trustee, each of whom is entitled to three-quarters of the fees awarded to the estate trustee (see Form 74.44). If increased lawyer fees beyond Tariff C are being sought, a hearing is mandatory, even if there are no unresolved issues.

For passings at a hearing, the assessment of costs is at the discretion of the court. While every person who is a beneficiary, and therefore interested in the accounts, may be represented by counsel on a passing, the court is not obliged to grant costs out of the estate to such a beneficiary. Costs of certain beneficiaries may be denied in a case where there are several beneficiaries who share a common interest and each is separately represented by different counsel. A beneficiary's costs may also be denied if the court is of the view that the separate representation on behalf of the beneficiary was without good reason.

On a contested passing, it is improper for the estate trustee to pay the lawyer's fees prior to the hearing. The court order approving the accounts includes the order regarding lawyer's fees of all of the parties.

If the estate trustee instructs the lawyer to carry out functions normally required of the estate trustee, the compensation paid to the lawyer for that portion of the lawyer's work may be charged against the estate trustee's compensation, rather than being treated as an additional disbursement to the estate. It is imperative that the lawyer advise the estate trustee of what the lawyer may be entitled to be paid from the estate for performing those functions requested of him or her by the estate trustee. Once this has been outlined to the estate trustee prior to the administration of the estate, it must be documented, in order that the lawyer may charge his or her portion of the estate trustee's fees.

Chapter 40
Estate litigation

1. Will contestation

1.1 Challenge to the validity of a will

A will challenge is a proceeding in which someone disputes the validity of the purported last will and testament of a deceased. The common grounds for challenging the validity of a will are

- lack of testamentary capacity;
- lack of approval or knowledge of the contents of the will;
- the presence of undue influence; or
- non-compliance with the requirements of due execution as set out in Part I of the *Succession Law Reform Act* (*SLRA*).

In addition, there are less frequent challenges based upon such allegations as forgery or fraud.

The onus of proof of testamentary capacity rests on those propounding the will. They must establish, on balance of probabilities, that the deceased had the requisite level of testamentary capacity when the will was executed. When undue influence is alleged, the onus of proof is upon those alleging the undue influence.

There has been much recent attention placed on what has become known as the doctrine of "suspicious circumstances." This may include such matters as the age and medical condition of the testator, the opportunity of others to exercise influence over the testator, and the significance of changes made in the will as compared to earlier versions. A number of the reported cases suggest that if there are factual circumstances present in the case that would ordinarily make one suspicious about whether the will truly represents the testamentary intent of the testator at the time it was executed, there is a very heavy onus on those propounding the will to satisfy the court as to its validity. Suspicious circumstances alone do not normally constitute a basis for challenging a will, but are usually considered within the context of a challenge based on undue influence or lack of testamentary capacity.

Suspicious circumstances may be

- circumstances surrounding the preparation of the will;
- circumstances tending to call into question the capacity of the testator; or
- circumstances tending to show that the testator's free will was overcome by undue influence, coercion, or fraud.

The presence of suspicious circumstances operates to remove the normal presumption of capacity, including the rebuttable presumption that the testator knew and approved of the contents of the will. Where suspicious circumstances are shown to have existed, the court will therefore be "vigilant and jealous in examining the evidence in support of the instrument, in favour of which it ought not to pronounce unless the suspicion is removed and it is judicially satisfied that the paper propounded does express the true will of the deceased."

The suspicions must be removed by proof of the testator's knowledge and approval of the contents of the will. In addition, if the suspicious circumstances relate specifically to mental capacity, the presumption of testamentary capacity no longer applies, and the propounder of the will reassumes the legal burden of establishing capacity. Both capacity, on the one hand, and knowledge and approval, on the other, must be proven in accordance with the civil standard.

Where suspicious circumstances exist, the presumptions of capacity, knowledge, and approval are spent—the legal burden of proving these elements reverts to the propounder of the will.

Proceedings to challenge a will should be commenced in the Superior Court of Justice in the jurisdiction in which the deceased last resided. These proceedings are commenced in one of two ways. If a certificate of appointment of estate trustee has not yet been obtained, a notice of objection must be prepared and filed with the court as soon as possible. If a certificate of appointment has been obtained, an order must instead be sought, usually by application, again as soon as possible, requiring the person to whom the certificate was issued to return it to the court in order that the issues relating to the validity of the will may be determined.

1.2 Notice of objection (probate not yet obtained)

A notice of objection (*Rules of Civil Procedure* (*Rules*), r. 75.03 and Form 75.1.) is notice to the registrar of the court that nothing should be done by anybody in relation to the will of a deceased without notice to the person who filed the objection (the objector). The notice of objection

sets out the interest that the objector has in the estate and the grounds upon which the will is being challenged.

The notice of objection should be filed with the estate registrar of the court in the jurisdiction in which an application for a certificate of appointment of estate trustee for the deceased's estate would be made pursuant to s. 7 of the *Estates Act*. There is no obligation to serve a copy of the notice of objection on any party, but the local registrar of the court is required to forward a copy of the notice of objection to the Estate Registrar for Ontario (who is also the Registrar for the Estates List in the City of Toronto). The Estate Registrar for Ontario maintains a register of all objections filed in the province. The local registrar of a court cannot issue a certificate of appointment unless confirmation has been received from the Estate Registrar for Ontario that no other application has been made with respect to the estate and that no notice of objection has been entered in any court in Ontario (*Estates Act*, s. 22).

The notice of objection will remain effective for a period of three years after it is filed; it may be withdrawn by the person who filed it at any time before the motion for directions (the next major procedural step) is heard, or it may be removed by order of the court (r. 75.03(2)).

If an application for a certificate of appointment is subsequently filed, the estate registrar must send notice that an objection has been filed to the applicant by regular mail to his or her address or the address of the estate's solicitor, as shown on the application (r. 75.03(3) and Form 75.2). The applicant must then serve the objector with a notice to objector (r. 75.03(4) and Form 75.3). This notice advises the objector that an application has been made to probate the will (probate means granting a certificate of appointment of estate trustee with (or without) a will). The objector must serve and file a notice of appearance within 20 days of service. A copy of the notice to objector (r. 75.03(4) and Form 75.3) must then be filed with the court, with proof of service (r. 75.03(4) and Form 75.3).

If the objector fails to serve and file a notice of appearance within 20 days after being served with the notice to objector, then the objection is removed by the registrar, and the application for the certificate of appointment shall proceed as if no notice of objection had been filed (r. 75.03(5)). If a notice of appearance is served and filed, the applicant for the certificate of appointment of estate trustee must then move for directions within 30 days, failing which, the objector may do so (r. 75.03(6)).

1.3 Order for return of certificate (probate already obtained)

If a certificate of appointment of estate trustee has already been issued, the proceedings to challenge a will cannot be commenced by filing a notice of objection. Instead, the party wishing to challenge the validity of a will must obtain an order requiring the certificate to be returned to the court (r. 75.05(1)). This order may be obtained on a motion without notice by filing a draft order and an affidavit in support. The affidavit should set out the interest of the party applying for the order and the general grounds upon which the order is sought. The order requires the estate trustee to return the original certificate of appointment to the court forthwith. Once the order has been served on the estate trustee, the appointment has no further effect, and no further action can be taken with respect to the administration of the estate until the issues respecting the validity of the will have been determined or the court orders the certificate to be released back to the estate trustee (r. 75.05(3)).

Within 30 days after the court makes an order requiring the certificate to be returned, the person who obtained the order must move for directions. Alternatively, the estate trustee may do so at any time (rr. 75.05(4)–(5)). If, however, a motion for directions is not brought by the party challenging the will within the 30-day period, the estate trustee may move, without notice, for an order releasing the certificate to him or her (r. 75.05(6)), which if granted, will permit the estate trustee to proceed with the administration of the estate in accordance with the terms of the will.

1.4 Motion for directions

Rule 75.06 addresses both applications and motions for directions, stating that "[a]ny person who appears to have a financial interest in an estate may apply for directions, or move for directions in another proceeding under this rule, as to the procedure for bringing any matter before the court."

After either

- an objector has served and filed a notice of appearance, where the proceedings were commenced by notice of objection; or
- an order has been obtained by an interested party requiring the estate trustee to return the certificate of appointment to the court,

a motion must be brought for directions as to the conduct of the proceedings within 30 days of either event (r. 75.05(4)). Notice of the motion must be served on all persons who appear to have a financial interest in the estate, or as the court directs, at least 10 days before the hearing date (r. 75.06(2) and Form 75.6).

1.5 Order giving directions

Upon the hearing of the motion for directions, the court may

- direct (i.e., make an order to this effect) the issues to be dealt with;
- define the parties and who is submitting which rights to the court; and
- specify who is to be served with the order giving directions and direct the method and timing of service.

The order giving directions (r. 75.06(3) and Form 75.9) will also address procedures for bringing the matter before the court in summary fashion, if appropriate. It may also deal with such matters as the appointment of an estate trustee to administer the estate during litigation and the requirement for security. Pre-trial procedure, such as mediation, examinations for discovery, and production of documents, is usually dealt with, as well. The Children's Lawyer or Public Guardian and Trustee is generally not required to submit to examinations for discovery but may participate in the examinations of other parties.

Generally, the order giving directions provides that the issues are to be tried before a judge without a jury. Upon completion of the pre-trial procedure, the matter is then ready to be set down for trial on a date to be fixed by the registrar, upon notice to all parties.

1.6 Procedure where a statement of claim is served

Although traditionally pleadings were not prepared and exchanged in these proceedings, the order giving directions may now require the plaintiff to serve and file a statement of claim pursuant to the order giving directions (r. 75.06(3)(e) and Form 75.7). When a statement of claim (Form 75.7) is required to be delivered, it must be served on each defendant, who may then serve on every other party and file, with proof of service, a statement of defence or a statement of defence and counterclaim (r. 75.07(1)(a)). In response, the plaintiff may then deliver a reply or reply and defence to counterclaim (r. 75.07(2)). Alternatively, a person served with a statement of claim may instead file a "statement of submission of rights to the court" (r. 75.07(1)(b) and Form 75.10). Any person who is served with a statement of claim and does not file one of these documents in response is not a party to the proceeding, and his or her consent to any settlement, agreement, or consent judgment is not required (r. 75.07(4)). Note that the *Rules* do not prescribe any deadline to file either of the aforementioned documents in response, so it is unclear when this rule takes effect (or in practical terms, when another party can avail itself of the rule).

1.7 Submission of rights to the court

When a person has submitted his, her, or its rights to the court (r. 75.07.1) either

- on a motion for directions respecting the conduct of the application for a certificate of appointment; or
- by filing a statement of submission of rights to the court in response to a statement of claim filed by the plaintiff in compliance with the order giving directions,

the person is not a party to the proceedings but is entitled to written notice of the time and place of the trial and a copy of the judgment disposing of the matter. A person submitting rights to the court is not entitled to costs nor is liable for any party's costs (except in the sense that costs ordered to be paid from the estate assets may reduce that person's residuary interest). An important advantage to this process is that the matter cannot be settled without that person's involvement.

1.8 Settlement involving a person who has submitted rights to the court

If parties to the issues to be tried reach a settlement, any person who has submitted his or her rights to the court (r. 75.07.1(c)) must either provide a written consent to the settlement or must be personally served with a "notice of settlement" (Form 75.11) to which is attached a copy of the agreement or minutes of settlement on which judgment will be sought. If the person served objects to the terms of settlement, he or she must serve and file a "notice of rejection of settlement" (Form 75.12), stating the reasons why the settlement is rejected. This must be served and filed within 10 days of service of the notice of settlement.

The court will not issue a judgment on consent approving settlement of a matter without either

> (i) the written consent of any person who has submitted his or her rights to the court; or
>
> (ii) in the absence of such consent, an affidavit of a solicitor of record in the matter attesting that a notice of settlement was personally served on the person and no rejection of settlement was filed within 10 days after service of the notice.

1.9 Request for notice of commencement of proceeding

At any time before a certificate of appointment of estate trustee has been issued, any person who has a financial interest in the estate and wishes to be informed of the commencement of a proceeding in the estate may file with the registrar a "request for notice" (r. 74.03 and

Form 74.3). The registrar will then notify the person, by regular mail, of any proceeding commenced in the estate. In this way, an interested party can be notified early if a notice of objection is filed challenging the validity of the will. The request remains in effect for three years, but a further request may be filed at any time before the certificate of appointment is issued.

1.10 Administration during litigation

At the time the motion for directions is brought, an order is often sought for the appointment of an estate trustee during litigation. An estate trustee during litigation has authority to administer the estate while the litigation concerning the validity of the will is pending, but has no authority to make distributions of the residue of the estate (*Estates Act*, s. 28). As soon as the litigation is concluded, the estate trustee so appointed automatically loses authority to act on behalf of the estate.

An estate trustee appointed to administer the estate during litigation is required to post bond in the amount of double the value of the property under administration, but the court has discretion to reduce the amount or dispense with the bond altogether in appropriate circumstances (*Estates Act*, ss. 35–37). Unless otherwise ordered, the bond must be issued by an insurer licensed under the *Insurance Act* to write surety and fidelity insurance in Ontario or one or more personal sureties who are resident in Ontario and over the age of majority. One personal surety is sufficient where the value of the assets of the estate does not exceed $100,000 (r. 74.11(1))(d).

Except on consent, the court will generally not appoint one of the parties to the proceedings or anyone whose involvement would bring into question the administrator's objectivity.

1.11 Order to accept or refuse appointment

An estate trustee takes authority from the will itself and does not always require a certificate of appointment to carry out the administration of an estate. Accordingly, while a person wishing to challenge the validity of a will may file a notice of objection with the court, one of the difficulties with this procedure is that the estate trustee named in the will is under no obligation to apply for a certificate of appointment or even to determine whether a notice of objection has been filed. If no application for a certificate of appointment has been made or if the objector does not know whether the estate trustee intends to apply for a certificate, the appropriate approach would be to apply for an order requiring the estate trustee to either apply for or refuse the appointment (*Estates Act*, s. 24; r. 74.15(1)(a) and Form 74.36). The "order to accept or refuse appointment" can be obtained without notice in the same manner as that used to obtain an order to return the certificate of appointment to the court, as described above.

Once an application for a certificate of appointment is filed in response to the order, the notice of objection takes effect, and the challenge to the will can proceed in the manner outlined above.

2. Revocation of certificate of appointment

Any person having a financial interest in an estate may make an application to the court to revoke the certificate of appointment of an estate trustee (r. 75.04). This procedure is distinct from a challenge to the validity of a will. It may be used where the validity of the will is not in question but the certificate was issued in error or as a result of a fraud on the court or where the appointment is no longer effective or for any other appropriate reason. For example, this rule might be invoked if a certificate of appointment is issued in connection with a will thought to be the deceased's last will, but a more recent unrevoked will is subsequently found. If the court is satisfied that the certificate was issued in error under such circumstances and no issue arises as to the validity of the more recent will, the court, on the hearing of the application, may order the revocation of the certificate, thereby permitting the more recent will to be probated.

In more complex or contentious circumstances, however, it may be necessary to move for directions under r. 75.06 with respect to the conduct of the proceedings. It is also possible in the context of an application to revoke a certificate to make a motion, without notice, for an order requiring the estate trustee to return the certificate of appointment to the court pending the determination of the issues (r. 75.05(1)(b)). Once such an order is served on the estate trustee, the appointment will have no further effect until the issues are determined or the certificate is ordered to be released back to the estate trustee.

3. Orders for assistance

There are other kinds of orders that may be obtained to assist in estate matters in specified circumstances (r. 74.15). An order for assistance is usually obtained on a motion made without notice, supported by affidavit evidence (r. 74.15(2)). Except as below, an order for assistance must be served by personal service or an alternative to personal service, as directed by the court. The court can also require any person to be examined under oath for purposes of deciding a motion for such an order (rr. 74.15(3)–(4)). Common types of orders for assistance include the following:

- **Order to Accept or Refuse Appointment as Estate Trustee With a Will (r. 74.15(1)(a) and Form 74.36)**

  This order compels an estate trustee to apply for a certificate of appointment within a particular period of time, failing which he or she will be deemed to have renounced the right to do so. This may be a useful tool in situations where a person having a financial interest in an estate knows of a will, but no steps have been taken by the named estate trustee to apply for a certificate of appointment, and there is a concern that steps may be taken in the administration of the estate without the knowledge of interested parties. It is also useful in situations where a party wishes to challenge the validity of a will and has filed a notice of objection, but no application for a certificate of appointment has yet been filed. Since the application must be filed before the notice of objection takes effect, obtaining an order to accept or refuse the appointment will initiate this process.

- **Order to Accept or Refuse Appointment as Estate Trustee Without a Will (r. 74.15(1)(b) and Form 74.37)**

  This order may be obtained in circumstances such as noted above where, on an intestacy, anyone having a financial interest in the estate is concerned that the person or persons entitled to apply for a certificate of appointment of estate trustee without a will may be taking steps in the administration of the estate without having obtained the certificate and without advising those beneficially entitled.

- **Order to Consent or Object to Proposed Appointment (r. 74.15(1)(c) and Form 74.38)**

  This order would be obtained and served on anyone having a financial interest in the estate whose consent to the appointment of an estate trustee is required but who has failed or refused to give it. Since this could lead to delays in obtaining the certificate and in administering the estate, the order compels the party to consent or object within a particular period of time, failing which he or she will be deemed to have consented to the proposed appointment.

- **Order to File Statement of Assets of Estate (r. 74.15(1)(d) and Form 74.39)**

  This order, which may be obtained by anyone having a financial interest in an estate, requires an estate trustee to file a statement of assets and their values and is useful in situations where this information has not been forthcoming. It may also be of assistance to persons who are contemplating a will challenge but who require information as to the value of the estate in order to assess the relative benefits and risks of proceeding.

- **Order for Further Particulars (r. 74.15(1)(e))**

  Where an estate trustee has filed a statement of assets, as above, but further details are required, a party with a financial interest in the estate may obtain an order requiring same. Unlike other orders for assistance, a motion for an order for further particulars may not be made without notice but must instead be made on 10 days' notice to the estate trustee (r. 74.15(2)).

- **Order to Beneficiary Witness (r. 74.15(1)(f) and Form 74.40)**

  When a beneficiary or a spouse of a beneficiary witnessed a will or codicil, any person having a financial interest in the estate may obtain an order requiring the witness to bring a motion within a specified period of time asking the court to find that he or she did not exert any improper or undue influence on the testator. Failure to bring such a motion will permit the applicant to obtain a certificate of appointment of estate trustee bearing a notation that the bequest to the witness is void under s. 12 of the *SLRA*.

- **Order to Former Spouse (r. 74.15(1)(g) and Form 74.41)**

  Subsection 17(2) of the *SLRA* provides that except when a contrary intention appears in the will, when, after the testator makes a will, his or her marriage is terminated by a judgment absolute of divorce or is declared a nullity, any devise or bequest of a beneficial interest in property to the testator's former spouse or any appointment of the former spouse as estate trustee and any power of appointment conferred upon the former spouse is revoked, and the will shall be construed as if the former spouse had predeceased the testator. In such circumstances, anyone having a financial interest in an estate may apply for an order requiring the former spouse of the testator to take part in the determination of the issue respecting the validity of any such bequest or appointment by entering an appearance within a specified number of days. The former spouse's failure to do so will result in the matter being determined in his or her absence, and the former spouse will be bound by the result.

- **Order to Pass Accounts (r. 74.15(1)(h) and Form 74.42)**

In addition, an order may also be obtained for any other type of assistance that the court directs (r. 74.15(1)(i)).

4. Formal proof of a testamentary instrument

Generally, probate is obtained in "common form" (meaning no court attendance is required) upon filing the necessary documents. In certain circumstances, a will must be formally proved in open court, with notice to all interested parties (a procedure sometimes referred to as "proof in solemn form"). A judge may require this procedure on an application for directions respecting proof of the will brought by the estate trustee or by any person having a financial interest in the estate (r. 75.01).

The need for formal proof of a will may arise in circumstances where, for example, both witnesses to a will cannot be located, both are dead, or the will being put forward as the last will and testament of the deceased is not an original. If a will is being challenged for any reason, formal proof is also necessary. In general, formal proof constitutes part of the hearing with respect to the contestation of the will. Formal proof requires that the due execution of the will and the testamentary capacity of the testator be established through the examination of one or more of the witnesses to the will and any others with knowledge of the facts and circumstances relating to these issues. A witness in the hearing is subject to examination, cross-examination, and re-examination in the usual manner of a trial.

4.1 Proof of lost or destroyed will

Where a last will has been lost or destroyed, it may be proved on an application supported by affidavit evidence, without the necessity for a court appearance, where all persons having a financial interest in the estate consent (r. 75.02). In the absence of full consent, it is necessary to apply to the court for directions respecting the procedure for proving the lost or destroyed will. As outlined above, all parties having a financial interest in the estate would have to be served with notice of the application for directions at least 10 days before the hearing (r. 75.06).

5. Applications to the court pursuant to r. 14.05(3)

5.1 Types of relief under r. 14.05(3)

Subrule 14.05(3) sets out specific types of claims that may be commenced by application, most of which are relevant to estate matters:

> **14.05—(3)** A proceeding may be brought by application where these rules authorize the commencement of a proceeding by application or where the relief claimed is,
>
> (a) the opinion, advice or direction of the court on a question affecting the rights of a person in respect of the administration of the estate of a deceased person or the execution of a trust;
>
> (b) an order directing executors, administrators or trustees to do or abstain from doing any particular act in respect of an estate or trust for which they are responsible;
>
> (c) the removal or replacement of one or more executors, administrators or trustees, or the fixing of their compensation;
>
> (d) the determination of rights that depend on the interpretation of a deed, will, contract or other instrument, or on the interpretation of a statute, order in council, regulation or municipal by-law or resolution;
>
> (e) the declaration of an interest in or charge on land, including the nature and extent of the interest or charge or the boundaries of the land, or the settling of the priority of interests or charges;
>
> (f) the approval of an arrangement or compromise or the approval of a purchase, sale, mortgage, lease or variation of trust;
>
> (g) an injunction, mandatory order or declaration or the appointment of a receiver or other consequential relief when ancillary to relief claimed in a proceeding properly commenced by a notice of application;
>
> (g.1) for a remedy under the *Canadian Charter of Rights and Freedoms*; or
>
> (h) in respect of any matter where it is unlikely that there will be any material facts in dispute.

5.1.1 Necessary material

The nature of the material required in support of the application will vary from case to case. In applications pursuant to r. 14.05(3), the title of the proceeding will set out that the question arises in the matter of a named estate or in the matter of a last will and testament of a named person. In addition, reference should be made to r. 14.05(3) together with the appropriate subsection, as well as any other statutory provisions that may relate to the application, such as s. 60 of the *Trustee Act*.

The notice of application should be consistent with Form 14E of the *Rules* and should set out with particularity the questions requiring the determination of the court.

Evidence is provided by way of affidavit. There should be a principal affidavit setting out in a straightforward manner a chronology of the events that give rise to the legal problem or problems set forth in the notice of application. The principal affidavit should be carefully drafted to ensure that the presiding judge can locate in one document all necessary information for the determination of the questions put to the court. Any available material in corroboration of statements made in the principal affidavit should be filed as an exhibit to the principal affidavit, such as a copy of letters probate of the last will and testament of the deceased.

The notice of application must be issued as set out in rr. 38.05 and 14.07. The notice of application and supporting material should be served upon all persons who have an interest in the outcome of the questions before the court, including those who may have contingent interests. If the questions are in whole, or in part, directed toward the possibility of a partial intestacy, the notice of application should also be served upon the next of kin. Pursuant to r. 38.06, the minimum notice period is 10 days except where the notice is served

outside Ontario, in which case it shall be served at least 20 days before the hearing date.

5.1.2 Application record

Rule 38 applies (r. 38.09) to applications brought under r. 14.05(3). Subrule 38.09(1) requires the applicant to serve the application record and a factum upon every other party at least seven days before the hearing. Further, the applicant must also file the application record and factum, with proof of service, in the court office where the application is to be heard, at least seven days before the hearing. The application record must contain

- a table of contents describing each document by nature and date;
- a copy of the notice of application;
- a copy of all affidavits and other material to be used on the application;
- a list of all transcripts of evidence (not relevant to r. 14.05(3) applications with respect to estates);
- a copy of any other material that is necessary for the hearing of the application; and
- a factum consisting of a concise statement, without argument, of the facts and law relied on by the applicant (this can be served and filed as a separate document).

Subrule 38.09(3) requires that each respondent serve and file a respondent's factum at least four days before the hearing. Subrule 38.09(4) also provides that the judge, before or at the hearing of the application, may dispense with compliance with the rule in whole or part.

The following are specific types of proceedings that may be brought within the framework of r. 14.05(3).

5.2 Application for advice and direction on the interpretation of a will — rr. 14.05(3)(a) and (d)

One of the most common types of estate proceedings is an application for the opinion, advice, and direction of the court on the interpretation of an ambiguous provision in a will. Section 60 of the *Trustee Act* confers on an estate trustee authority to seek the court's assistance on interpretation issues and provides as follows:

> **60.—(1)** A trustee, guardian or personal representative [which is an estate trustee with or without a will] may, without the institution of an action, apply to the Superior Court of Justice for the opinion, advice or direction of the court on any question respecting the management or administration of the trust property or the assets of a ward or a testator or intestate.
>
> **—(2)** The trustee, guardian or personal representative acting upon the opinion, advice or direction given shall be deemed, so far as regards that person's responsibility, to have discharged that person's duty as such trustee, guardian or personal representative, in the subject-matter of the application, unless that person has been guilty of some fraud, wilful concealment or misrepresentation in obtaining such opinion, advice or direction.

As is clear from s. 60(2), proceeding in this manner exonerates the estate trustee from liability for acting upon the opinion, advice, or direction obtained from the court on such an application. The estate trustee or any other party having an interest in the proceeding may commence an application of this nature in the Superior Court of Justice in the jurisdiction in which the certificate of appointment of the estate trustee was issued.

The manner in which the notice of application is framed in such proceedings is particularly important. The general principle to be followed when framing questions for the court's consideration is, wherever possible, to draft questions in such a manner that they must be answered in the affirmative or negative. This may require that a series of questions be posed. As an example, consider the question of when a class of beneficiaries is to be determined. Possible dates might be the date of death of the testator, the date of death of the life tenant or the date when the youngest member of the class attains the age of 18 years. Before framing the notice of application, all possible legal options must be explored. Each of the various possibilities is then posed as a question. It is not appropriate simply to ask the court: "At what date is the class to be ascertained?" where so many different possible answers exist. The alternative possibilities should instead be posited separately, in a logical sequence.

Questions should only be put to the court if it is otherwise impossible to proceed with the administration of the estate. Estate trustees should not ask the court how they should exercise their discretion.

The first step in defining the issues is to ascertain the "intent of the will." The next step is to examine the particular clause or clauses giving rise to the difficulty. Finally, determine who to serve with notice pursuant to r. 38.06.

5.2.1 Questions that should not be asked of the court

There are at least two types of questions that should not be put to the court by way of notice of application. One type includes matters of an academic or hypothetical nature. The court will refuse to answer questions in the abstract or make a declaration as to the general state of

the law. The court will only answer questions that apply to the facts of a particular case.

The other type of question that should not be put to the court is one that may or may not be a problem, depending on future events. The court will generally refuse to proceed with such applications. However, courts have been willing to make declaratory judgments on future matters where "it was almost inevitable that the question now raised would have to be answered sooner or later and that it was of (such) great practical importance that it be answered now." An example would be where the will is unclear on the distribution of an estate on the termination of a life interest and the death of the life tenant is imminent.

In addition to these two circumstances in which an application under r. 14.05(3) is considered inappropriate, the court has often expressed reluctance to make an order approving the sale of an asset of the estate where there is a disagreement among the estate trustees. As stated by Middleton J. in *Re Fulford* and reiterated by the court in *Re Wright*:

> The executors are protected from all liability if they honestly and with due care exercise the discretion vested in them. But the responsibility is theirs, and cannot be shifted upon the Court. The executors cannot come to the Court and ask whether the present is a good time or a bad time to sell stock or anything else, or ask whether a price offered is sufficient or insufficient. The advice which the Court is authorized to give is not of that type or kind; it is advice as to legal matters or legal difficulties arising in the discharge of the duties of executors, not advice with regard to matters concerning which the executors' judgment and discretion must govern.

5.2.2 Role of the estate trustee

The estate trustee is theoretically neutral in these proceedings, interested only in clarifying his or her obligations by determining the appropriate interpretation of the provision in issue. Although a judge hearing the application does have discretion, before or at the hearing, to dispense with compliance with R. 38 in whole or in part, it is nevertheless the generally accepted view that the estate has a primary responsibility to the court to prepare and file the required materials, including an application record and a factum setting out a brief summary of the facts and a review of the law relevant to the issues at hand, without taking any position.

Similarly, in oral argument, the role of the estate trustee is to assist the court by introducing the difficulty and by reviewing the possible interpretations, the law supporting such conflicting interpretations, and the consequences to the interested parties of each such interpretation. The respondents will argue in favour of their respective interests.

When there is more than one estate trustee and the estate trustees disagree as to how, or even if, to proceed to court, then R. 9 is of assistance. In such a situation, the one estate trustee may commence the proceeding as the applicant (or plaintiff), who then must name and serve the non-consenting estate trustee as a respondent (or defendant) (r. 9.01(1)).

5.3 Application to ascertain heirs — rr. 14.05(3)(a)–(b) and (d)

When an individual dies intestate, the estate trustee may be uncertain about who are the heirs-at-law. In these situations, the estate trustee may apply to the court for a determination of this issue to ensure that distribution is made to the proper beneficiaries. The estate trustee should provide an affidavit detailing the efforts made to locate the heirs and the particulars of those heirs who have been located. Alternatively, one or more individuals claiming to be heirs may commence this application. The onus rests with these individuals to prove, on a balance of probabilities, that they are heirs-at-law.

The proceedings are commenced by notice of application supported by a detailed affidavit attesting to the relevant facts pursuant to rr. 14.05(3)(a)–(b) and (d). If the applicant is an alleged heir, the notice of application may request an order confirming heirship or may request an order directing a reference pursuant to r. 54.02 for the determination of the issue. When the applicant is the estate trustee, the relief sought is generally in the nature of a claim for the opinion, advice, and direction of the court or for an order directing a reference on point. Most such claims are dealt with by way of reference, especially in the event of competing interests.

Once an order directing a reference is obtained, the applicant may proceed with a motion for directions. The notice of motion for directions, to be served by the applicant on the parties, should set out the procedure that the applicant wishes to follow. Parties will often agree in advance to a particular procedure, and the order giving directions can therefore often be obtained on consent.

As with an order giving directions in any challenge to the validity of a will, an order giving directions respecting a reference to determine heirship should address the conduct of the proceedings and will usually set out whether evidence will be adduced orally or by way of affidavit (or both), the timing for the production of documents (if materials have not already been produced), whether there will be cross-examination upon affidavits or examination for discovery (although

sometimes neither is necessary), and any other relevant procedural matters. A hearing date is also frequently specified in the order.

After the hearing of the reference (following discovery or cross-examination on affidavits), a decision is rendered. A report should then be prepared by one of the parties pursuant to r. 54.06 and forwarded to the other parties for approval. As with any order, the report must be signed and entered at the court office. In order to have effect, a report must be "confirmed." Generally, the order directing the reference does not require a report back to a judge, and pursuant to r. 54.09(1), the report is therefore automatically confirmed upon the expiration of 15 days after a copy has been filed, with proof of service, in the court office in which the proceeding was commenced. If the order directing the reference specifically requires a report back, the report may only be confirmed on a motion to the judge who directed the reference (r. 54.08(1)). Once the report has been confirmed, the estate trustee may distribute the estate in accordance with the findings made on the reference.

5.4 Removal and replacement of an estate trustee — r. 14.05(3)(c)

Disputes may arise between the beneficiaries and estate trustees or between estate trustees themselves. Unless there is some applicable mechanism either in the will or in a statute permitting an estate trustee to resign (see *Trustee Act*, ss. 2–3), recourse to the court may be necessary to resolve the dispute.

Section 37 of the *Trustee Act* provides for the removal of a personal representative (defined to mean an estate trustee with or without a will) by application to the Superior Court of Justice. On such an application, the court may also appoint a replacement or replacements to act in the place of the estate trustee who is removed (s. 37(1)), although this is not necessary if the estate trustee being removed was not acting alone (s. 37(4)).

The proceeding is commenced by notice of application under r. 14.05(3)(c), accompanied by a supporting affidavit. The affidavit should contain information about why the removal and substitution is sought, the size of the estate, who the beneficiaries of the estate are, and the relationship of the persons who are being proposed as substitute estate trustees. Should the beneficiaries include minors or other parties under disability, unborn or unascertained persons, or incompetent individuals, the involvement of the Children's Lawyer or the Public Guardian and Trustee or both will also be necessary. The rules described above for service and filing of material, cross-examination, etc., apply to these proceedings.

If granted, the order will generally provide for the removal and substitution (where appropriate) of the estate trustee and the vesting of all of the assets, both real and personal, in the remaining or replacement estate trustee; it will also usually require that the estate trustees who have been removed pass their accounts up to the date of removal. When an order removing an estate trustee and appointing a new one is obtained, a true copy should be filed with the registrar of the court that issued the certificate of appointment, together with a request for a "status certificate." This document serves as notice from the court to all concerned that the estate trustee named in the original certificate of appointment has been removed and other persons have been substituted.

An application pursuant to s. 37 may be brought by beneficiaries who are unhappy with the performance of the estate trustee or by an estate trustee desiring to be relieved of his or her duties. Where there are two or more estate trustees and they are unable to work together or cannot resolve a fundamental disagreement about an aspect of the administration of the estate, an application may be brought by any of the estate trustees complaining of the conduct of another. Mere disagreement or hostility between a beneficiary and an estate trustee is generally not sufficient to warrant removal in the absence of some evidence of mismanagement or breach of duty by the estate trustee. But where the hostility is such that it is no longer possible for the estate trustee to carry out his or her duties in an impartial and objective manner, an order will be made removing him or her.

5.5 Purchase of estate assets by the estate trustee — r. 14.05(3)(a)

If an estate trustee wishes to purchase an asset of the estate, it can only be done if all the beneficiaries, being of age and full capacity, consent to the transaction or, alternatively, with the approval of the court upon complete disclosure of all relevant facts. Such a transaction is otherwise prohibited because of the conflict between the estate trustee's fiduciary duty to the beneficiaries and his or her personal interest.

Approval is obtained by moving in a rather fictitious fashion to the court under s. 60 of the *Trustee Act* for the opinion, advice, and direction of the court on a question respecting the administration of the trust property pursuant to rr. 14.05(3)(a) or (f). The approach is somewhat fictitious because no section of the *Trustee Act* has any direct bearing on a transaction of this nature. Nevertheless, s. 60 of the *Trustee Act* is considered broad enough in its terms to permit such an application to be brought.

The court must be able to ascertain from the material filed in support of the application that complete disclosure has been made. A principal affidavit should be filed setting out the facts. This affidavit should disclose why the estate trustee wishes to purchase the asset in question. Full disclosure is made of the purchase price and the terms by having the estate trustee enter into an offer to purchase in a personal capacity that sets out all the details. This offer is accepted in his or her capacity as estate trustee. Assuming that all beneficiaries who are *sui juris* consent to the transaction, that consent should be in the terms of the offer to purchase in order that the court can see that full disclosure has been made to the beneficiaries. There should also be an affidavit of execution accompanying each beneficiary's consent. This affidavit of execution should not be overlooked because, in all likelihood, the court will refuse to approve the transaction unless it is satisfied the beneficiaries' consent was genuine and informed.

The court may approve the transaction on behalf of any person who is under a disability including, of course, a minor. The court's approval is only obtained by demonstrating that a proper price is being paid. This evidence is typically made available to the court by way of affidavits of value. There should be at least two such affidavits made by competent valuators or appraisers who should demonstrate their competence to the court by setting out their qualifications and experience. The valuator should make it apparent that the property in question has been examined and should describe it with a reasonable degree of particularity, including its state of repair if this is material. The valuator should set out the methods of valuation used, particularly if the property sought to be purchased is very valuable or there are complicating factors affecting its value. The appraisal should then conclude by setting forth the opinions of the valuator as to the value of the property.

If the valuator has prepared the appraisal by way of a report, the appraisal itself should be verified by way of an affidavit, identifying the report and stating that the statements contained in it are true.

If any of the beneficiaries who are of full age and capacity refuse to consent to a proposed sale of the trust property to the estate trustee, the court will only authorize the transaction under all of the following conditions:

- It is virtually impossible to find another buyer at an adequate price.
- It would be to the advantage of the estate for the estate trustee to buy.
- There are cogent reasons for selling at the particular time.
- It would be impossible or inexpedient to wait to see whether the market became more favourable.

The court has jurisdiction to approve *ex post facto* a voidable purchase of trust property by an estate trustee. The transaction would probably not be confirmed if the value of the property had risen between the date of the improper purchase and the date of the application for confirmation. In Ontario, it is likely that the applicant would have to demonstrate more than that a fair price was paid. Instead, he or she would have to show that the price paid was equal to or better than the price that would have been paid by any other person.

5.6 Declaration of death

Where a person having an interest in an estate cannot be located and has not been heard from, it may be necessary in order to complete the administration of an estate to obtain a declaration that the person be presumed deceased.

The *Declarations of Death Act, 2002* was proclaimed in force in 2002, and this statute provides a procedure for obtaining a declaration of death that is effective for all purposes. Under the *Declarations of Death Act, 2002*, a declaration may be obtained where a person has disappeared in circumstances of peril and has not been heard from since, or where the person has been absent for seven years or more and has not been heard from during that time. The declaration obtained under the statute is for all purposes, not only for the particular issue addressed in the application. Prior to this statute, the procedure was based on a common-law presumption of death arising after a seven-year period of absence. This common-law declaration of death was only binding in the proceeding in which it was obtained.

In the case of both a common-law presumption of death and a statutory declaration of death, the declaration will not be made without clear and cogent evidence that all necessary and reasonable inquiries have been made. Reasonable inquiries necessary to raise the presumption would include inquiries among all those persons who might normally have heard of or from the missing person, as well as inquiries in the places where the person might conceivably be. The cost and extent of such an inquiry in any given case will depend on the particular circumstances. An order obtained under the *Declarations of Death Act, 2002* states the date of death, which shall be the date upon which the evidence suggests the person died or the date of application. The statute gives the court the discretion to order a date of death that is other than either of these two possible dates if the court is of the opinion that it would be just to do so in the circumstances and it would not cause inconvenience or hardship to any of the interested persons.

6. The Variation of Trusts Act

This statute permits the court to approve an arrangement varying or revoking a testamentary or *inter vivos* trust on behalf of the following classes of beneficiaries who cannot themselves legally give consent:

- persons who are incapable of assenting by reason of infancy or other incapacity;
- persons who, whether ascertained or not (including unborn contingent unascertained beneficiaries), may become entitled to an interest under the trusts at a future date or on the occurrence of a future event; or
- persons who may have an interest that may arise by reason of any discretionary power given to anyone on the failure or determination of any existing interest that has not failed or determined.

It is not sufficient to show that the proposed variation will benefit the *sui juris* beneficiaries. Rather, the purpose of the *Variation of Trusts Act* is to ensure that no variations are made that would be detrimental to those who are incapable of consenting on their own behalf. Court approval will only be granted if the variation sought is to the benefit of those classes of persons referred to above who have an interest in the trust.

Certain conclusions regarding the type of variation to which the court will give approval can be drawn from the case law. There must be some real purpose to be served in approving the arrangement. The desire of the beneficiaries to rearrange a testator's will is not sufficient. It is not open to them, for instance, to advance a date of distribution so that they will have capital in their hands immediately as opposed to waiting until the death of a life tenant.

Generally, the court will approve a variation of an existing trust where in doing so it is to the advantage of the *sui juris* beneficiaries (who must consent to the variation otherwise it automatically fails) and those under a disability (on behalf of whom the court reviews the variation). This is particularly so when circumstances exist at the time of the application that did not apply at the time the trust was settled.

The *Variation of Trusts Act* applies only where property is held in a trust arising under any will, settlement, or other disposition. The trust concerned must therefore already be in existence. The court cannot create a trust where none existed before. The court will not make an order that has the effect of settling a new trust. The *Act* only authorizes approval of a variation or revocation, and if the court perceives that the proposed arrangement constitutes a resettlement, approval will not be granted. While the distinction between a variation, on the one hand, and a termination and resettlement, on the other, may be difficult to draw, there must remain a similarity to the original trust such that the "*substratum*" still exists. However, case law indicates that, where possible, the court tends towards a finding that what might be considered a resettlement is a mere variation.

The court, in approving an arrangement, will interpret the word "benefit" broadly and not limit its consideration to financial benefit.

The courts have also generally held that the proposed benefit need not be absolutely certain. Rather, there is a recognized degree of risk in any proposed variation that the benefit will not materialize. In considering this, the court is permitted, on behalf of those who cannot consent for themselves, to take the same risk that a prudent, self-interested adult would take under similar circumstances.

The following are the criteria to be considered in determining whether the court should approve a proposed arrangement.

- Does the arrangement keep alive the settlor's intentions?
- Is it beneficial to the class of beneficiaries on whose behalf consent is sought?
- Is the benefit such that a reasonably prudent adult would accept the risk of it not materializing?

An application to the court under the *Variation of Trusts Act* is made pursuant to r. 14.05(3)(f), and the provisions of R. 38 discussed in this chapter apply. The notice of application should set out the relief desired and should be filed with a supporting affidavit reciting chronologically the events that have given rise to the problems at hand. The difficulties should be clearly set forth so that the need for relief is immediately apparent to the court. It is usual for all the parties who are *sui juris* (and the Children's Lawyer, where there are minors, unborn persons, or unascertained interests involved) to enter into an agreement or deed of arrangement outlining the proposed variation, which the court can then approve on behalf of the persons who are under a disability, as defined in the *Act*.

The trustees and the next of kin should have separate counsel. In Ontario, the court does not require that the parties appear by counsel. In these circumstances, it is then sufficient for the court to approve of the variations set forth in the agreement on behalf of any one or more of those classes of persons defined in the *Act* as being under a disability. It follows that a copy of the agreement should be attached to the order.

7. Claims by dependants under the SLRA

Part V of the *Succession Law Reform Act* (*SLRA*) provides a comprehensive code regarding claims for support by dependants of the deceased. The operative section is s. 58(1), which states, "Where a deceased, whether testate or intestate, has not made adequate provision for the proper support of his dependants or any of them, the court, on application, may order that such provision as it considers adequate be made out of the estate of the deceased for the proper support of the dependants or any of them."

7.1 Who qualifies as a dependant

Section 57 of the *SLRA* provides a two-step definition of dependant. First, the dependant must be a spouse, parent, child, or sibling of the deceased; and second, the dependant must also be someone to "whom the deceased was providing support or was under a legal obligation to provide support immediately before his or her death."

"Spouse," "parent," or "child" all have expanded definitions under Part V of the *SLRA* (ss. 57 and 1(1)–(2)). "Spouse," for instance, includes a former spouse, a common-law spouse, and a same-sex spouse with whom the deceased was cohabiting continuously for a period of not less than three years or with whom the deceased was in a relationship of some permanence if they are the natural or adoptive parents of a child. "Child" includes a grandchild and a person whom the deceased has demonstrated a settled intention to treat as a child of his or her family (other than a foster child).

7.2 Limitation period

An application for support must be commenced within six months from the date on which the certificate of appointment of estate trustee was issued (*SLRA*, s. 61(1)). However, under s. 61(2), the court has discretion to allow an application to be commenced beyond the limitation period, but only in relation to the portion of the estate remaining undistributed as at the date of the application.

7.3 Procedure

A dependant support claim is commenced by notice of application to the Superior Court of Justice in the jurisdiction where letters probate or administration have been granted in the deceased's estate. Along with the notice of application, an affidavit in support should be filed, setting out the basis of the claim by the dependant. The affidavit should be comprehensive and should set out the relationship of the applicant to the deceased, the extent to which support was being provided, and/or the nature of the legal obligation to provide support. It is beneficial if the affidavit also refers to as many criteria in s. 62(1) of the *SLRA* (referred to below) as are relevant. This section sets out a detailed list of factors that the court shall consider in determining the quantum of support. The applicant should also file a financial statement setting out his or her net assets, current budget, and proposed budget.

As in all applications, the respondent will file a notice of appearance and, generally, a responding affidavit setting out the facts on which he or she relies.

If the application is contentious, the matter usually proceeds by way of cross-examination on affidavit evidence, following which a trial of an issue or application is directed. Since dependant support claims are mainly factual disputes, *viva voce* evidence may be necessary so that the judge can assess credibility.

7.4 Effect of commencement of application on distribution of estate

Subsection 67(1) provides for an automatic stay of the distribution of the estate once an application is made and notice thereof is served on the estate trustee. Subsection 67(2) provides an exception to this general rule by allowing an estate trustee to make "reasonable advances for support to dependants who are beneficiaries." Subsection 67(3) stipulates that if an estate trustee violates s. 67(1) and the court orders support, the estate trustee will be:

> personally liable to pay the amount of the distribution to the extent that such provision or any part thereof ought . . . to be made out of the portion of the estate distributed.

7.5 Interim support

Section 64 gives the court the authority to grant interim support. This is an important provision since many dependant support proceedings take considerable time to conclude.

7.6 Criteria for assessing support

Section 62 of the *SLRA* lists the criteria that the court "shall consider" in determining the "amount and duration, if any, of support."

The court is given the widest latitude to determine the issue of support. Each case is largely determined upon its own facts in relation to the criteria set out in s. 62.

The decision of the Court of Appeal for Ontario in *Cummings v. Cummings* has been regarded by some estates practitioners as adding another criterion to the list set out in s. 62. In this case, the Court of Appeal ruled that the deceased's moral duty to all of his or her dependants must be taken into account in any one dependant support application, whether or not other dependants (or potential dependants) are parties; by

s. 63(5), all potential claims for dependants' relief are activated by any application for dependant support. Some practitioners consider that *Cummings* effectively adds "moral obligation" as a ground for declaration of dependency and not merely a factor in determining quantum of support.

7.7 Order for support

Section 63 allows the court to be creative in determining how the estate should satisfy an order for support. The court may order periodic or lump-sum payments or the transfer or assignment of any property in the estate.

7.8 Assets included in estate for purposes of valuing estate

Section 72 deems certain assets to be part of the estate for the purposes of dependant support claims that would otherwise not be so. This increases the size of the estate for the calculation of support. The assets referred to in s. 72 include gifts *mortis causa*, joint bank accounts held by the deceased and a third party, RRSP or investment accounts designating third-party beneficiaries, and the proceeds of any insurance policies effected on the life of the deceased and owned by him or her, notwithstanding that these proceeds are payable to a designated beneficiary.

8. Summary disposition of claims against an estate

Where a claim or demand is made against the estate of a deceased person or where the estate trustee has notice of such a claim or demand and attempts to negotiate have failed (r. 75.08; *Estates Act*, ss. 44–45), the estate trustee may serve the claimant with a notice of contestation of claim (*Estates Act*, ss. 44–45; Form 75.13). The procedure that follows depends on whether the claim is for a liquidated or unliquidated debt.

8.1 Where a liquidated debt is contested

In the case of a liquidated cash debt, (i.e., a mortgage, loan, or other such creditor), once the notice of contestation has been served, the claimant may then apply to the court for an order allowing the claim and determining the amount (*Estates Act*, s. 44). This is done by filing a statement, verified by oath, detailing the amount of the claim and the grounds upon which it is made (Form 75.14). The claim must be served on the estate trustee and filed, with proof of service and a copy of the notice of contestation, within 30 days of the claimant receiving the notice (or within three months thereafter if a judge of the Superior Court of Justice, on application, so allows).

Once the claim and notice of contestation are filed with the court, the registrar fixes a date for trial, but if the claimant fails to serve and file the claim within the required time, he or she will be deemed to have abandoned the claim. Not less than seven days' notice of the claim must be given to the estate trustee and the Children's Lawyer and to any other beneficiaries ordered by the court entitled to receive notice.

The trial shall proceed in a summary manner unless the judge considers it appropriate to give directions as to the issues, parties, and pleadings. The court may hear whatever witnesses it deems appropriate to decide the claim.

Once an order establishing the debt has been made, the judge may direct enforcement. No such enforcement shall take place without the judge's order.

8.2 Where an unliquidated debt is contested

In the case of an unliquidated debt, upon serving the claim and filing this with proof of service and a copy of the notice of contestation, the claimant must apply to a judge for an order for directions as to the disposition of the claim or demand within the same time period noted above. The claimant who fails to do so is deemed to have abandoned the claim, which will thereafter be forever barred.

On the claimant's application for directions, the judge may make an order directing the claimant to bring an action for the recovery or establishment of the claim on such terms and conditions as the judge considers just. When the claim or demand is not presently recoverable, the judge may instead prescribe the time after which the claimant shall proceed pursuant to the directions given.

9. Mandatory mediation of estate matters

Rule 75.1 of the *Rules* provides for the mandatory mediation of estates, trusts, and substitute decision matters that are commenced in the City of Toronto (on or after September 1, 1999), the Regional Municipality of Ottawa-Carleton (on or after September 1, 1999, but before January 1, 2001), the City of Ottawa (on or after January 1, 2001), and the County of Essex (on or after January 1 , 2005). The provisions of R. 75.1 are very similar to those of the general mandatory mediation rule (R. 24.1) and apply to the following types of proceedings:

- a contested application to pass accounts (r. 74.18);
- formal proof of a testamentary instrument (r. 75.01);
- an objection to the issuing of a certificate of appointment (r. 75.03);
- a return of the certificate of appointment (r. 75.05);

- claims against an estate (r. 75.08);
- Part V of the *SLRA* (pertaining to dependant relief claims);
- the *Substitute Decisions Act, 1992*;
- the *Absentees Act*, the *Charities Accounting Act*, the *Estates Act*, the *Trustee Act*, or the *Variation of Trusts Act*;
- r. 14.05(3), if the matters relate to an estate or trust; and
- s. 5(2) of the *Family Law Act*.

9.1 Directions for conduct of mediation

Rule 75.1.05 provides that, except in a contested passing of accounts, the applicant shall make a motion in the same way as under r. 75.06 (application or motion for directions) seeking directions for the conduct of the mediation. Subrule 75.1.05(2) provides that the notice of motion for mediation directions is to be served within 30 days after the last day for serving a notice of appearance. On the hearing of this motion, the court may direct

- the issues to be mediated;
- who has carriage of the mediation and who shall respond;
- within what times the mediation session shall take place;
- which parties are required to attend the mediation session in person and how they are to be served;
- whether notice is to be given to parties submitting their rights to the court under r. 75.07.1;
- how the cost of the mediation is to be apportioned amongst the designated parties (i.e., those who are required to attend a mediation session); and
- any other matter that may be desirable to facilitate the mediation.

9.2 Preparing for mediation

In terms of who actually conducts the mandatory mediation session, r. 75.1.06 provides that the mediator can be a person chosen from the list maintained for the county by agreement of the designated parties; a person assigned from the list by the mediation co-ordinator for the county at the request of a designated party; or a person who is not named on the list if the designated parties consent.

Subrule 75.1.09(1) specifically requires that the designated parties and, if represented, their lawyers must attend the mediation session.

At least seven days before the mediation session, every designated party is required to prepare a "statement" in Form 75.1C. The statement identifies the factual and legal issues in the dispute and briefly sets out the position and interests of the party making the statement. The party will attach to the statement any documents that it considers of central importance in the proceeding, and the statement is then provided to every other designated party and the mediator.

Within 10 days after the mediation is concluded, the mediator is required to provide the mediation co-ordinator for the county and the designated parties with a report on the mediation. The *Rules* provide that if some or all of the issues in dispute have been settled, an agreement to that effect shall be signed by the designated parties or their lawyers. If the agreement resolves all the issues in dispute, the party with carriage of the mediation is required to file a notice to that effect with the court within 10 days. If, however, the settlement requires court approval on behalf of a person under disability, the notice is to be filed within 10 days after the agreement is approved. If no agreement is reached at mediation, the litigation shall continue in accordance with any directions given by the court under r. 75.06.

In jurisdictions not governed by mandatory estate mediation, r. 75.06(3)(f.1) allows a judge hearing an application or motion for directions to direct that a mediation session be conducted nonetheless. Counsel may want to keep this provision in mind when otherwise seeking directions in respect of a matter that may, in whole or in part, benefit from a mediation session.

9.3 Preparing the client

Most clients are vaguely familiar with the court process and think they know what to expect—they know it involves a judge, their lawyer, a trial, and a courtroom. Not many clients however know what to expect at mediation. As a result, it is important for counsel to take time to describe the process, answer any questions, and prepare their client for what they can expect to happen at mediation. By doing so, counsel can help reduce their client's anxiety about the attendance.

Estate mediations can be a very emotionally draining experience. Apart from any legal foundation to the dispute, many intangible factors also tend to be present in estate matters. Jealously, anger, and greed are difficult emotions to overcome and can be severe stumbling blocks in settlement. Sometimes, steering clients away from the emotional aspects and towards the financial implications of continued litigation assists them in moving past those types of difficulties.

Clients need to be assured that the mediation process is completely confidential and that anything that is said or admitted cannot be used against them at a later date. The fact that there will be no public record of the proceeding may provide some clients with the comfort to say things

that might otherwise not be said. In addition, clients can be advised that any information they provide to the mediator to help the mediator understand their position better can remain confidential and that the mediator will not disclose any information unless expressly authorized by the client. Having the opportunity to participate in open and frank discussions may be the key to resolving outstanding issues that might not otherwise be addressed in the litigation process.

10. Costs in estate proceedings

Traditionally, costs in estate proceedings were awarded out of the estate to all parties in any event of the cause, on a full indemnity basis. This is no longer the case. The Court of Appeal has made clear in *McDougald Estate v. Gooderham* that estate litigation, like any other form of civil litigation, operates subject to the general civil costs regime established by s. 131 of the *Courts of Justice Act* and R. 57 of the *Rules*, except in a limited number of circumstances where public policy considerations permit the costs of all parties to be ordered paid out of the estate. Those limited circumstances exist where the litigation arose as a result of the actions of the testator or those with an interest in the residue of the estate, or where the litigation was reasonably necessary to ensure the proper administration of the estate. If a special circumstance does not apply, the basic principle is the loser pays, subject to a court's consideration of all relevant factors under R. 57.

The costs of an application to interpret an ambiguous provision in a will are usually borne by the estate, the necessity for such proceedings having been caused by the testator, not the conduct of the litigants.

With respect to the costs of a challenge to the validity of a will, the court has a responsibility to ensure that any will under which an estate is distributed is a valid will as a matter of policy. While courts do not wish to preclude a party from raising concerns for fear of adverse cost awards, the recent trend is to more closely examine the circumstances of each case to determine where the costs should fall. One of the factors that will be taken into consideration is any allegation of misconduct, undue influence, or fraud that is not ultimately proven. The party who unsuccessfully makes such an allegation may be ordered to bear not only his or her own costs, but the costs of the other party as well. By contrast, where the circumstances lead reasonably to an investigation of the validity of the will, reasonable costs should be borne by those who incur them, and the unsuccessful party should not be required to pay the costs of the successful party.

Even when circumstances might originally have raised suspicions, the party investigating the litigation may nevertheless be denied costs and may even be ordered to pay the costs of the other party or parties if that party ought to have known, through reasonable and diligent inquiries, that there was no basis for pursuing the challenge.

11. Limitation periods in estate litigation

11.1 The Limitations Act, 2002

The *Limitations Act, 2002* (*LA, 2002*) came into force on January 1, 2004. It consolidates and reforms all existing provincial laws relating to limitation periods. It not only amends limitation periods set out in the predecessor statute, the *Limitations Act*, but also affects limitation periods in estates-related statutes, including the *Estates Act*, *Estates Administration Act*, *Family Law Act*, *Insurance Act*, *SLRA*, and *Trustee Act*.

Under the *LA, 2002*, there are two specific time limits for the commencement of an action. The first limitation period is two years from "discovery" of a claim (subject to certain exceptions), which is coupled with an "ultimate" limitation period of 15 years from the day of the act or omission, regardless of a claimant's state of knowledge (which is also subject to certain exceptions).

There are also a number of exceptions to these general limitation periods, and these exceptions are set out in the Schedule to the *LA, 2002*. The statutory provisions enumerated in the Schedule govern a number of estates-related claims. As a result, many of the limitation provisions currently applicable in the context of estate litigation will continue to apply under the *LA, 2002*.

Effective January 1, 2004, Parts II and III of the *Limitations Act* were repealed and replaced by the provisions of the *LA, 2002*. Part I of the previous *Limitations Act* dealing with real property matters was renamed the *Real Property Limitations Act*. Despite the new title, the substance of the *Real Property Limitations Act* is identical to that which appeared under Part I of the previous legislation. Specifically, the 10-year limitation period applicable to actions on the part of beneficiaries for the return of real property held pursuant to an express trust, where such property had been wrongfully conveyed, remains in effect. Similarly, the 10-year limitation period applicable to a claim to recover a legacy after the legacy accrues continues to govern.

11.2 Basic and ultimate limitation periods and the rule of "discoverability"

Under s. 4 of the *LA, 2002*, a basic limitation period of two years applies to all claims to remedy an injury, loss, or damage that occurred as a result of an act or omission. In addition, the "discoverability" doctrine is codified by the *LA, 2002*. The basic limitation period defined in s. 4

runs from "the day on which the claim was discovered," and s. 5 further defines that date:

> A claim is discovered on the earlier of,
>
> (a) the day on which the person with the claim first knew,
>
> (i) that the injury, loss or damage had occurred,
>
> (ii) that the injury, loss or damage was caused by or contributed to by an act or omission,
>
> (iii) that the act or omission was that of the person against whom the claim is made, and
>
> (iv) that, having regard to the nature of the injury, loss or damage, a proceeding would be an appropriate means to seek to remedy it; and
>
> (b) the day on which a reasonable person with the abilities and in the circumstances of the person with the claim first ought to have known of the matters referred to in clause (a).

In addition, the *LA, 2002* provides an "ultimate" limitation period. Subject to certain claims for which no limitation period will apply (see s. 16 of the *LA, 2002*), the *LA, 2002* provides that irrespective of the discoverability of the claim, an ultimate limitation period of 15 years will apply. This "ultimate" limitation period runs from the day of the occurrence of the act or omission on which the claim is based. As a result, a proceeding may not be commenced after the expiration of the 15-year period, even if the claim was not discoverable until many years after the occurrence of the act or omission. In the context of estates litigation, the saving provision in s. 15(4) should always be considered and may prevent the operation of the ultimate limitation period.

11.3 Impact of the Limitations Act, 2002 on will challenges

Perhaps the most significant impact that the *LA, 2002*, has upon estate practitioners is the fact that based on the wording of the provisions relating to the ultimate limitation period, it appears that the 15-year ultimate limitation period would apply to will challenges. While under the previous statutory scheme, a limitation period for commencing a challenge to a will did not exist, estate practitioners will now have to advise clients that there is likely a 15-year limitation period from the time of the death of the testator to commence a will challenge.

This conclusion would appear to be supported by the decision in *York Condominium Corp No. 382 v. Jay-M Holdings Ltd.* Although this case did not involve a will challenge, this decision appears to confirm that the "ultimate" limitation period of 15 years will be held to be a bar to an action if the action is not commenced within 15 years after the date on which the act or omission actually took place.

11.4 The Schedule to the Limitations Act, 2002

Pursuant to the *LA, 2002*, the general limitation provisions apply to all claims, unless an express exception is set out. Under s. 19, a limitation period set out in another act is of no effect unless the provision establishing the limitation period is listed in the Schedule to the *LA, 2002*. A limitation period in a statutory provision listed in the Schedule will prevail over the limitation provisions of the *LA, 2002* (s. 19(4)). In the estate litigation context, the relevant provisions are contained in the following chart:

Statute	**Section(s)**	**Limitation**
Estates Act	ss. 44(2), 45(2), and 47	Summary claims against estates — 30 days after notice of contestation of claim
Estates Administration Act	s. 17(5)	Court-directed distribution of estate — within 3 years
Family Law Act	s. 7(3)	Equalization claim — 6 months after the first spouse's death
Succession Law Reform Act	s. 61	Claim for support of dependants — 6 months from the grant of a certificate of appointment
Trustee Act	s. 38(3)	Personal claims by or against estates — 2 years from the date of death

It is also important to note that with respect to minors and incapable persons, a variety of circumstances will either delay or stop the running of time. Although the discoverability of the claim will not prevent the commencement of the ultimate limitation period, ss. 6 and 7 of the *LA, 2002* set out special rules with respect to minors and incapable persons. In particular, neither the basic nor the ultimate limitation period will begin to run while the potential plaintiff is both a person under the age of 18 and not represented by a litigation guardian.

With respect to incapable persons, the *LA, 2002* provides that the basic limitation period will not run during any time in which a person is incapable of commencing a proceeding in respect of the claim because of his or her psychological condition and is not represented by a litigation guardian.

11.5 Transition provisions

Pursuant to s. 24(3) of the *LA, 2002*, if the former limitation period expired before January 1, 2004, no proceedings shall be commenced. However by s. 24, if the former limitation period had not expired prior to January 1, 2004, three possible results may follow:

- If there is no applicable limitation period under the *LA, 2002* (i.e., those set out in the Schedule), the claim will not be subject to a limitation period (irrespective of the existence of an applicable limitation period at the time the act or omission took place).
- Acts or omissions giving rise to claims that were not discovered at the end of 2003 and not otherwise statute-barred will be deemed to have occurred on January 1, 2004. The deeming provision makes claims that were discovered after the *LA, 2002* came into force subject to the new legislation even though the *LA, 2002* was not in force at the time of the occurrence giving rise to the claim.
- If the claim was discovered before January 1, 2004, the former limitation period applies.

12. Summary of limitation periods

The chart below is a summary of limitation periods that are relevant in an estates litigation context, as well as a list of deadlines that frequently occur. (Please note that reference should be made to the provisions of the *LA, 2002*, as well as the new case law applying the provisions of the *LA, 2002* to the statutes referred to below.)

SUMMARY OF LIMITATION PERIODS

All of the following limitations are qualified.

Trustee Act, R.S.O. 1990, c. T.23.

s. 38(3)	Within 2 years from death	Actions by estates for torts or injuries to the person or property of the deceased or actions against estates for wrongs committed by the deceased.

Succession Law Reform Act, R.S.O. 1990, c. S.26.

s. 61(1)	Within 6 months of appointment	Application for dependant support.
s. 61(2)	Court may extend	Extension applies to undistributed amounts but not s. 72 assets.

Family Law Act, R.S.O. 1990, c. F.3.

s. 2(8)	Court may extend any *FLA* limitation	Where relief is apparent, delay is in good faith, and there is no substantial prejudice to any person.
s. 6(10)	Within 6 months from death	Spousal election under the *FLA* together with an application.
s. 6(14)	Within 6 months from death	Estate cannot distribute without a spousal consent.

s. 6(15)		No distribution after the personal representative has received notice of an *FLA* application unless the applicant gives written consent or a court authorizes the distribution.
s. 6(16)	Court may extend	Broad power (but the estate's NFP is based only on undistributed amounts).
s. 7(3)	Within 6 months from death	Application for equalization.

***Estates Act*, R.S.O. 1990, c. E.21.**

s. 44(2)	Within 30 days after being served	Claimants against estates who are served with a notice of contestation of claim must file affidavit and statement of claim.
s. 47(1)	Extension of *Trustee Act*	The *Trustee Act* does not affect claims against an estate where notice of the claim is filed by affidavit and served on the estate trustee before the expiry of the limitation period, but where no estate trustee has yet been appointed "... the notice may be filed in the office of a local registrar of the Ontario Superior Court of Justice."
s. 47(2)	Within 3 months from death	Claims expiring under the *Trustee Act* within 3 months from death of deceased are extended to a full 3 months after the date of death.

***Estates Administration Act*, R.S.O. 1990, c. E.22.**

s. 9	After 3 years after death	Real property not disposed of within 3 years of death is deemed to have vested in those beneficially entitled to property unless caution registered.
s. 17(5)	Within 3 years from death	Estate trustee or beneficiary may apply to court for order directing the estate to be distributed.
s. 26	Within 1 year from death	No distribution may be made on an intestacy within 1 year from death. If a distribution is made, the recipient may be required to refund estate.

***Limitations Act, 2002*, S.O. 2002, c. 24, Sched. B**

ss. 4 and 5	Basic limitation period of 2 years	A basic limitation period of 2 years applies to *all* claims to remedy an injury, loss, or damage that occurred as a result of an act or omission. A claim is discovered on (1) the day on which a person knew that he or she had incurred injury, loss, or damages; that the injury, loss, or damages were caused or contributed to by an act or omission on the part of a party whom the claimant can identify; and that a court proceeding is an appropriate remedy; or (2) the day on which the reasonable person ought to have known of the foregoing with regard to his or her abilities and the surrounding circumstances.
s. 15(2)	Ultimate limitation period of 15 years	For all but a few specific types of claims, an ultimate limitation period of 15 years applies, irrespective of the discoverability of the claim.

***Rules of Civil Procedure*, R.R.O. 1990, Reg. 194.**

r. 75.03(2)	Within 3 years from filing	Notice of objection expires three years after it is filed.
r. 75.03(5)	Within 20 days after service of notice to objector	Where notice to objector is served, the objector has 20 days to file a notice of appearance—otherwise the application for the appointment shall proceed as if no objection was filed.
r. 75.05(4)	Within 30 days from order	Where a party obtains an order for a return of the certificate of appointment, that party must move for directions within 30 days of the date of order—otherwise the certificate of appointment may be returned to the estate trustee.

Chapter 41

Claims by common-law spouses against estates

1. Legislative overview

Ontario's statutory framework does not grant common-law spouses all of the rights and entitlements of married spouses in the context of estates. In this chapter, the term "common-law spouse" includes same-sex spouses who are not married and have cohabitated in a relationship for a significant period of time, i.e., have a degree of permanence. The legislative provisions that will be examined in this chapter are as follows:

- *Family Law Act* (*FLA*), ss. 1(1), 5(2), and 6(1)–(3):

  A surviving "spouse" for purposes of an equalization claim is a married spouse.

  A surviving spouse has the right to elect to either (1) take his or her entitlement under the will, or (2) receive the equalization payment set out under the *Act*.

  The *FLA* does not grant the right of election to a common-law spouse. Based upon the Supreme Court of Canada's decision in *Walsh v. Bona*, it is highly unlikely that an Ontario court would find these provisions of the *FLA* unconstitutional.

- *Succession Law Reform Act* (*SLRA*), ss. 44–46:

  A "spouse" for purposes of inheritance on intestacy is a married spouse.

  On intestacy, only the surviving spouse of a married couple is entitled to the preferential and distributive share. A common-law spouse has no statutory entitlement.

- *SLRA*, s. 57:

  The definition of "spouse" in s. 57 of the *SLRA* (dependant support applications) is expanded to include two people who are not married to each other and have cohabited (i) continuously for a period of not less than three years, or (ii) in a relationship of some permanence and are the parents of a child.

  On the deceased's death, a dependant spouse can bring an application for support, and this includes unmarried (and same-sex) spouses.

  The definition of "dependant" in s. 57 of the *SLRA* is expanded to include "either of two people" in addition to married spouse and common-law spouse.

- *Estates Act*, s. 29:

  The class of persons having a presumptive priority to become the estate trustee where there is an intestacy is extended from the married spouse and common-law spouse to also include a person of the same sex who was living with the deceased in a conjugal relationship.

- Amendments to *SLRA* as a consequence of the Supreme Court of Canada decision in *M. v. H.* (provisions effective March 1, 2000):

  The definition of "dependant" in the *SLRA* is expanded. The concept of common-law spouse is inserted to Part V Support Provisions.

2. Common-law spouses

2.1 Rights with respect to estates

To date, the definition of "spouse" in s. 1 of the *SLRA* has not been amended as it relates to entitlement on intestacy. Under the existing definition on intestacy, a common-law spouse does not have any statutory entitlement in Ontario with respect to property. The intestate provisions of the *SLRA* (ss. 44–49) rely on the narrow definition of "spouse" in s. 1 of the *SLRA*, not the broader definition as set out in s. 57 with respect to dependant support applications. Section 1 of the *SLRA* defines "spouse" to mean either of two persons who are married to each other or have together and in good faith entered into a marriage that is voidable or void. Accordingly, only a surviving married spouse is entitled to the first preferential share, currently prescribed by regulation as $200,000 of the deceased's estate and a portion of the remainder (the percentage is dependent upon the number of children who have survived the deceased), but a common-law spouse has no such entitlement.

Under s. 29(1)(a) of the *Estates Act*, lawful spouses and persons with whom the deceased was living in a conjugal relationship outside marriage immediately before death, (which includes common-law spouses) share priority to become personal representatives of the estate. Although the statute does not provide these persons with mandatory priority to the appointment over other relatives, the general tendency of the courts has been to this effect. Consequently, the combination of s. 29 of the *Estates Act* and ss. 44–45 of the *SLRA* creates the anomalous result that if an individual dies intestate leaving a common-law spouse and other relatives, the common-law spouse has informal priority over the other relatives to become the estate trustee but has no statutory entitlement to any of the estate property.

Under s. 15 of the *SLRA*, a will is revoked by marriage, subject to s. 16. Because the law in Ontario does not recognize a common-law relationship as equivalent to a marriage and the word "spouse" in s. 1 of the *SLRA* only includes lawfully married spouses, entering into a common-law relationship would not revoke their respective wills. Since Ontario now permits legal marriages between same-sex couples, a will would now be revoked by a marriage between same-sex couples.

Section 1 of the *FLA* also does not include common-law spouses in the definition of "spouse." As a result, a common-law spouse is not entitled to make the election under s. 6 of the *FLA*, as to whether he or she wishes to take under the will (if there was a will) or to receive the entitlement under the *FLA*, which entitles a "spouse" to one-half of any positive difference between the net family property of the deceased spouse and the surviving spouse, calculated according to the formula in s. 5 of the *FLA*.

The result is that common-law spouses are not statutorily entitled to the preferential share of the estate in an intestacy nor the right to elect in favour of an equalization payment. Common-law spouses have the same priority to administer the estate (which provides no property entitlement) or to make a claim against the estate as a dependant.

The following scenario illustrates the practical effect of the differential treatment of common-law spouses in relation to property rights and estates. Consider a situation in which married spouses have been separated for some time and are involved in negotiations with respect to issues regarding division of property and support. Assume also that one of the spouses has been living in a conjugal relationship with a person for more than three years and then dies. The married spouse is entitled to make an election in favour of an equalization payment pursuant to the *FLA*. The common-law spouse is permitted to assert a claim against the estate as a dependant under the *SLRA*. However, as between these two claims against the estate, s. 6(12)(c) of the *FLA* gives the married spouse's claim priority over the dependant support claim of the common-law spouse.

2.2 Unjust enrichment, constructive trust, and quantum meruit claims

Despite the provisions discussed above in the *FLA* and *SLRA* that do not grant a common-law spouse an entitlement to a share in the estate of a deceased common-law spouse, common-law remedies relating to the doctrine of unjust enrichment, constructive trust, and *quantum meruit* may provide similar relief.

The application of the equitable doctrine of unjust enrichment enables a common-law spouse to assert property rights in estate assets in certain circumstances.

In theory, proving such entitlements in court is a complex process, requiring the common-law spouse to go the expense of initiating and proving a claim for a constructive trust or monetary compensation for services rendered. Claims based upon unjust enrichment are difficult to quantify because the claimant must prove the value of the contribution and that there was a reasonable expectation of receiving compensation. Evidence of this nature in the context of a spousal relationship is often based solely on the barely corroborated but uncontradicted word of the common-law spouse. "Barely," because any claims against an estate must be corroborated by evidence (*Evidence Act*, s. 13), though case law has set the evidentiary bar quite low.

However, in practice, trials have become exceedingly rare in estates litigation. The unpredictable nature of this type of claim, the natural sympathy attaching to the claimant, and the risk of adverse costs awards combine to create a strong incentive to recognition and settlement of the claim. Still, such a remedy is clearly less advantageous than a statutory entitlement.

A common-law spouse who advances any claim against his or her deceased spouse's estate should not act as estate trustee given the obvious conflict of interest.

2.3 Charter cases — same-sex partners

There appears to only be one reported Canadian case in which a same-sex spousal claim has been advanced against an estate in the context of the provisions for spouses under the *Estates Act*, *FLA*, and *SLRA* or similar statutes. This is the 2001 decision of the Surrogate Court of Alberta in *Johnson v. Sand*. In this case, the court found that the failure of the province's *Intestate Succession Act* to grant intestate succession rights to unmarried spouses was *ultra vires* the Constitution. However, in light of the Supreme Court of Canada decision in *Walsh v. Bona*, a constitutional claim of this nature is unlikely to succeed.

3. Conclusion

In Ontario, the estates law framework accords different entitlements to lawfully married spouses and common-law spouses. These differences are most evident in Ontario's treatment of common-law spouses under the *SLRA* and *FLA*. While new legislation and court decisions in the provinces appear to be moving towards providing identical benefits and rights for common-law spouses, the Supreme Court of Canada decision in *Walsh v. Bona* could be interpreted as slowing or even ending the

development of case law that had previously been making redundant such statutory development. Practitioners should pay close attention to how Canadian courts interpret the principles in *Walsh v. Bona* and apply them to similar *Charter* challenges by common-law spouses, and perhaps more importantly, in *Charter* challenges involving statutory intestate provisions rather than equalization claims.

Since same-sex partners can now enter into a valid marriage, it will be important to see how the courts deal with likely future challenges to the definition of "spouse" in various statutes or the statutes that were drafted on the basis that a valid marriage could only occur between a man and a woman. In the case of an intestacy, it appears now that a married same-sex "spouse" in Ontario should be entitled to his or her preferential and distributive share of his or her deceased spouse's estate just as the spouse in an opposite-sex marriage. However, a common-law spouse does not have such rights on an intestacy.

Chapter 42
Wills and estates of Indians

1. Introduction

The purpose of this chapter is to review the testamentary provisions of the *Indian Act* (*Act*), specifically those sections dealing with

- the powers and jurisdiction of the Minister of Indian Affairs and Northern Development (Minister);
- wills;
- distribution of property on intestacy;
- restrictions on devise and descent of property; and
- the administration of estates of dependent adults and minors.

The impact of family law legislation on estate matters will also be reviewed briefly. Because this chapter deals only with the application of the *Act*, it does not apply to Inuit, Métis, or non-status Indians.

2. The Indian Act

The *Act*, together with the *Indian Estates Regulations* (*Regulations*) made under the *Act*, purports to provide a code with respect to the domestic affairs of Indians and the use of reserve land.

The Department of Indian Affairs and Northern Development (also known as Indian and Northern Affairs Canada (INAC)) has also established the "Living Estates Program," which is responsible for ensuring that the federal government's legal obligations and responsibilities pursuant to ss. 51–52 of the *Act* are met by providing for the management and administration of the estates of Indian minors and mentally incompetent Indians (as defined by the *Act*).

INAC has also established the "Decedent Estates Program," which is responsible for ensuring that the federal government's legal obligations and responsibilities pursuant to ss. 42–50 of the *Act* are met by providing for the management of Indian estates.

It should be noted that the estate provision of the *Act* do not always apply—particularly where the relevant First Nation has their own laws pursuant to a self-government agreement.

3. Definitions

In order to understand the operation of the *Act* and the *Regulations*, it is essential to have an understanding of the terms used. Practitioners are cautioned not to assume that the definitions in provincial legislation are the same as those found within the *Act* and *Regulations*.

4. Jurisdiction

The following discussion on jurisdiction is subject to the overriding issue of self-government. Although the issue has not been resolved in jurisprudence, practitioners should be aware that matters of wills and estates may be ultimately recognized as within the jurisdiction of the First Nation, either by negotiation or jurisprudence.

The *Act* creates a discretionary and supervisory jurisdiction in the Minister rather than in the courts. If the Minister does not have jurisdiction, the case falls within provincial jurisdiction. Therefore, the first step when administering an estate of the deceased, mentally incompetent, or infant Indian is to determine whether the Minister has jurisdiction over the estate.

Under s. 42 of the *Act*, the Minister has "all jurisdiction and authority in relation to matters and causes testamentary, with respect to deceased Indians." Pursuant to s. 43, this includes but is not limited to the power to

- appoint and remove an executor or administrator;
- authorize an executor to carry out the terms of the will of a deceased Indian;
- authorize an administrator to administer the property of an Indian who dies intestate;
- act as executor of a will of a deceased Indian; and
- administer the property of an Indian who dies intestate.

Moreover, the Minister has a broad overriding jurisdiction and authority to give any order, direction, or finding that, in his or her opinion, is necessary with respect to any testamentary matter.

4.1 Exclusion for Indians residing off reserve

In 1985, an amendment was made to the *Act* that restricted, pursuant to s. 4(3), the application of the *Act*'s estate provisions and regulation to Indians who ordinarily reside on a reserve or on Crown lands.

Whether an Indian "ordinarily resides" on a reserve is a matter of fact that must be determined in each case. Factors to be considered include the general mode of life,

bodily presence and the intention of remaining, and the duration of stay.

Through s. 4(3), the Minister also retains an overriding jurisdiction and authority to order that the *Act*'s estate provisions and regulations apply to any Indian who does not ordinarily reside on a reserve.

4.2 Transfer of jurisdiction to the Superior Court of Justice

Although the *Act*'s provisions apply to a deceased Indian's estate if he or she ordinarily resided on reserve, s. 44 of the *Act* permits the Minister transfer all of the Minister's jurisdiction and authority to the Superior Court of Justice in the province where the deceased resided.

In addition to transferring jurisdiction to the Superior Court of Justice at the request of the descendants or devisees of a deceased, the Minister also has the power to specifically direct on his own accord that an application for a certificate of appointment of estate trustee be referred to the Superior Court of Justice.

4.3 Overriding jurisdiction over reserve land

Where the deceased had a possessory interest in any reserve lands, the *Act* has an overriding authority over deceased Indians who do not reside on reserve. In these cases, the *Act*'s provisions for the distribution of reserve property will apply in respect of that property (ss. 49-50).

Furthermore, notwithstanding the intentions of a testator or the rules of intestate succession, the Minister has an overriding discretion to approve or reject the transmission of interests in reserve land under s. 49 of the *Act*.

4.4 Matters beyond the jurisdiction of the Minister

Not all matters relating to estates fall within the jurisdiction of the Minister. Proceedings against administrators and executors based on contract or trust, wilful default, or breach of trust do not constitute matters or causes testamentary under the *Act* and would therefore fall within the jurisdiction of the provincial Superior Court of Justice.

5. Non-members' interest in reserve land

Title to Indian reserves is held by the federal Crown for the common use and benefit of members of a First Nation. The only way that an interest in reserve land may be transferred to a non-member of the First Nation is pursuant to the *Act*'s provisions. It would require either a surrender, designation, or lease, which would have to be made through the First Nation with the consent of the Minister.

Individual members of the First Nation may hold possessory interests to the land on a reserve, which may be recognized by a Certificate of Possession, which is issued by the chief and council of the First Nation. Such allotment of reserve land under the *Act* grants a right to possession that is similar in many respects to fee simple ownership. It may continue indefinitely so long as there are heirs to the estate, it may be sold or transferred during the lifetime of the owner, and it is exclusive.

However, the *Act* strictly limits the class of persons who may inherit or otherwise acquire the right to possession. In the case of a transfer during the owner's lifetime, the *Act* states that the land may be transferred to a band member or to the band. That the band member must be someone who has a right to reside on the reserve is implied by s. 25. When a right to possession forms part of an estate, the eligible heirs are only those who are entitled to reside on the reserve.

Section 50 of the *Act* provides that if a devisee or descendant is not a band member and therefore not entitled to possession of property on reserve, the land will be auctioned (to eligible members) and, if not purchased, will revert to the band free from any claim.

6. Wills

Indians may make wills and thereby devise or bequeath property. However, under the *Act*, the formal requirements are minimal in comparison to provincial legislation regarding wills. Subsection 45(2) requires that a will be in writing, be signed by the testator, and indicate his or her wishes or intentions with respect to the disposition of his or her property upon death. Section 15 of the *Regulations* simply states that a will be in writing and signed by the testator. It specifically states that a will need not conform to the requirements of the laws of general application in force in any province at the time of the death of the Indian. As well, through s. 45(3) of the *Act*, unless the Minister approves the will, it has no legal force or effect.

Section 46 of the *Act* provides that the Minister may declare a will void in whole or in part if he is satisfied of any of the following:

- The executor lacked testamentary capacity.
- The terms of the will would impose hardship on dependants.
- The will purports to dispose of reserve lands in a manner contrary to the interest of the band.
- The terms of the will are vague or uncertain.
- The terms of the will are against the public interest.

When a will is declared invalid, the person making the will is deemed to have died intestate. If the will is declared invalid in part, then any bequests or devises that are affected will be deemed to have failed (s. 46(2)).

7. Intestacy

Section 48 of the *Act* outlines the manner in which property is to be distributed when an Indian dies leaving property undistributed by a will, when the will is declared to be invalid by the Minister or by a court on the basis of one or more of the factors set out in s. 46, or when it is not in proper form (for example, it was not signed). While the intestate provisions are similar to those found in provincial legislation, some differences and restrictions exist with respect to the descent of reserve land.

- *Surviving spouse's share*: Where the net value of the estate of an intestate does not, in the opinion of the Minister, exceed $75,000, the estate goes to the surviving spouse. "Surviving spouse" is defined in the *Act* to include common-law spouses.

  Where the net value of the estate exceeds $75,000, $75,000 goes to the surviving spouse, and the remainder is divided as follows:

  – If the intestate left no issue, the remainder goes to the surviving spouse.
  – If the intestate left one child, one half of the remainder goes to the surviving spouse.
  – If the intestate left more than one child, one third of the remainder goes to the surviving spouse (s. 48).

  The above distribution applies as long as any children are living or died leaving issue.

  "Child" is defined in the *Act* as including "a legally adopted child and a child adopted in accordance with Indian custom."

- *Children who are not provided for*: Notwithstanding ss. 48(1)–(2), if the Minister is satisfied that any children of the deceased will not be adequately provided for, he or she may direct that all or any part of the estate that would have otherwise gone to the surviving spouse go to the children.

  Paragraph 48(3)(b) gives the Minister authority to direct that the surviving spouse shall have the right to occupy any lands on a reserve that were occupied by the intestate at the time of death. It is implicit in this subsection that this only applies to a spouse who is a member of the First Nation where he or she resides. It would otherwise be contrary to the remainder of the *Act*, which prohibits possession of lands on reserves by anyone except members of the First Nation. The only exception to this is under s. 28 (absent the consent of the First Nation): the Minister may issue a one-year permit authorizing a non-member to reside on the reserve.

  In cases where the surviving spouse is not a member of the First Nation, that spouse has no right to continue residing on the reserve, although it is possible that the children may be entitled to reside on the reserve. Subsections 81(1)–(2) of the *Act*, however, specify that First Nations may make by-laws "to provide for the rights of spouses or common-law partners and children who reside with members of the band on the reserve with respect to any matter in relation to which the council may make by-laws in respect of members of the band." In practice, few First Nations have enacted such by-laws.

- *Distribution to descendants/ascendants*: Where an intestate dies leaving children, their estate is distributed, subject to the surviving spouse's share, if any, *per stirpes* among such issue (s. 48(4)). Where there is no surviving spouse or issue, the estate goes to the father and mother of the deceased in equal shares if both are living and to the surviving parent if one parent predeceased the intestate (s. 48(5)). When an intestate dies leaving no spouse, issue, or parent, the estate goes to any brothers and sisters in equal shares; if any brother or sister predeceased the intestate but left children, the children shall take the share that their parent would have taken if living, unless the intestate left no living brothers and sisters, in which case, the nieces and nephews will share the estate *per capita* (s. 48(6)).

  As in provincial legislation, descendants and relatives of the intestate conceived before the intestate's death but born after death will inherit as if they had been born during the lifetime of the intestate (s. 48(10)).

  Transfer of reserve land on an intestacy is limited. The land will revert back to the band if the nearest kin of the intestate is more remote than a brother or sister.

8. Administration and probate

If the estate falls within the jurisdiction of the *Act*, the procedures for administration and probate are found within ss. 42–50 of the *Act* together with the *Regulations*.

It should be noted that although the administration of an Indian's estate falls within the jurisdiction of the Minister, INAC considers actual administration by departmental employees as a last resort. It is INAC's position that estate administration is a private family matter and should be done by the family, without assistance from INAC.

9. Appeals

The Minister's powers in connection with the administration of estates are subject to review by the

Federal Court under s. 47 of the *Act*. The standard of review is that of correctness.

10. Estates of persons not competent to handle their own affairs

Section 51 of the *Act* ousts the jurisdiction of the Superior Court of Justice in relation to the property of an Indian who is mentally incompetent and ordinarily resident on reserve or Crown land (s. 4(3)). Pursuant to s. 51, jurisdiction is vested in the Minister.

Section 2 defines "mentally incompetent Indian" as an Indian who, "pursuant to the laws of the province in which he resides, has been found to be mentally defective or incompetent for the purposes of any laws of that province providing for the administration of estates of mentally defective or incompetent persons."

For the purpose of ss. 51–52, the definition of "Indian" is extended to include any member of a band. This is in contrast to the definition of Indian that otherwise applies in the *Act*, which is restricted to those persons who are registered as an Indian with INAC. As a result of band (First Nation) membership laws, it is possible to be a band member, yet not recognized as an Indian under the *Act*.

Section 51 gives the Minister the authority over the property of an Indian who is mentally incompetent to

- appoint persons to administer the estate;
- order that any property be sold, leased, alienated, mortgaged, disposed of, or otherwise dealt with for the purpose of
  - paying debts or engagements;
  - discharging encumbrances on property;
  - paying debts or expenses incurred for the person's maintenance or otherwise for the person's benefit; or
  - paying or providing for the expenses of future maintenance; and
- make such order and give such directions as the Minister considers necessary to secure the satisfactory management of the estate.

The Minister may also order that any property situated off-reserve and belonging to a mentally incompetent Indian residing on-reserve be dealt with under the laws of the province in which the property is situated.

11. Property of minors

Sections 52 and 4(3) of the *Act* establish the Minister's jurisdiction to administer the property of Indian children ordinarily resident on reserve or Crown land and to appoint a guardian for that purpose.

However, as in the case with persons declared mentally incompetent, s. 4.1 expands the definition of "Indian" for s. 52 to include non-status Indian band members.

Guidelines for the release of funds by the Minister to parents and guardians of infant children are now provided in ss. 52.1–52.5.

Section 52.4 correspondingly protects the Minister from liability in respect of such payments made where it appears to a court that the Minister acted honestly and reasonably and ought fairly to be relieved from liability.

12. Impact of the Family Law Act

Under the *Family Law Act* (*FLA*), when a spouse dies, if the net family property of the deceased spouse exceeds the net family property of the surviving spouse, the surviving spouse is entitled to one-half the difference between them (s. 5(2)). If such an election is made, the surviving spouse forfeits any entitlement under the deceased's will, unless the will specifically states that the surviving spouse is so entitled. Likewise, if the surviving spouse elects for equalization of the net family property, he or she forfeits any entitlement as a result of intestacy.

Although the *FLA*, in general, applies to Indians as a result of s. 88 of the *Act*, any provisions that attempt to deal with possession of property on reserve does not necessarily apply. As a result, although the value of reserve property can be taken into account in determining values for net family property, there can be no order for seizure, partition, or sale in respect of property of the deceased located on reserve unless both spouses are members of the First Nation or a First Nation has enacted its own land code, in accordance with the *First Nations Land Management Act*.

Therefore, when advising a surviving spouse in respect of the *FLA* election, the lawyer should take into account the fact that a non-Indian (and non-member of the First Nation) probably will not be able to take possession of property on the reserve.

Real Estate

Chapter 43
Agreement of purchase and sale

The agreement of purchase and sale with respect to real estate ("agreement") is a contract (see Appendix A). It must be made in writing in order to comply with the *Statute of Frauds*. It brings with it all the obligations, responsibilities, and procedures of contract law. The elements of a binding contract are offer, acceptance, exchange of consideration, and the meeting of the minds.

Every real estate board in the Province of Ontario has adopted the Ontario Real Estate Association (OREA) form of agreement for residential real estate transactions. While this standard agreement incorporates issues common to many real estate transactions, a lawyer must be competent in drafting additional clauses to accommodate local requirements as well as the needs of the party the lawyer is representing.

When reviewing an agreement, always keep in mind that most of the issues that arise in the course of real estate transactions are dealt with in the agreement, which spells out all of the rights and obligations of the parties to the transaction.

1. The parties

1.1 Identification of parties

Before proceeding with the review and negotiation of the agreement, it is mandatory that the lawyer confirm the identity of the client, whether buyer or seller (By-law 7.1, made under the *Law Society Act*, ss. 21–23). This is part of the ongoing need to know one's client and guard against the possibility of assisting the client in fraudulent or other illegal conduct, whether knowingly or unknowingly. When acting for a buyer, it is also particularly helpful to verify the identity of the named sellers.

1.2 Buyer

When the contract is entered into, the buyer must exist. This applies to individuals, corporations, and partnerships alike.

The buyer must be competent. If a buyer is mentally incapacitated or is an undischarged bankrupt, for example, the buyer may not have such capacity.

Where one party is the buyer on the agreement and prior to closing that person decides to take title with another party (for example, a spouse deciding to register the title in both spouses' names), an amendment to the agreement is not required. A written direction to the sellers at closing is sufficient.

1.2.1 Corporate buyers, trustees, and agents

A purchase of land by a corporation must be specifically authorized by resolution of its directors.

Where the purchase is made by a religious organization as that term is defined in the *Religious Organizations' Lands Act*, the purchase can only be made for one of the purposes set forth in s. 2 of that *Act*. The trustees of the religious organization are the persons with the authority to sign on its behalf.

A trustee (on behalf of a trust) or agent (on behalf of a principal) must have authority to enter into the agreement. Where a trustee or agent is acting as buyer and is so described, the identity of the real buyer will probably be unknown. The name that appears as the buyer is a trustee or agent for the actual buyer.

If the buyer wishes that title ultimately be held in the name of a corporation, then the agreement should state that the buyer will have the right to transfer the agreement to a corporation. If the corporate entity refuses to complete the transaction, the original buyer may be responsible for any damages that the seller has incurred (Ontario's *Business Corporations Act* (*OBCA*), s. 21). This is based on the principle that a buyer can only assign its rights, not its obligations. For the buyer to avoid liability, it is necessary to provide for a release of the original buyer within the terms of the agreement.

1.3 Seller

1.3.1 Seller as an individual

It is critical to correctly identify the seller. If, for example, only one of two registered owners executes the agreement, then the buyer may ultimately only be able to obtain the interest of that seller. A subsearch of title before the agreement is entered into will reveal who the registered owners are. If those owners are not properly reflected in the agreement, an amendment must be prepared.

1.3.2 Corporate party

If the seller is a corporation, the corporate name must be accurately stated. In addition, it is important to ensure that the corporation's authorized officers sign

the contract. There is some protection from the "indoor management rule" (*OBCA*, s. 19).

1.3.3 Partnership property

While the law provides that a general partnership selling real estate in the ordinary course of business requires only one partner to execute a binding contract, in many instances the sale is not in that category. It is prudent in all cases to have all the partners execute the agreement.

1.3.4 Estate sale

Where the property being sold is part of an estate, all the estate trustees must sign on behalf of the estate. The estate trustees are identified in the will of the deceased. Where a certificate of appointment of estate trustee has already been issued under R. 74 or 75 of the *Rules of Civil Procedure,* the estate trustees will be identified in that document. If there is no will, estate trustees must be appointed by court order before the estate can agree to sell the property.

1.3.5 Seller as a trustee

If the buyer has actual or constructive notice that the seller owns the property in trust for a third party, consideration should be given to obtaining the written consent of the beneficial owner and of the spouse of the beneficial owner. Where the property being sold is a matrimonial home, the spouse of the beneficial owner may have an interest in the property under the *Family Law Act* (*FLA*), Part II, and the spouse's consent to the sale may therefore be required.

1.3.6 Seller not the registered owner

There are instances where the seller in the agreement is not the registered owner. This may occur where the property is being sold by the sheriff to satisfy an outstanding judgment or by a mortgagee under power of sale. In these circumstances, it is important to identify the capacity of the seller.

1.3.7 Joint tenants

Upon the death of any one of the joint tenants in a joint tenancy, the surviving joint tenants become the owners of the deceased's interest. There is an exception to this rule. Where a married spouse dies owning an interest in a matrimonial home as a joint tenant with a third person and not with the other spouse, s. 26 of the *FLA* dictates that the joint tenancy is deemed to have been severed immediately before the time of death.

1.4 Power of attorney

If any party (buyer, seller, or non-titled spouse of seller) will sign the agreement by way of power of attorney, it is essential to verify the validity of the power of attorney. Such verification includes ascertaining that the document meets the requirements of s. 10 of the *Substitute Decisions Act, 1992*, is a continuing power of attorney if the grantor is incapable, and is in effect and not subject to conditions that have not been fulfilled.

Clause 21(1)(a) of the *FLA* prohibits a spouse from disposing of or encumbering an interest in a matrimonial home unless the other spouse joins in the instrument or consents to the transaction. Therefore, if the seller is a spouse and is using a power of attorney to provide his or her spouse's consent, an authorization to this effect in the power of attorney ensures that the attorney is entitled to do this. This will become especially important when signing the electronic transfer at closing. A statement pursuant to O. Reg. 19/99, made under the *Land Registration Reform Act*, is then required of the solicitor submitting the document confirming among other things that the attorney is acting within the scope of the authority granted by the power of attorney. As a matter of practice, the land titles office will not register such a document unless the power of attorney contains an express authorization to provide the spouse's consent.

2. The property

This important section of the agreement identifies the property that is the subject of the agreement. The municipal address is the first component.

2.1 The dimensions of the property

The dimensions of the land are then set out "more or less." The general principle here is whether the buyer was content with the property as viewed? If so and in the absence of fraud or substantial errors resulting from negligence by the seller, minor discrepancies in dimensions as well as minor encroachments generally have no effect on the agreement.

There are cases that have attempted to define the parameters of "more or less." While in many transactions a minor discrepancy will be encompassed by "more or less," the concept of "more or less" becomes less forgiving in the case of vacant land being purchased for development purposes. This is especially true if the property is being explicitly purchased for redevelopment on a "per acre" basis by a developer. In a well drafted agreement, a clause providing for a measurement of the exact area of the land and for an adjustment to the purchase price following the

measurement will be included to avoid these kinds of issues.

A different example occurs where a minimum frontage is required to obtain a building permit and the seller is aware of this requirement (hopefully as a result of explicit language in the agreement). If the dimensions in such an agreement are described in terms of "more or less" and the actual frontage is less than what the seller represented in the agreement, the buyer's need for a specific minimum frontage may not be satisfied, and the buyer may then have rights arising from such misrepresentation.

2.2 Description by reference to a survey

Referring to and attaching a survey prepared by an Ontario land surveyor that identifies the property and its dimensions is one way to describe accurately a property's dimensions and to disclose the existence and location of easements and building and fence encroachments and should be considered a best practice. However, care must be taken to ensure that the survey reflects the current state of the land and registered title. For example, after the date of the survey, there may have been changes to the buildings, structures, or other improvements to the property: fences may have been installed in wrong locations, easements may have been added or revised, or the boundaries may have changed. All of these will render the survey outdated and significantly reduce its usefulness.

2.3 Legal description

Finally, there is space to provide a brief legal description of the property. The legal description will include such items as lot and plan, or lot and concession.

This is also the place to identify registered easements and rights of way. It should be noted that para. 10 of the agreement provides that the buyer will accept title subject to certain easements. If there are other easements beyond those described in para. 10, these must be disclosed either in this section or in a separate schedule. These might include mutual driveways, private laneways, a passageway between the subject property and the one adjoining to the side, or the right to enter onto the subject property to maintain the dwelling on the neighbouring property. Similarly, sewer and pipeline easements crossing the property, for example, must also be described.

It is necessary for a seller to set out any easements that the property is subject to because easements are a limitation upon the owner's right to use of the property. A seller cannot simply impose title constraints on a buyer. Such matters must be disclosed in the contract so that the buyer's offer is made with knowledge of such constraints. If the seller's title is not described as being subject to such easements, the buyer may have a valid complaint because the buyer has not been apprised of or bargained for such limitations when making the offer to purchase. On the other hand, once a buyer has agreed to purchase a property described in the agreement as being subject to a specified easement, the buyer will not later be in a position to require the removal of such easement from the title before closing.

3. The price

Ensure that the words and numbers coincide, since the purchase price often undergoes numerous alterations during negotiations.

4. The deposit

The deposit is security for the performance of the buyer's obligations, and it will be credited to the buyer against the purchase price at closing.

The seller will want the largest deposit possible to deter the buyer from default. The buyer will desire the smallest deposit possible.

There are two alternatives provided in the OREA form respecting the timing of deposits. The first is to have the deposit presented with the offer. The second is to have the deposit paid upon "acceptance," which is a defined term. Section 17 of O. Reg. 567/05, made under the *Real Estate and Business Brokers Act, 2002* requires that an agent place the deposit in his or her trust account within five banking days of receipt. As a result, it is possible for an agreement not to be accepted but for the deposit to be deposited into the listing broker's trust account. If the cheque was uncertified, the broker may have to wait for clearance, thereby delaying any future dealings by the buyers. Paying the deposit on acceptance of the offer avoids this difficulty.

There is a space on the OREA form to insert information as to whom the deposit is paid. Where a property has been sold through a listing, in most instances the deposit is paid to the listing broker in trust. If the property was sold without a broker, the deposit is usually paid to the seller's solicitor in trust. The payment of a deposit directly to a seller exposes the buyer to the risk of losing his or her deposit if the seller is selling fraudulently and is not the true owner. It is also a "red flag" that a real estate fraud might be occurring, and the lawyer should investigate this further.

5. Schedules

Most agreements include schedules with additional provisions such as warranties, conditions, or a copy of the survey (see above).

The terms of the agreement preceding the statement as to schedules is preceded by, "Buyer agrees to pay the balance as more particularly set out in Schedule A attached." On the schedule it would be appropriate to set out the terms of payment. For example:

> The buyer agrees to pay the balance of the purchase price, subject to adjustments, on completion by certified cheque or bank draft.

Conditions precedent (that is, conditions that must be satisfied or waived before the agreement becomes firm and binding) usually appear in this schedule. For example, these may deal with a buyer's need to confirm that he or she will be able to obtain bank financing or a buyer's requirement for a satisfactory professional building inspection before the agreement becomes firm and binding.

Also, if the seller is providing financing to the buyer, a paragraph will be included here setting out the terms of the "take-back mortgage."

In drafting conditions, it is imperative that the language be precise and complete. There are at least five elements required for a condition to be effective. First, the time frame must be clear. How long does the party (for whose benefit the condition is inserted) have to fulfill the requirements? Secondly, the terms of the condition should be defined clearly. If it is for financing or a home inspection, accurately describe what is being sought. Thirdly, a means of notice of fulfillment, waiver, or non-fulfillment of the condition should be provided. Fourthly, there should be a clause stating that if the condition is not met, the deposit is to be returned to the buyer. Finally, it may be appropriate to allow for a waiver so that the party for whose benefit the condition was inserted will have the option of continuing with the transaction even if the condition is not fulfilled.

Examples of clauses often added by way of a schedule can be found in Appendix B.

Sometimes the OREA form of agreement for residential real estate transactions will be adapted by small builders for use in the sale of newly constructed homes. In such cases, a schedule containing provisions applicable exclusively to new homes, including the statutory addendum required by the *Ontario New Home Warranties Plan Act*, needs to be added to the OREA form. A list of considerations that may require special drafting for new home agreements may be found in Appendix C.

6. Irrevocable date — para. 1

The agreement states that the offer will be void unless it is accepted before a specific date and time. Since the offer is stated to be irrevocable, the offeror cannot withdraw the offer until the expiration of the time period, with the *proviso* that the offeror receive some consideration for that irrevocable promise. The simplest method of providing consideration is to have the buyer sign under seal. (The OREA form contains a pre-printed seal.) On a counter-offer, the original irrevocable date may need to be changed, and certainly the offeror will change (seller or buyer as is appropriate).

7. Closing date and vacant possession — para. 2

It is important not to schedule the closing date for a Saturday, Sunday, or statutory holiday since, among other things, the transfer and mortgage cannot be registered on those dates. The first or last business days and Fridays of the month may not be good choices as many transactions are traditionally scheduled for those days, so the closing may not take place until late in the day.

Upon completion, vacant possession is to be provided unless otherwise provided in the agreement. In general terms, "vacant possession" means that the property must be unoccupied, with all of the seller's chattels removed except those bought by the buyer, and that keys representing access must be delivered to the buyer. If there is a tenancy to be assumed by the buyer, this must be specified.

8. Notices — para. 3

This paragraph of the OREA form authorizes the listing brokerage to give and receive notice on behalf of the seller. The buyer's brokerage is authorized to give and receive notice on behalf of the buyer only where the buyer has entered into a representation agreement with the brokerage. Where a brokerage represents both the buyer and seller, the brokerage cannot be either party's agent for the purpose of giving and receiving notices.

Notice to the parties may also be given by delivery to the address of service provided. This specific address is located at the end of the form. Notice may also be given by fax transmission where fax numbers have been inserted.

9. Fixtures and chattels — paras. 4 and 5

One of the more contentious issues that may arise in a real estate transaction is whether an item is a chattel or a fixture. The OREA agreement simplifies this issue. Fixtures always remain with the property unless specifically excluded. Chattels are not included unless specified in the agreement.

The rule to follow is "when in doubt spell it out." Detail in the chattel section (i.e., model, colour, and serial number) is strongly recommended. It is possible for the seller to suggest that the refrigerator in the garage is the one that was to be left behind, not the brand new one the buyer saw in the kitchen. In addition, as a buyer's solicitor, it might be appropriate to provide for a warranty in the agreement as to the "working order" of the chattels on closing. Avoid the term "good working order," since what constitutes "good" can be highly subjective. When it comes to fixtures, it is important to specify those items that the seller wishes to remove. These may include items such as the "dining room chandelier."

10. Rental items — para. 6

There are a number of items that could be listed in this section and that are generally subject to monthly payments such as hot water tanks, water softeners, furnaces, and other equipment. It is important to accurately disclose these items because they appear to be fixtures owned by the seller. If not mentioned in this section, the buyer may erroneously believe that he or she will become the owner of these items.

In many cases, rental equipment is subject to a contract requiring that the rental be specifically assumed by the buyer in writing and that the seller will remain responsible for all payments until that written assumption takes place. For this reason, the buyer obligates itself here specifically to assume the rental contracts.

11. Harmonized Sales Tax (formerly Goods and Services Tax) — para. 7

This paragraph contains a blank space that is to be completed by inserting either "included in" or "in addition to." This space is usually completed with "included in," on the assumption that the tax will not apply because the property is used residential property; however, if a home has been extensively renovated, for example, and particularly if the seller is in the construction business, the transaction may well be taxable. This is a potentially complex issue. If there is any doubt, advice should be obtained from professionals with relevant knowledge of the tax legislation.

12. Title searches — para. 8

This section provides the dates by which a buyer's lawyer must submit any title issues to the seller's lawyer. The means of submitting such issues is known as a "requisition letter."

Each requisition must identify a specific deficiency with respect to the property and outline a proposed resolution of the problem. If the contract fails to provide a specific time period for submitting requisitions, s. 4 of the *Vendors and Purchasers Act* prescribes a 30-day period from the date of the contract. If a requisition is submitted within the requisition period either as set out in the offer or pursuant to the *Act*, the seller's inability to properly answer it may in some circumstances enable the buyer to repudiate the contract or to demand an abatement (a compensating reduction) in the purchase price. The OREA form now provides that title insurance paid for by the seller is a contractually binding answer to a requisition (para. 10).

Paragraph 8 of the OREA form provides for two time periods for searches. The first period is to be specifically set out. The date inserted into the agreement is referred to as the "Requisition Date" and is meant to allow the buyer and the buyer's solicitor to examine title and submit any title requisitions revealed by this search.

The second time period is a maximum of 30 days after the requisition date but never less than five days prior to the completion date. The searches conducted under this section are essentially non-title matters. This second period is provided to search for work orders; to determine if the use of the property as set out may be lawfully continued; and finally, to inquire whether the principal building on the property may be insured against risk of fire.

A search with the municipality for outstanding work orders or deficiency notices may take some time depending on the response time of the relevant department. It is therefore prudent to attend to a request as soon as possible to ensure that the time frames are met. As far as the continuance of the current use, it is imperative to accurately identify what use the buyer expects when the transaction is completed. For example, a house might be described as "single family residential" or, if the buyer expects a basement apartment is to be legally available, the wording might read "two self-contained residential units." There are a number of requirements before an accessory apartment

will be considered "legal," and it would be appropriate to address these additional requirements separately in a schedule to the agreement.

The agreement provides an opportunity to determine whether fire insurance coverage can be arranged. Obtaining fire insurance coverage is increasingly challenging, especially for older homes where issues such as outdated electrical wiring may inhibit insurers. Consequently, in the case of older buildings, it may be appropriate to consider including in the agreement a condition precedent that will expire, allowing the buyer to investigate the availability of insurance at the outset of the transaction.

13. Future use — para. 9

If the buyer is contemplating a use different from the permitted use, the buyer's solicitor must make the agreement conditional upon being able to obtain permission for the change of use or being able to determine that the current zoning will permit this use.

14. Annulment clause — para. 10

Paragraph 10 is known as the annulment clause. The seller is to provide good title, free from all registered restrictions, charges, liens, and encumbrances except those that are listed in subparagraphs (a)–(d).

Subparagraph (a) excepts any registered restrictions or covenants that run with the land provided they are complied with. For example, many subdivisions are subject to restrictions prohibiting the operation of businesses, the placing of television antennas on properties, the parking of large trucks, and so on.

The buyer may not be aware of these restrictions or covenants when submitting an offer to purchase. If the buyer has a specific need in mind, it would be appropriate to make the offer conditional upon being able to accommodate that need. Consideration might also be given in such circumstances to deleting or limiting the exclusions in subparagraph (a).

It is not unusual in new construction that the title is subject to municipal and utility agreements. These agreements will remain on the title and are rarely released or discharged. Subparagraph (b) requires that the buyer accept these without complaint provided that the agreements have been complied with and sufficient security has been posted to ensure compliance.

Pursuant to subparagraph (c), the buyer must also accept the property subject to any minor domestic utility or telephone easements for the supply of service to the property or to adjacent properties.

If the property is subject to any easements as set out in subparagraph (d) (drainage, cable, etc.), the buyer must also accept these, provided they do not materially affect the use of the property. Keep in mind that the existence of this kind of easement may limit the buyer's ability to build on the land or to install improvements such as a building extension or a swimming pool.

If the buyer is purchasing the property, for example, to construct a brand new dwelling, it is important that there be no limitation upon the title to restrict the buyer's ability to build a structure to their particular specifications. In those cases, it would be advisable either to check the title before submitting the offer to determine if there are any limitations or, in the alternative, to delete or revise subparagraphs (a)–(d).

It might be difficult to determine if an easement materially affects the use of the property. The seller's solicitor should disclose any easement that could reasonably be raised later as significant and outside the parameters of subparagraphs (c)–(d). Such disclosure in the agreement of purchase and sale can prevent a later dispute.

Paragraph 10 next provides that if, within the specified time periods, searches reveal a valid problem with title, work orders or deficiency notices, lawful use of the property, or insurability of the principal buildings, as more particularly set out in the paragraph, that the seller is unable or unwilling to remove, remedy, satisfy, or obtain title insurance for and which the buyer will not waive, then the transaction is over. The language in the agreement permits the seller's solicitor to obtain title insurance to resolve a problem or insure a potential problem in order to facilitate the completion of the transaction.

Both parties must act reasonably and in good faith in completing their obligations under the agreement. The term "unwilling" cannot be utilized in a capricious or arbitrary manner. If, for example, the seller will be required to expend large sums of money in order to correct a problem, then in those circumstances, the seller may rely upon the "annulment clause" to terminate the agreement.

15. Closing arrangements — para. 11

Most Ontario real estate transactions are completed by way of electronic registration using computers. To accommodate for electronic registration, this provision in the agreement is meant to set out the general parameters surrounding the completion of such a transaction. It is an acknowledgement and agreement by the parties that the transfer of funds and registration of documents may not occur simultaneously. It

acknowledges that there will be an agreement (called a "document registration agreement") between the respective lawyers regarding the closing of the transaction.

16. Production of documentation and mortgage discharges — para. 12

The seller is to provide the buyer with title documentation in the seller's possession. In addition, upon request, the seller is to supply any sketch or plan of survey in the seller's possession.

This paragraph may not be sufficiently specific in respect of the survey, because surveyors produce a variety of surveys for various purposes. Therefore, a buyer's solicitor should consider adding a paragraph in a schedule requiring the seller to deliver a new survey or, in the alternative, an existing survey showing the current location of all the buildings, improvements, fences, decks, swimming pools, additions, or changes to the property or to the buildings and structures on it.

The paragraph provides that if there is an outstanding mortgage that is not to be assumed by the buyer and that is held by one of the institutional lenders listed, then a discharge of such mortgage will not have to be provided on closing. Instead, the seller has the option of delivering a mortgage statement from the lender for discharge purposes, a personal undertaking of the seller's solicitor to obtain and register a discharge of such mortgage, and if not a real-time cleared funds transaction, a direction that part of the balance due on closing be made payable by a separate certified cheque to the mortgagee, such cheque then to be delivered by the seller's solicitor.

Electronic registration has brought with it a number of other changes respecting the discharge of outstanding mortgages. If the mortgage is to be discharged by the seller's solicitor, then an undertaking is to be provided to obtain and register a discharge within a reasonable time after closing. If the mortgagee will register the discharge itself, the seller's solicitor will undertake to "cause to be registered" a discharge within a reasonable period of time after closing.

Mortgages outside of those held by the listed financial institutions (generally, private mortgages) must be discharged on closing. In such cases, the lawyer for the non-institutional lender will be a third lawyer involved in the electronic registration process and the document registration agreement.

17. Inspection clause — para. 13

In Ontario, the common-law doctrine of *caveat emptor* ("let the buyer beware") applies to the sale of used residential and commercial buildings, except to the extent that the doctrine is qualified by terms set out in the agreement. Buyers take such property subject to "patent defects," that is, building defects that would have been patently visible or easily discoverable on a physical inspection of the property. The law regarding "latent defects" is complex and not always clear.

The first part of this paragraph is an acknowledgement that the buyer has had the opportunity to inspect the property prior to submitting the offer. This is intended to limit a buyer's right to demand repairs of patent defects after the seller has accepted the offer. The buyer is however entitled to require repair of minor damage (beyond ordinary wear and tear) that occurs between the date of acceptance of the agreement and the closing date. The buyer should therefore make careful notes and take photos of the state of the property at the time of the offer.

The buyer's solicitor should add a clause to the offer that allows the buyer to inspect the property on one or more occasions prior to closing. Buyers should be encouraged to reserve one such inspection for the day of closing or as close to it as possible, in order to verify before closing that the property is in substantially the same condition it was in when the agreement of purchase and sale was entered into.

The second part of this paragraph is an acknowledgement by the buyer that once accepted by the seller, the offer will become a binding contract.

The last part of this provision addresses the matter of a home inspection by the buyer who, in a competitive market, may decide against requiring a property inspection as a condition precedent. This part of the provision contains an acknowledgement by the buyer of the opportunity to obtain an inspection and the decision not to obtain one.

18. Insurance and risk of loss — para. 14

Upon the agreement between the parties becoming firm, the common law provides that the seller is a trustee holding the property in trust for the buyer who is then the beneficial owner. As such, the buyer becomes responsible and obligated to accept the property despite any damage that has occurred before closing.

The provision in para. 14 transfers the risk of loss to the seller. If the seller insures the property, then he or she is a trustee of the policy and any proceeds from it, for both the seller and the buyer. If the property incurs substantial damage before closing, the buyer has the option of either terminating the transaction or

accepting any insurance proceeds and closing the transaction.

19. Compliance with the Planning Act — para. 15

An agreement made in contravention of the *Planning Act* does not create or convey any interest in land unless it is entered into subject to compliance with the *Planning Act*. This provision accommodates that requirement. This paragraph also provides that, if necessary, the seller will diligently proceed to obtain any consent under the *Planning Act*.

20. Preparation of documents — para. 16

The Transfer/Deed is prepared by the seller's lawyer at the seller's expense and registered by the buyer's lawyer. A take-back Charge/Mortgage, if any, is prepared by the buyer's lawyer at the buyer's expense and registered by the seller's lawyer. Each party pays the registration fees for the documents it is responsible for registering.

The final matter in this paragraph entitles the buyer to require that the statements in the Transfer/Deed contemplated by s. 50(22) of the *Planning Act* be completed by the seller and the seller's solicitor. Where the Transfer/Deed contains the completed statements of the seller, seller's solicitor, and buyer's solicitor, then any previous contravention of the *Planning Act* does not prevent the conveyance of any interest in the property.

21. Residency of the seller — para. 17

Section 116 of the *Income Tax Act* (*ITA*) imposes potential tax liability upon a non-resident seller. "Non-resident" is a defined term in the *ITA*. If the tax obligations are not fulfilled by the seller, then there is the potential under the *ITA* for even greater liability to be placed on the buyer.

The buyer is obligated by the *ITA* to make reasonable inquiries as to the residency of the seller. Where the seller is not a non-resident, the contract provides that the seller may deliver to the buyer at closing a statutory declaration stating that the seller is not a non-resident. Unless the buyer has knowledge otherwise, this will generally relieve the buyer of liability under the *ITA*. The statutory declaration should state that the seller is not a non-resident at the date the declaration is signed and sworn, as well as at the date of the completion of the transaction.

Where the seller is a non-resident, in order to protect the buyer from liability, the buyer's lawyer must require the seller's lawyer to withhold the amount of money for which the buyer would become liable if the seller did not pay (currently 25% of the sale price). The seller must provide the buyer with a certificate from the Canada Revenue Agency (CRA) exempting the property from any tax or verifying that all tax has been paid, failing which the buyer will remit the money to the CRA. In practice, the CRA may take several months to process the matter and provide the certificate, and during that time the seller's lawyer will retain 25% of the sale price in trust pending receipt of the certificate.

22. Adjustments — para. 18

Under this provision of the agreement, certain items of prepaid expenses (for example, realty taxes, charges for local improvements, unmetered utility charges such as prepaid water bills, unmetered cost of fuel such as prepaid tanks of heating oil) and prepaid income (such as rents) will be credited to the appropriate party as a price adjustment at closing.

The seller is responsible for the expense items (such as property taxes) up to the day before completion and similarly is entitled to revenue items (such as rent) until the day before completion. The buyer assumes responsibility on and from the day of completion.

23. Property assessment — para. 19

Under the *Assessment Act*, the Province of Ontario may reassess properties for municipal tax purposes as often as annually. Assessments are made on the basis of market value. Thus, there is always a possibility that the assessed value (and therefore the property tax bill) for a property may increase after a transaction has closed. This paragraph is an agreement by the parties that no party will have a claim arising from such a chain of events. The only exception is that the usual tax adjustment would be made on the basis of the revised tax bill should the taxes change before the transaction is completed.

24. Time limits — para. 20

The dates and times for completing all matters set out in the agreement must be strictly adhered to. If a party to the agreement defaults in his or her obligations under the agreement, the non-defaulting party may pursue damages if able to demonstrate that he or she was ready, willing, and able to complete the transaction in accordance with the terms of the agreement at the appropriate date and time.

The date for completing a matter may be altered in one of two ways. First, the parties to the agreement may amend the terms by agreement in writing. Secondly, if specifically authorized to do so, the lawyers for the

parties by agreement in writing may also change the closing date. In either case, in addition to the amendment being in writing, the other terms of the agreement must be confirmed, including that time remains of the essence.

25. Tender — para. 21

In the event that a transaction is not to be completed within the terms of the agreement, in order to pursue any remedies, the respective parties must be able to demonstrate they were ready, willing, and able to complete, as required under the terms of the agreement. To evidence this, delivery and presentation (a "tender") to the other party of all the documentation and funds is required. For the seller, this will also require keys to be produced. This paragraph permits the tender to be made on a party or that party's lawyer.

26. Family Law Act — para. 22

The term "spouse," for the purposes of real property, is defined in s. 1(1) of the *FLA* as a married spouse. Matrimonial home is defined in s. 18 of the *FLA*.

Where ownership of a matrimonial home is registered in the name of one spouse only, the consent of the unregistered spouse to a sale of the matrimonial home is required. The unregistered spouse signs for the purpose of consent in the signature area following para. 28.

The provision in para. 22 of the agreement is in the form of a warranty by the seller that such a consent is not necessary unless the spouse has signed the consent in the agreement. Refer also to the section "Seller," above. If despite this warranty, the seller has a spouse and the property is their matrimonial home, the absence of the consent of the spouse in the agreement could provide a basis for the unregistered spouse to refuse consent to the registration of the transfer at closing.

27. Urea Formaldehyde Foam Insulation Warranty ("UFFI") — para. 23

UFFI is a banned substance used many years ago as a form of building insulation. This warranty is two-tiered. The first level is a warranty by the seller that the seller has not insulated the premises with UFFI during the time that the seller was the owner of the property. The second level is a warranty that to the best of the seller's knowledge there is no UFFI in the buildings. While it may not be necessary to specify, the warranty does not merge in the registration of the Transfer/Deed but survives the completion of the transaction.

28. The broker's disclaimer — para. 24

Real estate brokers have in the past been exposed to liability arising from statements made by them to buyers or sellers. This paragraph attempts to relieve them of such exposure.

29. Consumer reports — para. 25

This paragraph is notification in accordance with the *Consumer Reporting Act* that a consumer report may be obtained or relied upon in the course of the transaction. This would occur, for example, where there was a mortgage taken back by the seller and the seller wanted to review the creditworthiness of the buyer/mortgagor as a condition of taking back the mortgage.

30. Agreement in writing — para. 26

If there has been any addition to the agreement that is in conflict with the preset portions, the addition will supersede the preset provisions. The paragraph further confirms that if in the course of discussions involving the transaction there were any collateral agreements, representations, warranties, or conditions stated that are not in the agreement, they do not constitute part of the agreement.

Throughout the agreement, the terms buyer and seller are used to identify the parties to the contract. In order to ensure that there is no confusion respecting the *Vendors and Purchasers Act* or any court decisions, the form provides that buyer means purchaser and seller means vendor.

31. Time and date — para. 27

Times and dates in the body of the agreement, being the irrevocable date, closing date, and title search date and time, but presumably not dates appearing in the signature areas, refer in each case to the time and date in effect where the property is situated.

32. Successors and assigns — para. 28

This paragraph makes it clear that there will be an enforceable contract even if one or more of the parties should die before closing.

33. Agreement and instruction

The first part of this area of the form contains the buyers' signatures. In accordance with the *Real Estate and Business Brokers Act, 2002*, they must also date their signatures. It is appropriate to identify the seal to the parties at the time of signing. These signatures must be witnessed.

The second part of this paragraph is the seller's statement agreeing to the above offer. Where the deposit is insufficient to pay the broker's commission, the seller irrevocably instructs his or her solicitor to pay any unpaid balance from the sale proceeds before any payment is made to the seller. The solicitor is not a party to the agreement and may not be obliged to honour this direction if the seller later directs otherwise or there are prior claims to the sale proceeds. The courts have held, however, that where the seller has executed under seal, the irrevocable instruction is binding upon the solicitor, and non-compliance will result in liability. It is also arguable that the seller's solicitor holding the sale proceeds is a trustee for the broker as well as for the seller. The solicitor must therefore be careful about refusing to pay the balance of commission simply because the seller has "revoked" the seller's irrevocable direction. If a solicitor receives conflicting demands for this money, payment into court of the disputed funds pursuant to s. 36 of the *Trustee Act* or the *Rules of Civil Procedure* should be considered.

34. Spousal consent

If consent by an untitled seller's spouse is necessary, the spouse would sign beside the seal.

35. Confirmation of acceptance

There are instances where conditions to the agreement are worded such that they expire a certain number of days after acceptance. In the past, it has been difficult to determine specifically when the transaction was finally accepted. This provision is to be completed by the party who signs or indicates acknowledgement of the agreement in its final form.

36. Confirmation of representation

The brokers involved in the transaction confirm their representation status. It is possible to have the broker acting for the seller and the co-operating broker acting for the buyer. In the alternative, all the brokers may be acting for the seller. Further, it is possible for one broker to be representing both the seller and the buyer.

37. Acknowledgement

The purpose of this area of the form is to obtain acknowledgement from the parties that they have received an originally signed copy of the agreement, as required under the *Real Estate and Business Brokers Act, 2002*. In addition, this section provides the seller's and buyer's address for service of notice as set out in the notice paragraph. Finally, the lawyers for the parties are identified with their addresses and telephone and fax numbers.

38. Commission trust agreement

In this paragraph, the listing broker and the co-operating broker confirm that all commission moneys are to be held in trust by the listing broker and the co-operating broker.

Appendix A
Agreement of Purchase and Sale

OREA Ontario Real Estate Association

Agreement of Purchase and Sale

Form 100
for use in the Province of Ontario

This Agreement of Purchase and Sale dated this..... day of ..... 20.....

BUYER,.....(Full legal names of all Buyers)....., agrees to purchase from

SELLER,.....(Full legal names of all Sellers)....., the following

REAL PROPERTY:

Address.....

fronting on the ..... side of.....

in the .....

and having a frontage of ..... more or less by a depth of..... more or less

and legally described as .....

.....(Legal description of land including easements not described elsewhere)..... (the "property").

PURCHASE PRICE: Dollars (CDN$).....

.....Dollars

DEPOSIT: Buyer submits .....(Herewith/Upon Acceptance/as otherwise described in this Agreement)

..... Dollars (CDN$).....

by negotiable cheque payable to..... "Deposit Holder" to be held in trust pending completion or other termination of this Agreement and to be credited toward the Purchase Price on completion. For the purposes of this Agreement, "Upon Acceptance" shall mean that the Buyer is required to deliver the deposit to the Deposit Holder within 24 hours of the acceptance of this Agreement. The parties to this Agreement hereby acknowledge that, unless otherwise provided for in this Agreement, the Deposit Holder shall place the deposit in trust in the Deposit Holder's non-interest bearing Real Estate Trust Account and no interest shall be earned, received or paid on the deposit.

Buyer agrees to pay the balance as more particularly set out in Schedule A attached.

SCHEDULE(S) A.....**attached hereto form(s) part of this Agreement.**

1. **IRREVOCABILITY:** This Offer shall be irrevocable by .....(Seller/Buyer)..... until ..... a.m./p.m. on the ..... day of ..... 20 ....., after which time, if not accepted, this Offer shall be null and void and the deposit shall be returned to the Buyer in full without interest.

2. **COMPLETION DATE:** This Agreement shall be completed by no later than 6:00 p.m. on the ..... day of ....., 20 ..... Upon completion, vacant possession of the property shall be given to the Buyer unless otherwise provided for in this Agreement.

INITIALS OF BUYER(S): **INITIALS OF SELLER(S):**

3. **NOTICES:** The Seller hereby appoints the Listing Brokerage as agent for the Seller for the purpose of giving and receiving notices pursuant to this Agreement. Where a Brokerage (Buyer's Brokerage) has entered into a representation agreement with the Buyer, the Buyer hereby appoints the Buyer's Brokerage as agent for the purpose of giving and receiving notices pursuant to this Agreement. **Where a Brokerage represents both the Seller and the Buyer (multiple representation), the Brokerage shall not be appointed or authorized to be agent for either the Buyer or the Seller for the purpose of giving and receiving notices.** Any notice relating hereto or provided for herein shall be in writing. In addition to any provision contained herein and in any Schedule hereto, this offer, any counter-offer, notice of acceptance thereof or any notice to be given or received pursuant to this Agreement or any Schedule hereto (any of them, "Document") shall be deemed given and received when delivered personally or hand delivered to the Address for Service provided in the Acknowledgement below, or where a facsimile number or email address is provided herein, when transmitted electronically to that facsimile number or email address, respectively, in which case, the signature(s) of the party (parties) shall be deemed to be original.

FAX No.: ..... FAX No.: .....
(For delivery of Documents to Seller) (For delivery of Documents to Buyer)

Email Address: ..... Email Address: .....
(For delivery of Documents to Seller) (For delivery of Documents to Buyer)

4. **CHATTELS INCLUDED:**.....
.....
.....
.....
.....
.....

Unless otherwise stated in this Agreement or any Schedule hereto, Seller agrees to convey all fixtures and chattels included in the Purchase Price free from all liens, encumbrances or claims affecting the said fixtures and chattels.

5. **FIXTURES EXCLUDED:**.....
.....
.....
.....
.....
.....

6. **RENTAL ITEMS:** The following equipment is rented and **not** included in the Purchase Price. The Buyer agrees to assume the rental contract(s), if assumable: .....
.....
.....

7. **HST:** If the sale of the property (Real Property as described above) is subject to Harmonized Sales Tax (HST), then such tax shall be ..... the Purchase Price. If the sale of the property is not subject to HST,
(included in/in addition to)
Seller agrees to certify on or before closing, that the sale of the property is not subject to HST.
Any HST on chattels, if applicable, is not included in the purchase price.

INITIALS OF BUYER(S): **INITIALS OF SELLER(S):**

8. **TITLE SEARCH:** Buyer shall be allowed until 6:00 p.m. on the..... day of....., 20....., (Requisition Date) to examine the title to the property at Buyer's own expense and until the earlier of: (i) thirty days from the later of the Requisition Date or the date on which the conditions in this Agreement are fulfilled or otherwise waived or; (ii) five days prior to completion, to satisfy Buyer that there are no outstanding work orders or deficiency notices

   affecting the property, and that its present use(.....) may be lawfully continued and that the principal building may be insured against risk of fire. Seller hereby consents to the municipality or other governmental agencies releasing to Buyer details of all outstanding work orders and deficiency notices affecting the property, and Seller agrees to execute and deliver such further authorizations in this regard as Buyer may reasonably require.

9. **FUTURE USE:** Seller and Buyer agree that there is no representation or warranty of any kind that the future intended use of the property by Buyer is or will be lawful except as may be specifically provided for in this Agreement.

10. **TITLE:** Provided that the title to the property is good and free from all registered restrictions, charges, liens, and encumbrances except as otherwise specifically provided in this Agreement and save and except for (a) any registered restrictions or covenants that run with the land providing that such are complied with; (b) any registered municipal agreements and registered agreements with publicly regulated utilities providing such have been complied with, or security has been posted to ensure compliance and completion, as evidenced by a letter from the relevant municipality or regulated utility; (c) any minor easements for the supply of domestic utility or telephone services to the property or adjacent properties; and (d) any easements for drainage, storm or sanitary sewers, public utility lines, telephone lines, cable television lines or other services which do not materially affect the use of the property. If within the specified times referred to in paragraph 8 any valid objection to title or to any outstanding work order or deficiency notice, or to the fact the said present use may not lawfully be continued, or that the principal building may not be insured against risk of fire is made in writing to Seller and which Seller is unable or unwilling to remove, remedy or satisfy or obtain insurance save and except against risk of fire (Title Insurance) in favour of the Buyer and any mortgagee, (with all related costs at the expense of the Seller), and which Buyer will not waive, this Agreement notwithstanding any intermediate acts or negotiations in respect of such objections, shall be at an end and all monies paid shall be returned without interest or deduction and Seller, Listing Brokerage and Co-operating Brokerage shall not be liable for any costs or damages. Save as to any valid objection so made by such day and except for any objection going to the root of the title, Buyer shall be conclusively deemed to have accepted Seller's title to the property.

11. **CLOSING ARRANGEMENTS:** Where each of the Seller and Buyer retain a lawyer to complete the Agreement of Purchase and Sale of the property, and where the transaction will be completed by electronic registration pursuant to Part III of the Land Registration Reform Act, R.S.O. 1990, Chapter L4 and the Electronic Registration Act, S.O. 1991, Chapter 44, and any amendments thereto, the Seller and Buyer acknowledge and agree that the exchange of closing funds, non-registrable documents and other items (the "Requisite Deliveries") and the release thereof to the Seller and Buyer will (a) not occur at the same time as the registration of the transfer/deed (and any other documents intended to be registered in connection with the completion of this transaction) and (b) be subject to conditions whereby the lawyer(s) receiving any of the Requisite Deliveries will be required to hold same in trust and not release same except in accordance with the terms of a document registration agreement between the said lawyers. The Seller and Buyer irrevocably instruct the said lawyers to be bound by the document registration agreement which is recommended from time to time by the Law Society of Upper Canada. Unless otherwise agreed to by the lawyers, such exchange of the Requisite Deliveries will occur in the applicable Land Titles Office or such other location agreeable to both lawyers.

12. **DOCUMENTS AND DISCHARGE:** Buyer shall not call for the production of any title deed, abstract, survey or other evidence of title to the property except such as are in the possession or control of Seller. If requested by Buyer, Seller will deliver any sketch or survey of the property within Seller's control to Buyer as soon as possible and prior to the Requisition Date. If a discharge of any Charge/Mortgage held by a corporation incorporated pursuant to the Trust And Loan Companies Act (Canada), Chartered Bank, Trust Company, Credit Union, Caisse Populaire or Insurance Company and which is not to be assumed by Buyer on completion, is not available in registrable form on completion, Buyer agrees to accept Seller's lawyer's personal undertaking to obtain, out of the closing funds, a discharge in registrable form and to register same, or cause same to be registered, on title within a reasonable period of time after completion, provided that on or before completion Seller shall provide to Buyer a mortgage statement prepared by the mortgagee setting out the balance required to obtain the discharge, and, where a real-time electronic cleared funds transfer system is not being used, a direction executed by Seller directing payment to the mortgagee of the amount required to obtain the discharge out of the balance due on completion.

13. **INSPECTION:** Buyer acknowledges having had the opportunity to inspect the property and understands that upon acceptance of this Offer there shall be a binding agreement of purchase and sale between Buyer and Seller. **The Buyer acknowledges having the opportunity to include a requirement for a property inspection report in this Agreement and agrees that except as may be specifically provided for in this Agreement, the Buyer will not be obtaining a property inspection or property inspection report regarding the property.**

INITIALS OF BUYER(S): **INITIALS OF SELLER(S):**

14. **INSURANCE:** All buildings on the property and all other things being purchased shall be and remain until completion at the risk of Seller. Pending completion, Seller shall hold all insurance policies, if any, and the proceeds thereof in trust for the parties as their interests may appear and in the event of substantial damage, Buyer may either terminate this Agreement and have all monies paid returned without interest or deduction or else take the proceeds of any insurance and complete the purchase. No insurance shall be transferred on completion. If Seller is taking back a Charge/Mortgage, or Buyer is assuming a Charge/Mortgage, Buyer shall supply Seller with reasonable evidence of adequate insurance to protect Seller's or other mortgagee's interest on completion.

15. **PLANNING ACT:** This Agreement shall be effective to create an interest in the property only if Seller complies with the subdivision control provisions of the Planning Act by completion and Seller covenants to proceed diligently at Seller's expense to obtain any necessary consent by completion.

16. **DOCUMENT PREPARATION:** The Transfer/Deed shall, save for the Land Transfer Tax Affidavit, be prepared in registrable form at the expense of Seller, and any Charge/Mortgage to be given back by the Buyer to Seller at the expense of the Buyer. If requested by Buyer, Seller covenants that the Transfer/Deed to be delivered on completion shall contain the statements contemplated by Section 50(22) of the Planning Act, R.S.O.1990.

17. **RESIDENCY:** Buyer shall be credited towards the Purchase Price with the amount, if any, necessary for Buyer to pay to the Minister of National Revenue to satisfy Buyer's liability in respect of tax payable by Seller under the non-residency provisions of the Income Tax Act by reason of this sale. Buyer shall not claim such credit if Seller delivers on completion the prescribed certificate or a statutory declaration that Seller is not then a non-resident of Canada.

18. **ADJUSTMENTS:** Any rents, mortgage interest, realty taxes including local improvement rates and unmetered public or private utility charges and unmetered cost of fuel, as applicable, shall be apportioned and allowed to the day of completion, the day of completion itself to be apportioned to Buyer.

19. **PROPERTY ASSESSMENT:** The Buyer and Seller hereby acknowledge that the Province of Ontario has implemented current value assessment and properties may be re-assessed on an annual basis. The Buyer and Seller agree that no claim will be made against the Buyer or Seller, or any Brokerage, Broker or Salesperson, for any changes in property tax as a result of a re-assessment of the property, save and except any property taxes that accrued prior to the completion of this transaction.

20. **TIME LIMITS:** Time shall in all respects be of the essence hereof provided that the time for doing or completing of any matter provided for herein may be extended or abridged by an agreement in writing signed by Seller and Buyer or by their respective lawyers who may be specifically authorized in that regard.

21. **TENDER:** Any tender of documents or money hereunder may be made upon Seller or Buyer or their respective lawyers on the day set for completion. Money may be tendered with funds drawn on a lawyer's trust account in the form of a bank draft, certified cheque or wire transfer using the Large Value Transfer System.

22. **FAMILY LAW ACT:** Seller warrants that spousal consent is not necessary to this transaction under the provisions of the Family Law Act, R.S.O.1990 unless Seller's spouse has executed the consent hereinafter provided.

23. **UFFI:** Seller represents and warrants to Buyer that during the time Seller has owned the property, Seller has not caused any building on the property to be insulated with insulation containing ureaformaldehyde, and that to the best of Seller's knowledge no building on the property contains or has ever contained insulation that contains ureaformaldehyde. This warranty shall survive and not merge on the completion of this transaction, and if the building is part of a multiple unit building, this warranty shall only apply to that part of the building which is the subject of this transaction.

24. **LEGAL, ACCOUNTING AND ENVIRONMENTAL ADVICE**: The parties acknowledge that any information provided by the brokerage is not legal, tax or environmental advice.

25. **CONSUMER REPORTS: The Buyer is hereby notified that a consumer report containing credit and/or personal information may be referred to in connection with this transaction.**

26. **AGREEMENT IN WRITING:** If there is conflict or discrepancy between any provision added to this Agreement (including any Schedule attached hereto) and any provision in the standard pre-set portion hereof, the added provision shall supersede the standard pre-set provision to the extent of such conflict or discrepancy. This Agreement including any Schedule attached hereto, shall constitute the entire Agreement between Buyer and Seller. There is no representation, warranty, collateral agreement or condition, which affects this Agreement other than as expressed herein. For the purposes of this Agreement, Seller means vendor and Buyer means purchaser. This Agreement shall be read with all changes of gender or number required by the context.

27. **TIME AND DATE:** Any reference to a time and date in this Agreement shall mean the time and date where the property is located.

INITIALS OF BUYER(S): **INITIALS OF SELLER(S):**

28. **SUCCESSORS AND ASSIGNS:** The heirs, executors, administrators, successors and assigns of the undersigned are bound by the terms herein.

SIGNED, SEALED AND DELIVERED in the presence of: IN WITNESS whereof I have hereunto set my hand and seal:

.....(Witness) .....(Buyer) ● (Seal) DATE.....

.....(Witness) .....(Buyer) ● (Seal) DATE.....

I, the Undersigned Seller, agree to the above Offer. I hereby irrevocably instruct my lawyer to pay directly to the brokerage(s) with whom I have agreed to pay commission, the unpaid balance of the commission together with applicable Harmonized Sales Tax (and any other taxes as may hereafter be applicable), from the proceeds of the sale prior to any payment to the undersigned on completion, as advised by the brokerage(s) to my lawyer.

SIGNED, SEALED AND DELIVERED in the presence of: IN WITNESS whereof I have hereunto set my hand and seal:

.....(Witness) .....(Seller) ● (Seal) DATE.....

.....(Witness) .....(Seller) ● (Seal) DATE.....

SPOUSAL CONSENT: The Undersigned Spouse of the Seller hereby consents to the disposition evidenced herein pursuant to the provisions of the Family Law Act, R.S.O.1990, and hereby agrees with the Buyer that he/she will execute all necessary or incidental documents to give full force and effect to the sale evidenced herein.

.....(Witness) .....(Spouse) ● (Seal) DATE.....

CONFIRMATION OF ACCEPTANCE: Notwithstanding anything contained herein to the contrary, I confirm this Agreement with all changes both typed and written was finally accepted by all parties at.....a.m./p.m. this.....day of....., 20..... . .....(Signature of Seller or Buyer)

INFORMATION ON BROKERAGE(S)

Listing Brokerage..... Tel.No.(.....).....

.....

Co-op/Buyer Brokerage..... Tel.No.(.....).....

.....

ACKNOWLEDGEMENT

I acknowledge receipt of my signed copy of this accepted Agreement of Purchase and Sale and I authorize the Brokerage to forward a copy to my lawyer.

.....(Seller) DATE.....

.....(Seller) DATE.....

Address for Service.....

.....Tel.No.(.....).....

Seller's Lawyer.....

Address.....

(.....).....Tel.No. (.....).....FAX No.

I acknowledge receipt of my signed copy of this accepted Agreement of Purchase and Sale and I authorize the Brokerage to forward a copy to my lawyer.

.....(Buyer) DATE.....

.....(Buyer) DATE.....

Address for Service.....

.....Tel.No.(.....).....

Buyer's Lawyer.....

Address.....

(.....).....Tel.No. (.....).....FAX No.

FOR OFFICE USE ONLY

COMMISSION TRUST AGREEMENT

To: Co-operating Brokerage shown on the foregoing Agreement of Purchase and Sale:
In consideration for the Co-operating Brokerage procuring the foregoing Agreement of Purchase and Sale, I hereby declare that all moneys received or receivable by me in connection with the Transaction as contemplated in the MLS® Rules and Regulations of my Real Estate Board shall be receivable and held in trust. This agreement shall constitute a Commission Trust Agreement as defined in the MLS® Rules and shall be subject to and governed by the MLS® Rules pertaining to Commission Trust.

DATED as of the date and time of the acceptance of the foregoing Agreement of Purchase and Sale. Acknowledged by:

.....(Authorized to bind the Listing Brokerage) .....(Authorized to bind the Co-operating Brokerage)

OREA Ontario Real Estate Association

Schedule A
Agreement of Purchase and Sale

Form 100
for use in the Province of Ontario

This Schedule is attached to and forms part of the Agreement of Purchase and Sale between:

BUYER,....., and

SELLER,.....

for the purchase and sale of .....

..... dated the ..... day of ....., 20..... .

Buyer agrees to pay the balance as follows:

This form must be initialed by all parties to the Agreement of Purchase and Sale.

INITIALS OF BUYER(S): **INITIALS OF SELLER(S):**

Appendix B

Sample Condition/Termination Clauses for Residential Re-Sale (Non-Rural) Transactions

1. Conditional upon arranging a new Charge/Mortgage

This Offer is conditional upon the Buyer arranging, at the Buyer's own expense, a new Charge/Mortgage for not less than _____ ($_____), bearing interest at a rate of not more than ___ % per annum, calculated semi-annually not in advance, repayable in blended monthly payments of about _____ ($_____) including principal and interest, and to run for a term of not less than _____ years from the date of completion of this transaction. Unless the Buyer gives notice in writing delivered to the Seller not later than ____ p.m. on the ____ day of _____, _____ , that this condition has been fulfilled, this Offer shall be null and void, and the deposit shall be returned to the Buyer in full without deduction. This condition is included for the benefit of the Buyer and may be waived at the Buyer's sole option by notice in writing to the Seller within the time period stated herein.

NOTE: If a seller take-back charge/mortgage is also being arranged, delete the phrase "not less than" preceding the amount being financed and specify the amount (to prevent the property being over-financed to the seller's detriment.)

NOTE: The time period needed for fulfilling this condition is typically about five business days.

2. Condition: assumption of existing Charge/Mortgage (chargee/mortgagee approval)

The Buyer agrees to assume the existing _____ Charge/Mortgage held by _____ for approximately _____ ($_____), bearing interest at the rate of ____% per annum, calculated semi-annually not in advance, repayable in blended monthly payments of _____ ($_____) including both principal and interest, and due on the ____ day of _____, _____. This Offer is conditional upon the Buyer obtaining approval of the Chargee/Mortgagee to assume the existing Charge/Mortgage. Unless the Buyer gives notice in writing delivered to the Seller not later than ____ p.m. on the _____ day of _____, _____, that this condition has been fulfilled, this Offer shall be null and void, and the deposit shall be returned to the Buyer in full without deduction. The Buyer hereby agrees to proceed immediately to make application and provide such material as may be required by the Chargee/Mortgagee for approval of the Buyer as the Chargor/Mortgagor.

NOTE: The time period needed for fulfilling this condition is typically about five business days.

3. Conditional upon sale of the buyer's property

This offer is conditional upon the sale of the Buyer's property known as_____

_____. Unless the Buyer gives notice in writing delivered to the Seller not later than ____ p.m. on the _____day of _____, _____, that this condition is fulfilled, this Offer shall be null and void, and the deposit shall be returned to the Buyer in full without deduction. This condition is included for the benefit of the Buyer and may be waived at the Buyer's sole option by notice in writing to the Seller within the time period stated herein.

4. Escape clause (removal of all conditions)

Provided further that the Seller may continue to offer the property for sale and, in the event the Seller receives another Offer satisfactory to the Seller, the Seller may so notify the Buyer in writing by delivery to the Buyer or the Buyer's address hereinafter indicated. The Buyer shall have _____ hours from the giving of such notice to waive all conditions by notice in writing delivered to the Seller, failing which this Offer shall be null and void, and the deposit shall be returned to the Buyer in full without deduction.

NOTE: The escape clause will almost always be required by the seller when Condition 3 is included in an agreement.

5. Conditional upon inspection — seller allowed to remedy

This Offer is conditional upon the inspection of the subject property by a home inspector at the Buyer's own expense and the obtaining of a report satisfactory to the Buyer [in the Buyer's sole discretion][1] [or a report revealing deficiencies in the property which the Seller is willing and able to remedy].[2] Unless the Buyer gives notice in writing delivered to the Seller not later than _____ p.m. on the _____ day of _____, _____,[3] that this condition has been fulfilled, this Offer shall be null and void, and the deposit shall be returned to the Buyer in full without deduction. The Seller agrees to co-operate in providing access to the property for the purposes of this inspection. This condition is included for the benefit of the Buyer and may be waived at the Buyer's sole option by notice in writing to the Seller within the time period stated herein.

NOTE 1: Most commonly, the words "in the Buyer's sole discretion" appear here.

NOTE 2: This wording may be used in place of "in the Buyer's sole discretion." However, this wording may create new and difficult issues between buyer and seller: What constitutes a "deficiency"? What contractor must the seller use for the repairs? What work must be done? What quality of materials must be used?

NOTE 3: The time period needed for fulfilling this condition is typically about five business days. Condition 5 and Condition 1 will usually run concurrently.

6. Conditional upon review of condominium documents

This Offer is conditional upon the Buyer's Solicitor reviewing the following Condominium Corporation documentation: a Status Certificate, the last annual financial statements (audited if available), the current budget, the Declaration, by-laws, rules, any management agreement, and all current insurance certificates, and finding all of the foregoing satisfactory in the Buyer's Solicitor's sole and unfettered discretion. Unless the Buyer gives notice in writing delivered to the Seller not later than _____ p.m. on the _____ day of _____, _____, that this condition has been fulfilled, this Offer shall be null and void, and the deposit shall be returned to the Buyer in full without deduction. The Buyer or the Buyer's Solicitor agrees to request the foregoing documentation within _____ days after acceptance of this Agreement. This condition is included for the benefit of the Buyer and may be waived at the Buyer's sole option by notice in writing to the Seller within the time period stated herein.

NOTE: The time period needed for fulfilling this condition is typically about 12 business days. The *Condominium Act, 1998* allows the condominium corporation up to 10 business days to provide the documents, and the buyer's solicitor will need time after receipt to review it with the buyer.

NOTE: Despite the words "in the Buyer's Solicitor's sole and unfettered discretion," the discretion cannot be exercised arbitrarily without sufficient reason.

7. Seller agrees to provide existing survey with declaration

The Seller agrees to provide, at the Seller's own expense, not later than _____ p.m. on the _____day of _____, _____, an existing survey of the said property showing the current location of the all structures, buildings, fences, improvements, easements, rights-of-way, and encroachments affecting the said property. The Seller will further deliver, on completion, a statutory declaration confirming that there have been no additions to the structures, buildings, fences, and improvements on the property since the date of this survey.

NOTE: This is not a condition, but a term being added by the buyer to the agreement. The date specified should be well before the Requisition Date.

8. Conditional upon obtaining insurance

This offer is conditional on the Buyer obtaining insurance for the property satisfactory to the Buyer in the Buyer's sole and absolute discretion. Unless the Buyer gives notice in writing delivered to the Seller not later than _____ p.m. on the _____day of _____, _____, that this condition is fulfilled, this offer shall be null and void, and the deposit shall be returned to the Buyer in full without deduction. The Seller agrees to co-operate in providing access to the property, if necessary, for any inspection of the property required for the fulfillment of this condition. This condition is included for the benefit of the Buyer and may be waived at the Buyer's sole option by notice in writing to the Seller within the time period stated herein.

NOTE: Due to the nature of this clause, a short time frame should be chosen for this condition. In practice it is not usual to include this condition unless the buyer has reason to believe that it will be difficult to obtain insurance for the property.

9. Condition: oil tank — aboveground or underground

This Agreement is conditional upon the Buyer obtaining a report from a fuel oil distributor registered under the *Technical Standards and Safety Act, 2000*, S.O. 2000, c. 16, as amended, and any Regulations thereto as amended from time to time stating the tank system in, on, or about the property is in a safe operating condition and complies with the requirements of the *Technical Standards and Safety Act, 2000*, S.O. 2000, c. 16, as amended, and any Regulations thereto as amended from time to time. The Seller agrees to allow access to the property by the fuel oil distributor for the purpose of obtaining a report. Unless the Buyer gives notice in writing delivered to the Seller not later than _____ p.m. on the _____ day of _____, 20___, that this condition has been fulfilled, this Offer shall be null and void, and the deposit shall be returned to the buyer in full without deduction. This condition is included for the benefit of the Buyer and may be waived at the Buyer's sole option by notice in writing to the Seller within the time period stated herein.

Appendix C

Additional Considerations for Agreements of Purchase and Sale of New Homes

1. Confirming
   (a) the registration of the seller/builder, as well as the enrolment of the dwelling unit itself, with the Ontario New Home Warranty Program (ONHWP);
   (b) the registration status of the plan of subdivision encompassing the dwelling; and
   (c) the status of the issuance of the building permit authorizing construction of the dwelling.

   NOTE: This information must be included in the agreement pursuant to s. 12 of R.R.O. 1990, Reg. 894, made under the *Ontario New Home Warranties Plan Act*.
2. Procuring an ONHWP deposit receipt for up to $40,000 of the deposit moneys on a new freehold home ($20,000 for a new condominium unit).
3. Requiring additional deposits required by the seller at various stages of construction.
4. Obliging the seller to construct the dwelling in accordance with certain plans, specifications, and/or model.
5. Requiring procurement of a mortgage approval with respect to the buyer's assumption of a first mortgage against the dwelling on closing and/or the requirements for a seller take-back mortgage on closing, and outlining the consequences of the buyer's failure to obtain such mortgage approval.
6. Reserving a seller's lien for unadvanced mortgage moneys.
7. Extending closing for construction delays and other reasons beyond the seller's control, including the mandatory addendum to each offer prescribed by the *Ontario New Home Warranties Plan Act*.
8. Requiring completion of the transaction when the interior of the dwelling has been substantially completed sufficient to permit lawful occupancy thereof, notwithstanding that exterior work (i.e., landscaping, exterior painting, etc.) may still be outstanding.
9. Entitling the seller to pass title directly from the registered owner (i.e., the subdivider/developer) to the unit buyer.
10. Requiring the buyer to abide by the seller's building scheme and other restrictive covenants that, among other things, would preclude any changes by the buyer to the grading and drainage patterns of the property.
11. Providing for an expanded list of permitted encumbrances to which title will be subject and obliging the buyer to grant easements (after closing) to various utility agencies or authorities to facilitate the servicing of the subdivision.
12. Requiring the buyer to accept the seller's solicitor's undertaking to discharge outstanding blanket mortgages.
13. Providing for additional adjustments, namely
    (a) interest on unadvanced mortgage proceeds;
    (b) ONHWP enrolment fees;
    (c) water meter charges and connections;
    (d) tree planting, boulevard sodding, landscaping, and/or fencing charges;
    (e) mortgage insurance fees for high ratio mortgage loans;
    (f) security deposits for damage to municipal services;
    (g) proportionate increase in levies charged pursuant to the *Development Charges Act, 1997*; and
    (h) Harmonized Sales Tax (HST).
14. Applying the new housing rebate of HST, which now combines two different rebates.
15. Prohibiting assignment of the offer (and the buyer's interest in the property) before closing, without the seller's prior consent.
16. Providing for the statutory safeguards under the *Ontario New Home Warranties Plan Act*, with respect to
    (a) protection of deposits under $40,000 for a new freehold home (under $20,000 for a new condominium unit);
    (b) protection against incomplete work;

(c) protection against defects in workmanship and materials (and breaches of the Ontario *Building Code*, O.Reg. 350/06, made under the *Building Code Act, 1992*);

(d) warranty protection against basement leakage;

(e) warranty protection against major structural defects;

(f) minimum notice periods of extensions of closing and compensation for the failure to comply with same;

(g) a maximum period for the extension of closing without the buyer's consent;

(h) restrictions on major substitutions involving key elements of the house; and

(i) compensation to the buyer for minor substitutions to the house made without the buyer's consent.

17. Reserving a right of re-entry in favour of the seller for the rectification of deficiencies and/or completion of grading.

Chapter 44

Land registration in Ontario

1. The ownership of land

Land is a scarce resource. It provides income for farmers and landlords, and places to live for owners and tenants alike. Because of its scarce nature and value, it is critical to have a system of registration that provides for certainty of ownership. Ontario has one of the most advanced systems of land registration in the world.

2. Division of land — a historical overview

Historically, lands were divided into counties, which were subdivided into townships. Townships were divided into concessions, and concessions were further divided into lots.

3. Land registration systems

The purpose of the land registration systems is to provide notice to the public about the various interests that individuals and/or corporations have in land. It also establishes priorities of these interests and an orderly method of recording them. Therefore, the systems will show who the owner of a particular property is and what mortgages or other encumbrances may be registered against it; they also disclose various other documents that may affect a property, such as easements or subdivision agreements.

The two systems under which title is recorded in Ontario are the "registry system," which is governed by the *Registry Act*, and the "land titles system," which is governed by the *Land Titles Act*. The registry system is an older system where documents are registered without review for legal sufficiency by the Government of Ontario. It is, therefore, not conclusive evidence of the interest described in the particular instrument. Each instrument must be examined to determine its legal effect. The land titles system, on the other hand, confirms title to the property and thus prohibits the registration of a transfer from a person who is not a registered owner.

Each system is unique. As an example, title under the registry system may be taken "in trust" for the benefit of another party, while s. 62 of the *Land Titles Act* states, "A notice of an express, implied or constructive trust shall not be entered on the register or received for registration."

The *Land Registration Reform Act* (*LRRA*), which has introduced most changes to the land registration system including automation, applies to both systems.

4. Registry system

4.1 Registration of instruments

The *Registry Act* provides for the registration of instruments relating to and affecting title to the land.

Instruments that may be registered under the *Registry Act* are listed in s. 1 "instrument" of the *Registry Act* and Part 1 of the *LRRA*.

Section 1 of the *Registry Act* defines "instrument" very broadly. It includes every instrument whereby titles to land may be transferred, disposed of, charged, encumbered, or affected in any other way. It also includes a Crown grant, deed, conveyance, mortgage, assignment of mortgage, assurance, lease, release, discharge, and agreement for sale and purchase of land.

4.2 Effect of registration

Pursuant to s. 74 of the *Registry Act*, registration of an instrument constitutes notice of the said instrument. The lawyer must review the instrument to determine its legal effect.

4.3 Priorities

Priority of registration is very important; for example, in cases where the same interest is disposed of to different individuals and the later instrument is registered first, one needs to decide which of the two individuals has the interest.

For example, assume Mr. Jones sold his property to A and then sold the same property to B on the following day, having B register the deed without B knowing about A. In this case, the later instrument will have priority, since B did not have actual notice from A of the deed provided to her by Mr. Jones. Sections 71 and 49 of the *Registry Act* deal with priorities.

4.4 Registration: when instruments are deemed to be registered

Section 77 of the *Registry Act* deems registration when the registrar has accepted the documents for registration.

5. The land titles system

The land titles system provides a statement of title. It therefore confirms who the owner is of the particular property. The *Land Titles Act* applies to this system of registration.

Each separately owned piece of land is called a "parcel." Each parcel has a number and is registered in a book or electronically. The book is called the "register" or the "parcel register" when referring to a particular parcel. The parcel register is the title to the property, since it shows the owner of the parcel and lists the encumbrances.

When a certain instrument disposing of an interest is registered, the registrar "rules off" the previous instrument that disposed of the same interest. A Transfer for Lot A that was registered April 4, 1999, will be ruled off when the next transfer of the same Lot A is registered on March 7, 2005. The parcel register will show the last registered instruments for the property, and the lawyer will not have to examine those that have been ruled off.

For lands designated under Part II of the *LRRA*, each property has a property identification number, or "PIN" for short. This is entered into the automated system to make it easy to retrieve the parcel.

5.1 Instruments that may be registered

The *Land Titles Act* does not provide a definition of "instrument" in contrast to the *Registry Act*. Different sections of the *Land Titles Act* allow for registration of various instruments. The forms of these instruments are prescribed by the regulations.

As the parcel register is a statement of title, the presentation of an instrument for registration is more than just registration. Pursuant to s. 77(1) of the *Land Titles Act*, every instrument presented for registration, which upon registration creates, transfers, or terminates an interest in land, is deemed to be an application to the registrar to amend the registered title.

Section 81 of the *Land Titles Act* describes situations where the land registrar may refuse registration of an instrument.

5.2 Registration: when instruments are deemed to be registered

Pursuant to s. 78(3) of the *Land Titles Act*, an instrument is complete when the instrument and its entry is certified by the land registrar or deputy or assistant deputy land registrar, and the time of receipt shall be deemed to be the time of its registration. For example, if a mortgage was received on July 7, 2004, and certified on August 6, 2004, then the instrument is still deemed to be registered on July 7, 2004.

5.3 Effect of registration

No instrument is registered unless certified. It is reviewed and approved by the land registrar.

5.4 Priorities

Subsection 78(5) of the *Land Titles Act* provides that priority of registration prevails, irrespective of notice.

6. The Land Registration Reform Act

There are various documents under the *LRRA* whose names have changed over the years. "Transfer," for example, is now used to cover all conveyances of freehold and leasehold lands. The term "deed" is no longer applicable. "Mortgage" is no longer used, but has been replaced with "charge." The term "discharge" has been adopted to describe both discharges of mortgages and cessations of charges. Finally, "document" replaces "instrument."

There are only four basic types of documents allowed for registration. These are Transfer/Deed of Land, Charge /Mortgage of Land, Discharge of Charge/Mortgage, and Document General. There is also a form of acceptable schedule for attachment to the other forms. It is permitted under s. 39(1)(b) of the *LRRA* to register other forms as long as they are attached to a prescribed form.

Section 5 of the *LRRA* deems certain covenants to be implied in the transfer unless expressly excluded in a schedule.

7. Deferred indefeasibility: fraudulent transactions

What if, through identity theft or otherwise, a fraudster stole the title of a property and conveyed it to a *bona fide* purchaser for value without notice and/or mortgaged a property and stole the proceeds of the mortgage?

The Ontario Court of Appeal in *Household Realty Corporation Ltd. v. Liu* held that a fraudulently signed mortgage was valid and enforceable against the homeowner husband where a wife had signed her husband's name using a fraudulent power of attorney. The court considered s. 78(4) of the *Land Titles Act* in this decision. The recourse of the defendants was to obtain compensation through the Land Titles Assurance Fund. The model of deferred indefeasibility (the registration of a void instrument does not cure its defect and does not give good title, but a subsequent person dealing with the property may rely on the otherwise defective document and/or registration) had, in effect, been replaced by a model of immediate indefeasibility (the registration of a void instrument can give good title immediately). The Ontario Court of Appeal in *Lawrence v. Wright* did not agree with the findings of *Household Realty* and reached an opposite conclusion effectively reinstating the doctrine of deferred indefeasibility.

Based on, amongst other things, certain contradictory decisions, the government moved to amend the *Land Titles Act*. On or after October 19, 2006, a fraudulent instrument is void, will not have any effect on the title, and can be removed from the parcel register. The Director of Titles may order a fraudulent instrument deleted from the title register (s. 57(13)) and return title to the rightful owner.

However, a transfer to an innocent purchaser or lender registered subsequent to a fraudulent instrument and that is not a fraudulent instrument will, however, be effective (s. 78(4.2)).

The amendments also allowed compensation claims to the Land Titles Assurance Fund to be processed much more quickly.

Rules 2.02 and 2.04 of the *Rules of Professional Conduct* (*Rules*) require a lawyer acting for a borrower and lender to make full disclosure of material facts to the lender and borrower and to provide final reports to lenders within 60 days of the registration of a mortgage. Rule 2.04 simplifies the manner in which a lawyer acting jointly for a borrower and lender can obtain consent from an institutional lender.

Chapter 45

Automated land titles records in Ontario

1. Automation of the land registration records

Land registration records are being automated by land registration jurisdiction (i.e., county, regional municipality, or district). During the automation process, registry system records are converted to the land titles system.

2. Organization of the automated land titles records

When the property is automated, the parcel register is assigned a unique property identification number, or "PIN," which pursuant to the regulations, must be referred to in any subsequent registration. The land registrar records the document based on both legal description and PIN and verifies both at the time of registration.

3. Bringing registry land into land titles — non-automated owner application

In the land registration system, lands can be brought from the registry system into the land titles system by way of an application for first registration under the *Land Titles Act* (*LTA*), commonly referred to as a "first application." Generally, a first application is done when an owner wishes to register a plan of subdivision or condominium. In an area with a land titles system, such a plan may only be registered if the property is recorded in the land titles system (see s. 144 of the *LTA*), and therefore a first application would be necessary. (If only the *Registry Act* applies where the subject property is, then an application similar to a first application is made under the *Certification of Titles Act*.)

In the first application process, a survey is undertaken on the property in question. The owners of all adjoining properties and certain other interest holders, such as mortgagees, related to the property are required to be served with the first application and plan of survey. These interested parties are entitled to object to the first application, in which case a hearing will be held to determine their respective interests. At the end of the process, a land titles parcel is granted that states the interests to which the parcel is subject. Any issues of adverse possession are dealt with, and from that time forward, there is no ability to obtain title by adverse possession to the land once it is recorded in the land titles system (see s. 51 of the *LTA*).

The land titles parcel issued is subject to the qualifications listed in s. 44(1) of the *LTA*, even though it is not specifically stated on the title. The *LTA* also provides that the land registration system may grant titles that are subject to other qualifications, commonly referred to as "qualifiers" (see s. 46). The *LTA* requires that these titles be referred to as "qualified" because they are subject to different qualifiers than those enumerated in s. 44(1). This requirement to qualify parcels existed in the *LTA* prior to the automation of the records.

4. Conversion of registry records to land titles during automation — administrative conversion

During the automation process, the registry system records are administratively converted to land titles system records. Section 32 of the *LTA* is the authority for this conversion. When the registry records are searched during the automation process, they are parcelized on the basis of ownership. Most of the registry system records searched are converted to land titles system records, and the land registration system makes a statement of ownership. All active interests that apply to that record are brought forward to the automated parcel register. If the land registration system is unable to convert the record to the land titles system, the record is usually automated but left in the registry system.

A first application is not done during this administrative conversion process. There is no survey of the property; no notice is served on interested parties; and some issues that can be dealt with in a first application, such as adverse possession, cannot be dealt with. As a result, the land registration system can bring the land into the land titles system; however, additional qualifiers to those listed in s. 44 of the *LTA* are added to the parcel. Conversely, because of the searches performed during the conversion process, additional guarantees to the title can be given, and therefore certain s. 44(1) qualifiers are removed from the parcel. The net result is that the land registration system is able to offer a title with additional guarantees and fewer qualifications to ownership than "Absolute," notwithstanding the requirement that it be referred to as "Qualified."

5. Types of land titles parcels

The following are the types of parcels available for search in the land titles system. Since these parcels are governed by the *LTA*, the documents presented for registration

must comply with the procedures for registering in the land titles system.

5.1 Land Titles Absolute

This is the traditional Land Titles Absolute parcel issued pursuant to a first application under s. 44 of the *LTA*. Each parcel is subject to those qualifiers listed in s. 44 unless otherwise noted on the parcel register. The current transfer is recorded on the parcel, and previous ones are deleted or "ruled out." Once an entry is ruled, users of the system do not need to take notice of that document.

- **Paper system:** If the land is recorded in the paper system, there is a parcel register for each parcel of land. The statement of ownership is made through the current transfer or transfer-type document, such as a vesting order.
- **Automated system (LT):** This parcel is similar to the paper land titles parcel register with a few exceptions. Like the paper record, there are no qualifiers shown, and the parcel is subject to those qualifiers listed in s. 44 of the *LTA*. In the automated system, once a transfer or other transfer-type document is certified, the ownership field is amended to show the names of the registered owner(s). Only active documents are brought forward on a search unless deleted instruments are requested when searching.

The automated parcel printout contains an estate qualifier field that states: FEE SIMPLE ABSOLUTE. The date that the land was automated is also shown on the PIN printout. Each PIN created references the previous or parent PIN in the "recently" field. If it is the first PIN created at automation, it will state "conversion from book."

5.2 Land Titles Converted Qualified (LTCQ)

This is the parcel created during the administrative conversion of the parcel from the registry system to the land titles system, and the qualifiers on the guarantee of ownership differ from the Land Titles Absolute (or traditional land titles) parcel. These parcels are commonly referred to as "Qualified Land Titles."

The qualifiers stated on these parcels are as follows:

> Subject, on first registration under the *Land Titles Act*, to:
>
> Subsection 44(1) of the *Land Titles Act*, except paragraph 11, paragraph 14, provincial succession duties and escheats or forfeiture to the Crown.
>
> The rights of any person who would, but for the *Land Titles Act*, be entitled to the land or any part of it through length of adverse possession, prescription, misdescription or boundaries settled by convention.
>
> Any lease to which s. 70(2) of the *Registry Act* applies.

As a result of the searching procedures employed during the automation and conversion to the land titles system, there are a number of items that the land registration system guarantees in this parcel that it does not guarantee in the traditional absolute parcel. These include a guarantee against *Planning Act* contravention up to the time the parcel is issued (para. 11); a guarantee against dower (para. 14); and a guarantee against succession duty and previous corporate escheats or forfeitures to the Crown.

These guarantees apply as of the date of conversion, and therefore one does not need to search behind the record to ensure compliance with these items. From the date of conversion forward, *Planning Act* and corporate escheats can apply, and the appropriate searches should be performed. Since there can be no new claims for dower or succession duty, these items do not need to be searched.

Since the automation and conversion process does not include notifying all interested parties, the system cannot guarantee against mature claims for adverse possession and other survey issues, misdescription, and unregistered *Registry Act* leases.

It is important to note that the guarantee given by the province in an LTCQ parcel is different from the Land Titles Absolute mainly due to the guarantee up to the date of conversion against *Planning Act* contravention or corporate escheat. For the most part, this is superior to Land Titles Absolute.

5.3 Land Titles Plus

This is the record created when an owner makes an application to remove the additional qualifiers in the LTCQ parcel. This is required when the owner wishes to develop the property by registering a plan of subdivision or condominium on an LTCQ parcel, consolidate an LTCQ parcel with an LT parcel, or deal with issues such as mature claims for adverse possession. The application is required to resolve these adverse possession issues, and parcels must have compatible qualifiers to be consolidated. In these circumstances, a modified first application to land titles called an "application for absolute title" is made to deal with the LTCQ qualifiers related to adverse possession, misdescription, and the *Registry Act* leases. Since the ownership has already been established in the administrative conversion process, the applicant must deal only with those issues enumerated above. The applicant is required to obtain a survey of the subject land and serve all interested parties.

The parcel continues as a land titles parcel, subject to the qualifications listed in s. 44 of the *LTA* and to those different qualifiers noted on the parcel. The qualifiers are

amended to reflect that the issues raised in the LTCQ qualifier have been dealt with. The term "Plus" is used only to distinguish it easily from other land titles parcels issued.

In these parcels, the Estate/Qualifier is shown as "FEE SIMPLE ABSOLUTE." The parcel issued will have different qualifiers than either the "LT Absolute" or the LTCQ. The qualifier states

> Subject to s. 44(1) of the *Land Titles Act*, except paragraphs 3 and 14 thereof and provincial succession duties and except paragraph 11 and escheats or forfeitures to the Crown up to the date of registration with an absolute title.

These qualifiers are excepted, since it is no longer necessary to qualify the title to the possessory interests of adjoining owners (para. 3) or for dower (para. 14), because there can be no new claims for dower or for succession duty. All these items have been dealt with during the process for the application for absolute title. In other words, these parcels are not subject to any such interest.

Compliance with the *Planning Act* was guaranteed to the time of conversion (i.e., LTCQ). In the application for absolute title since August 2001, the solicitor for the applicant has been required to make a statement regarding the *Planning Act* for the period between the conversion (i.e., LTCQ) and the application. Therefore, in the parcels resulting from these applications, the above qualifier relating to the *Planning Act* will be on the title.

If the LT Plus PIN was issued prior to August 2001, no *Planning Act* statement is made on the PIN, since no statement related to *Planning Act* compliance would have been made in the application. In these instances, a search for *Planning Act* compliance is required back to the date the LTCQ parcel was originally created by searching abutting parcels.

Chapter 46
Title searching

Part I: Legal descriptions

1. Ascertaining the legal description

A search of title should be conducted as soon as possible once the agreement of purchase and sale is received. This will give the lawyer enough time to conduct the appropriate searches and submit and answer requisitions on title within the time provided for in the agreement of purchase and sale.

A legal description is usually found in the beginning paragraph of the agreement of purchase and sale after the words "and described as," although it may or may not be accurate. If the property is described by the municipal address alone, the legal description may be obtained from the following sources:

- Registry offices: Some have a series of maps and assessment lists which tie the legal descriptions to municipal addresses.
- The vendor's solicitor: This is available only if the vendor has retained one.
- A survey of the property: This is available only if the client or the real estate agent has provided a copy.
- Assessment department or realty tax office: Sometimes, an assessment office will give the legal description that corresponds to a municipal address. Many departments refuse to give this information over the phone.
- Teraview software for automated titles: The municipal address or owner's name can be used to search for the legal description.

1.1 Why correct legal description is important

A correct legal description is crucial. A small mistake in the legal description may result in the vendor or purchaser being unable to deal with the property. For example, the owner of the property may be identified as someone other than the vendor, or there may be mortgages registered that do not pertain to the property being bought or sold.

It is very important to check the legal description against the agreement of purchase and sale. Any significant differences should be discussed with the purchaser, including the size of the lot the purchaser thinks he or she is buying. If there are discrepancies that are inadvertent errors, these may be corrected by simply amending the agreement of purchase and sale or by correspondence between solicitors. If the discrepancies are significant, the purchaser will have to be advised of his or her rights and remedies, which may include the option of terminating the agreement of purchase and sale.

Part II: Conducting the search

1.2 Steps in a search

The following is a brief summary of the essential steps involved in searching title:

- determining the commencement date for the search of title (registry system only)
- summarizing all of the documents in the chain to determine their legal effect (registry system only) and of any other encumbrances or documents affecting title ("abstracting") (registry and land titles systems)
- conducting a *Planning Act* search (registry and land titles systems)
- conducting other miscellaneous searches, such as a review of the Crown patent, corporate owners, and executions (registry and land titles systems)
- reviewing the search by the solicitor (unless the solicitor conducted the search) (registry and land titles systems)
- preparing a solicitor's abstract of title (registry and land titles systems)
- checking for fraud indicators (registry and land titles systems)

1.3 Delegation to non-lawyers

As in any other area of law, the practice of real estate has become more specialized. While some lawyers conduct their own searches, many firms use conveyancers to conduct searches. These conveyancers do not work for the lawyer on a full-time basis, but only as needed. Law clerks often perform a number of functions as well. Although some matters may properly be delegated to non-lawyers, others must be performed by the solicitor. For example, the lawyer must always review the search of title and prepare a solicitor's chain of title. Rule 5.01 of the *Rules of Professional Conduct* and commentaries should be referred to regarding delegation

2. The 40-year search (registry)

Generally, the conveyancer

- notes the names of the parties to the instrument;

- ensures that the names of the parties are consistent from one document to the next (particularly relevant in the case of deed/transfers);
- checks the contents of any recitals to ensure they are accurate, in particular references to the dates and numbers of other registered instruments;
- always ensures that the legal description is accurate and consistent; and
- confirms that the documents are signed and sealed by the appropriate parties.

2.1 The root of title

With a few exceptions, the conveyancer needs to search title for the last 40 years. Subsection 112(1) of Part III of the *Registry Act* provides:

> **112.—(1)** A person dealing with land shall not be required to show that the person is lawfully entitled to the land as owner thereof through a good and sufficient chain of title during a period greater than the forty years immediately preceding the day of such dealing, except in respect of a claim referred to in s. 113(5).

Subsection 113(5) contains a number of exceptions, such as claims of the Crown in some circumstances, claims arising by possession, or statutory claims.

In other words, a person must show that he or she has good title for a period of 40 years (title search period). The search will commence on the date that is 40 years prior to the date of the agreement of purchase and sale (commencement date). If the agreement is dated December 31, 2005, the commencement date is December 31, 1965.

The conveyancer looks for the first conveyance of the freehold estate registered after the commencement date. This deed becomes the "root of title" and will serve as the starting point for preparing the chain of title. If there is no conveyance of the freehold estate registered after the commencement date, the conveyancer must go back further in time to the first conveyance registered before the commencement date, and that deed becomes the root of title (s. 112(2)).

For example, if the first deed registered after the commencement date was registered on January 1, 1972, that deed is the root (Scenario A). If there was no deed registered after December 31, 1965, but there is a deed registered on March 3, 1913, the search will commence in 1913.

In Scenario A, the chain of title commenced on January 1, 1972. Does this mean that the conveyancer can ignore anything registered on title before that date? The answer is NO. Every document registered within the title search period still affects the lands. It is possible, for example, that a predecessor in title granted an easement in 1966. The document is not a root because it is not a conveyance of the freehold estate. Even though this document was registered before the root, it is still within the title search period and still affects the lands.

2.2 Notice period — expiration of claims

Any rights arising from a registered instrument expire 40 years from the date of registration unless the claimant registers a notice of claim in the prescribed form (ss. 111 and 113(1)). As an example, an easement right granted in 1963 will expire in 2003 unless a notice is registered. This will rarely be an issue from a title searcher's point of view because a document that has expired will not usually show up in the title search period. If the conveyancer searches back 40 years, he or she will not find a document that was registered more than 40 years ago. However, the document is relevant if the client has rights to lands by virtue of a registered instrument. The client should be told that an interest in lands will expire in 40 years' time unless a notice of claim is registered in the prescribed form.

2.3 Searching behind the root

Subsections 112(1)–(2) of the *Registry Act* make it quite clear that a chain of title commences with the first conveyance of the freehold estate within the title search period. A conveyancer only has to search prior to the commencement date if there is no conveyance of the freehold estate registered after the commencement date. This invites the possibility of fraud.

2.3.1 Specific registry search points

(a) Deed/transfers of land

Current transfers are registered on the document prescribed by the *Land Registration Reform Act* and are deemed to include certain covenants and a release. For those deeds registered prior to April 1, 1985, the clauses and covenants will usually be in the actual deed:

- Granting clause: Typically, the grantor will grant the lands to the grantee in fee simple as joint tenants, tenants in common, partnership property, or trustee.
- *Habendum* clause: This clause usually follows the granting clause and begins with the words "to have and to hold." If there are any restrictions to the grant, they are usually contained in this clause and must be carefully noted.
- The four covenants: The following covenants should be included:
  - The grantors have the right to convey the lands.

- The grantee will enjoy quiet possession of the lands.
- The grantors will execute further assurances of the lands as may be required.
- The grantors have done no act to encumber the lands.

- Release: The grantor usually releases any claims against the lands.

(b) Dealing with lands of a deceased (executor's deed, wills, letters probate)

A deed from an executor of a registered owner's estate must be checked to ensure that it has all of the appropriate recitals.

The following should be noted:

- Wills or letters probate will usually be registered in the general register. The contents of these documents must also be noted for the search.
- If a person died while owning property between January 1, 1970, and April 10, 1979, any deed, mortgage, or other instrument must have a consent of the Treasurer of Ontario attached (alternatively, a certificate of consent may subsequently be registered).
- An estate tax release for federal taxes owing used to be required for a person who died between January 1, 1959, and December 31, 1971. As a result of amendments to the *Estate Administration Tax Act, 1998*, unpaid taxes no longer form a lien on the property, and a release is not required.

(c) Deposits on title

Sometimes the notation "see deposit No. xxx" will appear on the abstract pages. This means that a document (as defined by s. 105) has been deposited in the deposit index in accordance with s. 106 of the *Registry Act*. Its mere deposit on title does not amount to notice under s. 70. Nonetheless, a careful solicitor will read the deposit. Once a deposit is read by a solicitor, he or she then has notice of its contents.

This list is not exhaustive. For example, deeds granted pursuant to power of sale proceedings by a mortgagee, construction lien claims, and deeds from a municipality after a tax sale should be checked to ensure compliance with the applicable statutory regime.

(d) Adjoining owner's search: Planning Act and legal description

There are two reasons to search adjoining lands:

- to ensure that there is no encroachment (overlap); and
- to ensure there has been no violation of the *Planning Act*.

(e) Encroachments

The legal description of all adjoining properties should be checked. Ideally, there will be no overlap between the lands being purchased and the neighbouring lands. Any discrepancy could signify a cloud on title or a potential boundary dispute.

(f) Spousal interests

Each transfer and charge in the 40-year period by an individual must contain an affidavit of marital/spousal status or statement confirming spousal status.

3. Searches under the Land Titles Act

3.1 Guaranteed title

The land titles system is a register of titles. This means that (subject to the exceptions identified below) the state of title is guaranteed by the provincial government. A searcher is entitled to rely on the fact that the party who appears as owner in the register does in fact have good title to the property. There is no need to conduct a 40-year search nor is there a need to produce a chain of title to the property, except for use in off-title searches.

3.2 The mechanics of searching

Land registered in the land titles system is identified by both parcel and section numbers (except for converted automated titles). Once the conveyancer pulls the appropriate book (called the "register"), the conveyancer need only obtain a copy of the pages in the register book that relate to the parcel in question. These pages contain similar entries as the pages in land registry abstract books. The main difference is that everything that no longer affects the lands will be crossed off and initialled by the registrar. The conveyancer need only worry about those entries that are still outstanding.

A conveyancer will obtain copies of all instruments that still affect the lands for the solicitor. This includes a copy of the plan of subdivision, which must be examined for the items referred to earlier.

3.3 Exceptions to guaranteed title and searches required

Section 44 of the *Land Titles Act* sets out a number of exceptions to the guaranteed title, the most significant of which are the following:

- Crown claims: The Crown could have a claim to the lands if the lands escheated. Hence, the conveyancer must conduct a search of the names of all corporate owners throughout the chain of title so that a corporate search can be performed.

- *Planning Act* violations: A search of all adjoining owners back until 1967 is still required (as with the registry system, sometimes the search can end sooner). Extra care is needed because it is more difficult to identify the legal descriptions for all adjoining owners in the land titles system.

Under s. 44(6) of the *Land Titles Act*, title is not affected by a writ registered against a prior owner unless a notice of the writ has been registered on the title register. Hence, it is not necessary to search the names of the predecessors in title. In addition, s. 136 provides that a writ does not bind a current owner until the sheriff forwards a copy of the writ to the Land Titles office.

4. Other searches arising from the search of title

4.1 Crown patent

The Crown patent is the initial grant from the Crown to a private party. Most of the Crown patents are for huge parcels of lands and were granted a long time ago.

The title searcher is concerned about the Crown patent for two reasons. First, s. 22(3) of the *Registry Act* provides that (except in certain unusual circumstances) any instrument purporting to affect unpatented lands is of no effect. It is essential that the conveyancer ensures that there is a Crown patent covering the lands in question and makes a notation to that effect.

Secondly, the 40-year limitation of claims does not apply to restrictions contained in a Crown patent. Some lawyers will obtain a copy of the patent to see if it contains any restrictions regarding the use of the lands.

4.2 Corporate owners

If a corporation involuntarily dissolves (i.e., if its corporate charter is revoked) while owning lands, the lands "escheat" to (vest in) the Crown. Claims of the Crown are an exception to the rule that a person need only show entitlement to the lands for a 40-year period. Accordingly, the prudent solicitor will instruct the conveyancer to list all of the corporate owners in title from the Crown patent onward and will then order a corporate search to ensure that the corporation was in existence during the period it owned the lands (the corporate searches are not performed in the registry office; someone must search the records of the provincial Ministry of Government Services or Industry Canada, federally).

If a corporation dissolves voluntarily, its shareholders (or in some instances, its creditors) are entitled to distribution of its assets. In such cases, the shareholders or creditors may have to be located to correct a gap or to feed the chain of title.

4.3 Executions

A creditor with a judgment against a debtor that remains unsatisfied may file its writ of execution with the local sheriff. The execution binds the debtor's interest in lands. Accordingly, if the land is in the registry system, the conveyancer should list the names of all persons who had a beneficial interest in the lands throughout the 40-year period. If the land is in the land titles system, only the current owner's name is searched.

The execution search should be made in the jurisdiction where the property is located. A search of executions should be made and updated on the day of closing against the current owner to ensure that nothing has been filed between the time of the initial search and the date of closing.

If the purchaser is planning to place a mortgage on title, you will want to search the names of the purchaser exactly as the name or names will be appearing on the deed. A mortgagee will be reluctant to advance moneys in the face of a writ against its borrower since its mortgage will be subject to the writ. In other words, the writ will rank in priority to the mortgage to the extent of the amount of the writ plus interest and costs, if any.

4.4 Registered plans of subdivision

The plan should be checked to see if there is a notation for a "one-foot-reserve" located on the streets. A one-foot-reserve is a technique used by municipalities to ensure that a developer complies with its obligations under subdivision or development agreements. The city, municipality, or region will be granted title to one or more strips of the street by the developer; if the developer defaults on any of its obligations, the relevant authority can block access along the road by virtue of its ownership of the reserves. Once the developer has complied with all of its obligations, the city will pass a by-law dedicating the reserves as public highways. An entry for this by-law will be placed in the back of the plan book.

4.5 Charge/mortgages of land and assignments and discharges

Details of any outstanding mortgages should be noted, since the requisition letter will request that all encumbrances be discharged or that the appropriate undertakings be given (depending upon the wording of the agreement of purchase and sale).

If the agreement provided that the purchaser is assuming a mortgage, the lawyer should obtain a copy of the mortgage so he or she may fully advise the client of its terms. The mortgagee should also be contacted for a statement to confirm the outstanding balance of the mortgage being assumed and to ensure it is in good standing.

If there are any assignments of outstanding mortgages, that is, the original mortgagee has transferred its interest, then the conveyancer should ensure that the proper party provides a discharge.

4.6 Subdivision agreement (homes in new or fairly new developments)

This is an agreement between the municipality or region and the developer that outlines the obligations of the developer. The conveyancer should check to see if there are any financial obligations that form a charge on the property (if so, you may try to get a release, depending upon the wording of the client's agreement of purchase and sale). Alternatively, the lawyer will have to ensure that the agreement is in good standing by writing a letter to the relevant authority.

4.7 Easements or rights of way

If the property is subject to a right of way or easement, you will want to make careful note of its location and advise your client accordingly. Depending upon the wording in the agreement of purchase and sale, submit the appropriate requisition. The conveyancer may also want to search back to ensure that the right of way or easement was validly conveyed by a predecessor in title.

4.8 Planning Act

The purpose of the *Planning Act* is to control the manner in which land is divided. The consequence of non-compliance is severe; a violation of the *Planning Act* means that no interest in land is created or passes. Consequently, a violation by a predecessor in title can disrupt the entire chain of title.

Section 50 of the *Planning Act* (which contains the basic prohibition) provides that a person cannot enter into certain transactions (including a sale, transfer, or mortgage) unless the person does not retain an interest in the abutting lands.

This prohibition is illustrated in the following example: assume Jane owns an acre of land. Any dealings in connection with this land (for example, a sale, mortgage, or other interest (such as a lease) that exceeds 21 years) must encompass the entire acre. Jane cannot transfer one-half of the acre because she would retain the ownership interest in the other half and thereby violate the basic prohibition. By conveying half of the land, she would retain the fee simple in abutting land, therefore subdividing land without the proper legal authority to do so. One of the basic premises that underlies the *Planning Act* is that to subdivide land without authority will result in a lack of infrastructure such as schools, parks, roads, and other basic services.

Therefore, a purchaser must search title to make sure that there was never any common ownership between the subject lands and the adjoining lands. Hence, the conveyancer needs only to look at the names of the owners, lessees, and mortgagees on title and compare them with the names and dates in the chain of title for the subject lands.

Note the following additional points:

- There are a number of important exceptions to the basic prohibition. The main one is that no *Planning Act* search is required if the lands in question constitute the whole of a lot on a registered plan of subdivision.
- In addition, all violations prior to June 15, 1967, were forgiven. Accordingly, it is not necessary to search prior to this date.
- On the other hand, in addition to the basic prohibition, the legislation prohibits a number of other transactions.

5. Summary of title search variations

5.1 Registry systems searches

5.1.1 Registry system non-automated search

This refers to the conventional, non-automated, 40-year search.

5.1.2 Parcelized Day Forward Registry search

In an attempt to compress the overall automation time frame, a Parcelized Day Forward Registry (PDFR) was introduced to certain land registry offices.

In PDFR, some registry properties have been parcelized, mapped, and assigned PINs based on the description of the most recent apparent change of ownership document. A thumbnail description including an "as in number" is provided on each PIN. The most recent apparent change of ownership document will be loaded on the PIN allowing the use of a PIN to assist in identifying a PIN when performing a search. No registrations and deposits prior to the activation date will be brought forward. All documents registered or deposited after automation will be abstracted on the automated parcel. As a result, for these records, both the paper and automated systems must be searched.

To make searching these records easier after automation, discharges of mortgages are entered in full on the automated system, and the affected mortgages will be deleted from the paper record. Any required corrections to pre-automation entries will also be made in the automated system. The creation and maintenance of property divisions and consolidations in the parcelized registry system will be processed in a similar manner as automated land titles.

It is important to note that while PDFR records are parcelized and automated, they are still administered under the registry system, and the ownership is not guaranteed by the province. Accordingly, you must still complete a full 40-year search. PDFRs are no longer being created, and where they do exist, they are being converted to LTCQ.

5.2 Land titles system searches

5.2.1 Land titles non-automated searches

To conduct a conventional, non-automated land titles search, the title searcher must obtain copies of the pages in the register. Since instruments that no longer affect the land are ruled off, the search involves the review of the documents that are currently shown on title. Titles are subject to the qualifiers listed in s. 44(1) of the *Land Titles Act*.

5.2.2 Land titles automated searches

In the land titles system, the PIN for automated traditional land titles parcels is obtained. The POLARIS print out of the parcel register is a complete copy of the paper parcel register for that particular property and reflects all active instruments, including the registered owner(s), outstanding encumbrances, and other documents that affect title to that property. Land titles system properties have all relevant documents entered on the automated system, completely eliminating the need to look at the paper records. However, one must still examine the documents entered on the automated system in order to ascertain their content.

PIN pages do not set out measurements for the parcel. The underlying documents such as the plan of subdivision or reference plan must also be reviewed with reference to the measurements set out in the agreement of purchase and sale.

6. Solicitor review and abstract

The conveyancer's search of title will include the following:

- a list of the instrument numbers that affect title (registry only);
- a copy of any plan of subdivision or reference plan survey or sketch referred to in the legal description of any documents on title that can assist in reviewing a legal description;
- copies or abstracts of each instrument affecting title;
- a chain of title (registry);
- a sketch of the property, which will identify the adjoining lands and their legal descriptions;
- a search of the adjoining lands;
- a list of all corporate owners from the Crown patent (except for LTCQ titles);
- details of the Crown patent;
- the names of all owners on title for the lands over the last 40 years for an execution search or an actual sheriff's certificate for these names (registry); and
- notation of the last instrument number registered on title.

In land titles, the conveyancer will provide a copy of the parcel register. If the lands are in the POLARIS system, copies of the POLARIS printout will be included.

The solicitor must review each document with great care. This task cannot be delegated to a non-lawyer. A solicitor should take careful notes during the course of reviewing the search. Custom dictates that the solicitor prepare a "solicitor's abstract" or a "solicitor's chain of title." This is done to ensure that the conveyancer has not made any errors and to be fully familiar with the search. The search and the solicitor's search notes can become relevant years down the road if a problem is discovered when the client or another successor in title sells the property. It is essential that the search file is complete, accurate, and stored in a safe location.

7. Subsearches

Immediately prior to the registration of the deed or mortgage, a subsearch must be conducted to ensure that there have been no intervening registrations from the date of the original search. The abstract index or parcel register must be checked. The registry office keeps a list of instruments (called the "fee book" or the "day book") that have been registered recently but not yet recorded in the appropriate book; this too must be checked. If there are any instruments that have just been registered but are not yet entered into the day book, these too should be checked. The search of adjoining lands must be updated. If your lands are in POLARIS, an automated subsearch should be requested.

8. Search of title: fraud indicators

When conducting a title search of a property, a lawyer should carefully review all documents on title affecting the client's interest in the property, including the registration shortly before closing of recent discharges or transfers that may indicate suspicious activity and transactions where the purchase price has increased substantially over a short period of time. Also, lawyers should be sure to include deleted instruments when obtaining parcel pages for all land titles searches so as to give a complete picture of all outstanding documents registered on title and to reveal any suspicious activity.

Chapter 47
Letter enquiry searches

In addition to a title search, there are other searches that are necessary to assure title and marketability of a property. These searches are made to determine whether there are any statutory liens or orders that may affect a property and whether a property complies with municipal by-laws or other statutory requirements.

The searches will vary depending on the type of property that is being purchased. This chapter will provide an outline of standard searches for the purchase of urban properties, farm properties, cottage properties, vacant land, and properties located in an unorganized territory. These standard searches are referred to as letter searches, on the basis that they are done by way of a letter. Some of these searches may be conducted online.

After reading the agreement of purchase and sale and determining the relevant searches to make, it is advisable to speak to the client about the searches that are relevant to the property being purchased and obtain the client's instructions as to whether to institute some of the searches. For example, there are searches, such as the fire marshal's search or a municipal work order search, that may trigger an on-site inspection that can reveal violations for which the client may be responsible under the agreement of purchase and sale.

Also, some of the searches may be costly, and the client may be limited in funds. If the client instructs the lawyer not to complete a search, the lawyer should fully explain the risk of not having such a search completed, confirm the consequences in writing, and have a direction signed by the client not to do this search.

Lastly, keep in mind that some of these searches may not be required if the client is purchasing title insurance. Before conducting a letter search, check the requirements of the title insurer against the checklist of searches. Also, keep in mind that if the lawyer also acts for the lender, its instructions must also be obtained.

It is important to note that even if title insurance may not require certain searches, some lawyers still proceed to order them to facilitate the preparation of certain documents for closing. For example, a tax certificate is not required to be ordered if obtaining title insurance. However, in order to ascertain if the statement of adjustments is properly prepared and that the vendor actually paid the taxes as stated on the statement of adjustments, one needs to confirm this with the tax department. The best way to confirm this is to obtain a tax certificate. Otherwise, the client may call the lawyer after closing, complaining about arrears that were the vendor's responsibility, a situation that will then result in extra letters to the other side and eventually a title insurance claim if the other side refuses to comply. Again, each case is different, and one must make the decision based on the circumstances.

1. Searches for urban properties

1.1 Realty taxes

Under s. 349(3) of the *Municipal Act, 2001*, taxes due on land are a special lien on the property in priority to every claim, privilege, lien, or encumbrance of every person except the Crown, and its priority is not lost or impaired by any neglect, omission, or error of the municipality or its agents or through taking no action to register a tax arrears certificate. As a result, arrears of realty taxes take priority over any instrument registered on title. To determine whether there are any arrears of realty taxes, send a request for a tax certificate to the municipality in which the property is located together with the requisite fee. Information on the tax certificate varies from municipality to municipality.

A tax certificate indicates any arrears of taxes, any penalties chargeable on the arrears, the total taxes for the preceding year, any local improvement charges, the total taxes for the present year, and the instalments due for the current taxes.

If there are taxes owing, there are several options available to the lawyer:

- Obtain the undertaking of the vendor's lawyer to pay the arrears and penalties to the date of closing as well as a redirection with respect to the said amount.
- Deduct the amount of the arrears and penalties from the balance due on closing so that the lawyer can ensure that payment is made.
- Credit the purchaser with the arrears and penalties on the statement of adjustments.

The lawyer will requisition that taxes be paid on closing and then provide the options listed above so that the taxes get paid.

In addition to helping determine whether there are arrears of taxes, the information that the lawyer obtains from a tax certificate enables him or her to check the adjustment for taxes shown on the statement of

adjustments. Specifically, the lawyer can check the amount of the total current year's taxes and the amounts paid by the vendor. If the amounts shown on the tax certificate are not the same as the figures on the statement of adjustments, draw this discrepancy to the attention of the vendor's lawyer and obtain the necessary undertaking, adjustment, or credit as described above.

1.2 Water account

The collection of water/sewer charges is based upon s. 398(2) of the *Municipal Act, 2001*, which states that a municipality or a local board may add to the tax roll any fees and charges imposed by a municipality or a local board on a person for the supply of a public utility. Such fees and charges may be collected in the same manner as taxes on the property and may be recovered with interest and costs.

To determine whether there are any outstanding water/sewer charges, send a letter enquiry either to the tax department or to the clerk of a local municipality. In some municipalities there is a separate department that handles the collection of water/sewer charges, and in that instance, the letter enquiry is directed to that separate department.

If there are outstanding water arrears, the lawyer would deal with them in the same manner as tax arrears described above.

Generally, a vendor will give an undertaking to pay all utility accounts to the date of closing. Since the final bill is rendered after closing, it is impossible to require the payment. So unless there are actual arrears of the water account, the lawyer requests payment from the closing funds, since this is covered by the vendor's undertaking. However, if there are arrears of water charges, then the same procedure used for tax arrears described above should be used.

1.3 Local improvements

If a person wishes to have certain services undertaken by a municipality or a local board on their property, such as the installation of municipal services or sidewalks, a municipality or a local board pursuant to s. 326(1) of the *Municipal Act, 2001* may enact a by-law for the installation of such services.

A special levy for such services is then imposed by a municipality or local board, and pursuant to s. 398(1) of the *Municipal Act, 2001*, the fees and costs of a municipality or local board for such services constitute a debt of such person to a municipality or local board. Pursuant to s. 398(2) of the *Municipal Act, 2001*, such fees and costs may be added to the tax roll and be collectible in the same manner as taxes.

When requesting a tax arrears certificate, the letter enquiry should contain an enquiry as to whether there are any other outstanding charges for special services that have been added to the tax roll.

If there are such outstanding charges, a purchaser's lawyer should requisition the vendor's lawyer for either an adjustment of such charges on the statement of adjustments or payment in full of such charges if they were not dealt with in the agreement of purchase and sale as an item to be adjusted on closing.

The local improvement charges may be spread out over several years, and it is important to ascertain for what period the charges are being levied. If the charges apply to the period of time that the vendor has lived in the property, then the full amount should be paid on closing or a credit given to the purchaser on the statement of adjustments.

If the amount applies to a time that both parties have owned the property, then an adjustment has to be made on a *per diem* basis as to how much each should pay, and this should be reflected in the statement of adjustments.

1.4 Hydro arrears

Unpaid hydro arrears do not form a lien on land. Consequently, a letter search for hydro arrears is no longer necessary.

However, utility companies continue to request change of ownership letters on the sale and purchase of residential homes or whenever there is a change of tenants. It is recommended that both the purchaser's lawyer and vendor's lawyer send a change of ownership letter.

In addition, if the lawyer is acting for a vendor, his or her client should be reminded to read the meters the day before closing and to close the account or transfer it to the vendor's new residence.

1.5 Gas arrears

Arrears of gas do not constitute a lien on the land unless the gas company is owned or operated by a municipal corporation. Since the lawyer would wish to ensure that his or her client will not have to deal with the vendor's gas arrears after closing, the comments made with respect to payment of hydro, water, and tax arrears also apply in this instance.

1.6 Zoning compliance

Most municipalities have a zoning by-law, which deals with such matters as the uses permitted for a property, requirements for lot size and frontages, location of buildings on the lot (setback requirements), and size and height of the dwelling. If a municipality has a zoning by-

law, obtain information as to whether the property that the lawyer is dealing with conforms with its zoning by-law. Some municipalities will not give such an opinion, while others will for a fee.

If a municipality will not give a zoning opinion, the lawyer will have to obtain a copy of the zoning by-law, locate the zone in which the property is situated, refer to the zoning requirements, and determine whether the property complies.

The lawyer will be unable to confirm conformity of the property with all of the provisions of the zoning by-law since some information will not be available. At the very least, he or she should determine the use of the property, the lot size, and the setback requirements. When the lawyer reports to the client or to the mortgagee as to zoning, the lawyer should qualify any opinion as to zoning requirements for which the lawyer was unable to satisfy himself or herself.

1.7 Legal non-conforming use

If the property does not comply with a zoning by-law, determine when the original building and any addition to it were built and the date of the enactment of the current zoning by-law. The property may have the designation of legal non-conforming use as to the location of the existing improvements if they were constructed before the enactment of the subject zoning by-law or if the original building and any addition to it conformed with the zoning by-law then in effect at the time of construction. The current by-law would indicate what rights a building would acquire if its construction predated the by-law's enactment.

Additions to an original building must conform to the zoning by-law then in effect at the time of its construction. This means that, although the original building might have enjoyed a legal non-conforming use as to its location because it pre-dated the enactment of a zoning by-law, an addition to the original building might not have the same status if the addition was not in compliance with the zoning by-law then in effect when it was constructed.

Whenever possible, obtain a letter from the municipality confirming that the building on the property and any addition to it have acquired a legal non-conforming use designation as to their present location. There are municipalities, such as the City of Toronto, that will not give this type of letter of compliance. In that instance, rely upon the research and findings. The area of legal non-conforming use(s) has been dealt with extensively by the courts, and great care should be exercised before assuring a client that a property to be purchased is legally non-conforming.

If the property does not enjoy a legal non-conforming use designation, look at the agreement of purchase and sale to determine what remedies are available, discuss the problem with the client, confirm the client's instructions in writing, and protect the client's rights under the agreement of purchase and sale or at law by way of requisition.

1.8 Work orders

1.8.1 Property standards by-law, building by-law, and the Ontario Building Code

Municipalities enforce the requirements of the *Building Code Act, 1992* and *Building Code*, O. Reg. 350/06, made under the *Building Code Act, 1992*.

If a property does not comply with the *Building Code*, s. 15.2(2) of the *Building Code Act, 1992* provides that a violation order may be issued specifying the violation and requiring the property owner to rectify the deficiency within a certain period. This violation notice becomes an outstanding work order until it is completed. If the property owner fails to satisfy the work order, the municipality may complete the work to put the property into compliance and charge the cost of the work to the property owner, which is then collected in the same manner as municipal taxes.

Also note that s. 15.2(4) of the *Building Code Act, 1992* states that an order may be registered in the proper land registry office, and upon such registration, any person acquiring an interest in the land subsequent to such registration shall be deemed to be served with such order on the day the order was initially served.

The lawyer will want to order a building compliance report from the building department or property standards department or the clerk of a municipality to determine whether there are any outstanding work orders on file for the subject property and any violations of the by-laws.

Unless instructed by a client, do not authorize the municipality to do an inspection, since this may uncover possible violations for which the purchaser may be responsible. For example, some standard forms of agreement of purchase and sale provide that the vendor is responsible for any outstanding work orders up to the date of acceptance of the agreement of purchase and sale and the purchaser is responsible for any work orders after that date.

If the vendor is responsible for rectifying the work order, write a letter to the vendor's lawyer advising of the outstanding work order and requiring the vendor to comply with the work order prior to closing.

If the purchaser is responsible for rectifying the work order, speak with the client about the work order and the requirement of having the work completed and confirm the discussion with the client by letter.

1.8.2 Electrical Safety Authority orders

Under Part VIII of the *Electricity Act, 1998*, the Electrical Safety Authority is empowered under s. 113(1) to regulate the design, construction, installation, protection, use, maintenance, repair, extension, alteration, and connection used or to be used in the generation, transmission, distribution, retail, or use of electricity in Ontario.

All major electrical work to premises requires a permit from the Electrical Safety Authority. If a permit is taken out for such electrical work, an inspection follows to ensure that the work is done properly. If the work is deficient or improperly done, the Electrical Safety Authority is empowered under s. 113(11) of the *Electricity Act, 1998* to issue orders relating to such work.

To ensure that there are no such work orders, write a letter to the local Electrical Safety Authority together with the requisite fee, if any. If there are outstanding work orders, the comments pertaining to work orders under a property standards by-law or the Ontario *Building Code* would similarly apply.

1.8.3 Fire Protection and Prevention Act, 1997

Section 19 of the *Fire Protection and Prevention Act, 1997* states that a Fire Marshal, an assistant to a Fire Marshal, or a fire chief (collectively referred to in the *Act* as an "inspector") may, with or without a warrant, enter and inspect lands and premises for assessing fire safety at all reasonable times. Under s. 21 of this *Act*, an inspector who carries out such inspection may order an owner or an occupant to take any necessary measure to ensure fire safety on the property.

Consequently, before writing to the Fire Marshal's Office to enquire about any work order that may be issued with respect to a property, first speak to the client about the consequences of such a search and obtain the client's written instruction.

The lawyer can enquire about a work order search only on record, which does not necessitate an inspection. However, the Fire Marshal does have discretionary power to inspect any premises, notwithstanding that the enquiry may request only an "on record" search.

1.9 Occupancy permits

If a dwelling is newly built or renovated or if an extension or addition has been added to the dwelling, find out whether the local municipality has issued an occupancy permit under its building by-law or property standards by-law or under the Ontario *Building Code*.

There may be several reasons why an occupancy permit has not been issued. For example, there are some municipalities that do not issue these permits after a final inspection. The lawyer can, however, call the inspector and get a verbal response with respect to the premises. The lawyer will usually have to pay the prescribed fee for a building/zoning compliance letter, which requests information whether occupancy has been granted, in order for the inspector to provide such information. Some other reasons for the absence of an occupancy permit are perhaps an inspection has not yet been made, the paperwork is not completed, or the permit is not required for the extension, renovation, or addition.

In most agreements of purchase and sale for newly constructed dwellings, it is stated that the vendor will not be obligated to provide an occupancy certificate or permit to the purchaser. Unless a lawyer has reviewed the agreement of purchase and sale prior to signing and deleted this clause, the purchaser may not be entitled to require the vendor to provide the occupancy certificate or permit. In this case, the lawyer should explain the situation to the client that the remedies in this case are virtually non-existent. Title insurance may help, so the lawyer may want to review its policies.

If the agreement of purchase and sale does not exclude the provision of an occupancy certificate or permit and the vendor is unwilling to give the undertaking requested, discuss the risk of closing with the client.

Essentially, it is contrary to a building by-law and the Ontario *Building Code* to occupy newly built or renovated premises without an occupancy permit or a final inspection having been made by a municipality's building inspector. If there are deficiencies, the client may be ordered to rectify them. If the client instructs the lawyer to close without an occupancy permit or a final inspection, confirm this instruction in writing. Optimally, the vendor should rectify all deficiencies prior to closing.

1.10 TARION

In Ontario, every builder is required to register under this program and, in doing so, obtains an enrolment number. In addition, every builder is required to register every home that the builder constructs. If the client is buying a newly built home, ask the local TARION Office for the enrolment number of the builder and the home. If the property is a condominium unit, ask for the enrolment number of the common elements as well.

TARION provides, amongst other things, a warranty of the builder's workmanship and certain deposit guarantees.

1.11 Unregistered hydro easement

Generally, easements relating to the transmission, distribution, or use of electricity in Ontario are registered on title. However, there are instances where an easement document has not been registered and a right to such easement is claimed pursuant to s. 46(1) of the *Electricity Act, 1998* or pursuant to the predecessor legislation, s. 48(2) or (3) of the repealed *Power Corporation Act*.

It is uncommon to find unregistered hydro easements in urban areas that have been subdivided, since such easements are more commonly found in rural or cottage areas. Nonetheless, there are properties in urban areas that have not been subdivided. The lawyer should make a determination whether such a search should be made depending on the type of property the client is purchasing and send a letter search to the local utility company.

Subsection 46(3) of the *Electricity Act, 1998* specifically provides that on the request of an owner of land or a person intending to acquire an interest in such land, the holder of such a right shall make a search of its records and, within 21 days after receiving a request, inform such person whether such an unregistered right affects such land and the term and extent of such right.

1.12 Bankruptcy

Although many solicitors search the records of the Registrar in Bankruptcy and the Official Receiver to ascertain any bankruptcies of a vendor, these searches are not necessary until the trustee-in-bankruptcy registers an appropriate notice on title.

1.13 Waste disposal search

This search is relevant where large tracts of land are purchased and then developed for commercial or residential purposes. However, this is a rarely conducted search in a residential transaction, since the underlying assumption is that all required searches were conducted before the creation of a subdivision or condominium.

Section 46 of the *Environmental Protection Act* provides that no use shall be made of land or land covered by water that has been used for the disposal of waste within a period of 25 years from the year in which the land ceased to be so used unless approval of the Minister of the Environment for the proposed use has been given.

To enquire whether a parcel of land has been used as a waste disposal site, write to the Ministry of Environment. Unfortunately, its records start only from 1971. For any information before 1971, the lawyer must write to the planning department of the relevant local municipality. When sending the enquiry, include a copy of a plan of the land to assist in locating the area in which the land is situated and indicate the lot and plan numbers and the underlying lots and concession numbers.

1.14 Heritage designation

If a property is designated under the *Ontario Heritage Act* to be of historic or architectural value or interest, a by-law is enacted by the municipality in which the property is located and registered on title, designating the property as a "designated property." If a property becomes a "designated property," any alteration or improvement to the property is subject to the provisions of the *Act*.

Further, if a property owner applies to a municipality for a loan to alter or improve a "designated property," s. 39 provides that the loans shall be a lien on the property until paid.

Under s. 27 of the *Ontario Heritage Act*, the clerk of a municipality must keep a register containing

- a legal description of the "designated property";
- the name and address of the owner; and
- a short statement of the reason for the designation.

Extracts from the register can be issued to any person on payment of the fee prescribed by the regulations.

Another way to search whether the property being purchased is a "designated property," send a letter of enquiry to the clerk of the municipality enquiring whether the property is a "designated property," whether any by-law designating the property has been proposed or pending under s. 29 of the *Act*, and whether there is a lien claimed against the property by virtue of a loan under s. 39.

1.15 Corporate status

When the lawyer receives the search of title and there are corporations that held the property in the chain of title, the lawyer should check whether these corporations were in existence during the period of ownership of the property. Both the federal and provincial corporate statutes provide that, upon dissolution of a corporation, its property is escheated, or forfeited, to the Crown.

This constitutes a break in the chain of title and subsequent grants would be void. For a fee, the Ministry of Government Services or other service providers will provide the lawyer with information stating the name of the corporation, its corporate number, its jurisdiction of

incorporation, the date it was incorporated, and if applicable, the date it was dissolved.

If any corporation in the title search period is not an Ontario company, a similar letter must be obtained from the jurisdiction in which that corporation is incorporated.

This search is not necessary if the title to the property has undergone a land titles conversion to Land Titles Conversion Qualified. However, subsequent to the time of conversion, this search is again required for any corporate registered owner.

1.16 Compliance with registered agreements

Subsection 51(25) of the *Planning Act* allows for the municipal or other approval authority to impose certain conditions on the developer and/or builder necessary for the approval of a plan of subdivision. For example, they may want the owner of the land to enter into one or more agreements with the municipality, referring to matters such as provision of municipal services; letters of credit; installation of sidewalks, street lighting, and drainage; and other conditions that the authority may consider necessary. The municipality may have the right to correct the default and then create a lien on the land for the amount.

This agreement may be registered against the land to which it applies, and the municipality or approval authority shall be entitled to enforce its provisions against the owner and subsequent owners of the land, subject to the *Land Titles Act* and *Registry Act*.

If the title search reveals an agreement, which may be called a subdivision, development, or site-plan agreement, check for compliance with the terms of the agreement by sending a letter to the legal department or the clerk's office of the relevant municipality inquiring whether the agreement has been complied with or, in the alternative, whether the municipality holds sufficient security to ensure compliance with the agreement.

If the search reveals that there is non-compliance, find out what work is outstanding, what steps the municipality will take to correct this outstanding work, and what remedies are available to the client under the agreement of purchase and sale. Discuss these matters with the client and document the client's instruction in writing.

1.17 Airport zoning regulations

If the property is located in the vicinity of an airport, the title search may reveal airport zoning regulations that impose height restrictions for structures and grade elevations of properties, expressed in units above sea level.

Airport zoning regulations are made pursuant to Part I of the *Aeronautics Act*, which permits the Governor in Council to make such regulations to prevent the incompatibility of the use of adjacent lands with the safe operation of an airport or prevent uses that would cause interference with signals or communications to and from an aircraft.

It is difficult to check compliance of airport zoning regulations registered on title. Consequently, the lawyer cannot give any opinion regarding the compliance of such regulations, and the title opinion should be qualified accordingly. The lawyer should advise the client of the existence and particulars of the regulations.

The lawyer should also advise the clients to check with the local municipality's planning department for further details regarding such regulations.

1.18 Development charges

The *Development Charges Act, 1997* allows municipalities to levy a development charge upon the development of property. Section 26 of this *Act* provides that a development charge is payable immediately upon the parties entering into an agreement unless a development charge by-law provides otherwise.

Alternatively, s. 27(1) states that a municipality may enter into an agreement with a person who is required to pay a development charge before or after it would otherwise be payable. Such an agreement is generally registered on title. If a development charge remains unpaid after it is payable, s. 32(1) provides that the amount unpaid is added to the tax roll and is collected in the same manner as taxes.

If the lawyer is dealing with a new home or a renovated home, he or she should review the title to see if an agreement or a by-law in respect of development charges is registered on title. If there is no such agreement or by-law, he or she should write to the building department of the local municipality to enquire if a development charge is payable with respect to such development, how much is payable, and when it is payable.

If the charges are payable on closing, requisition the vendor's lawyer for the payment of such charges on closing. As part of the closing arrangements, a portion of the balance should be due on closing, directly payable to the municipality for the required amount, and the vendor's lawyer's personal undertaking to remit such payment to the municipality and to provide the lawyer with evidence of such payment within a reasonable time after closing should be obtained.

1.19 Environmental searches

It is not typical to send out environmental enquiries in a residential real estate transaction. It is unlikely that the normal activities of a homeowner would lead to *Environmental Protection Act* orders. In addition, plans of subdivision are generally circulated to the Ministry of Environment for comment prior to final approval, and the probability of significant environmental problems is remote.

Environmental searches are more routinely conducted in instances where commercial or industrial properties are being purchased or financed or where vacant land is being acquired.

1.20 Underground fuel oil storage tanks

There are properties that contain underground fuel oil tanks that may be in use. These tanks may be wholly or partially buried somewhere outside of the main dwelling or wholly or partially buried in the basement.

If the client is purchasing a property with an underground fuel oil tank, *Fuel Oil,* O. Reg. 213/01, made under the *Technical Standards and Safety Act, 2000*, sets out rules for these underground fuel oil tanks.

As of May 1, 2002, all underground fuel oil tanks must be registered with the Technical Standards and Safety Authority (TSSA). The TSSA maintains a registry of underground fuel oil tanks.

To determine whether an underground fuel oil tank is registered, contact the TSSA, and give the TSSA the address of the property. The TSSA will advise the lawyer verbally without charge if its records reveal the registration of an underground fuel oil tank on a specific property. For a fee, the TSSA will provide a written response.

If the underground fuel oil tank is not registered, then requisition the vendor's lawyer about its registration, since no fuel oil for a heating system can be delivered until the tank is registered. To register the tank, work may have to be done to the tank and/or soil. Therefore, the requisition should include not only completion of the registration but also any remedial work to the soil, which may have been contaminated by the existence of the underground tank.

If the underground tank is not in use, the lawyer would requisition the vendor's lawyer for the removal of the tank and any remedial work to be done to the soil. In addition, advise the client's lender and title insurer of this matter to determine their respective requirements.

1.21 Underground utility facilities

The lawyer may come across a situation where the client needs to know if there is an underground utility cable buried somewhere in a parcel of land. There is a 24-hour/7-days-a-week service that will locate underground utility services throughout Ontario. Ontario One Call will assist in locating these buried utility wires and cables. The service is free of charge.

2. Farm properties

2.1 Realty taxes

As in urban properties, check for outstanding realty taxes by writing to the clerk of the municipality and requesting a tax arrears certificate for a fee.

2.2 Water

2.2.1 Serviced by a water main system

Some rural properties are connected to the water main system of the local municipality. If so, enquire of the local municipality as to whether there are any arrears for outstanding water accounts and whether there are outstanding deferred frontage charges. The latter pertains to the cost of connecting the property to the water main system and is generally done through an agreement, which may or may not be registered on title.

The agreement provides that the municipality will supply materials and labour in connecting the subject property to the water main system. Payment for the labour and materials is spread over a number of years. Upon the sale of the property, the entire amount becomes due and owing. Some municipalities register this agreement on title.

If the agreement is not registered, the lawyer must enquire directly of the municipality whether any such agreement has been entered into and, if so, the amount outstanding. The lawyer would then requisition the vendor's lawyer to pay out of the balance due on closing the amount owing under the agreement for deferred frontage charges and, if the agreement is registered on title, obtain and register a release from the municipality with respect to this agreement.

2.2.2 Serviced by a privately owned well

If the subject property is not connected to a municipal water system and obtains its water from a well, there are several concerns:

- the quality of the water or its potability;
- the quantity of the flow of the water;
- the capacity of the well; and
- the operational efficiency of the well.

A water sample should be delivered to the local health unit for testing.

Well drillers' certificates are usually available and should be requested from the vendor or by conducting a search of Ministry of Environment records.

2.2.3 Private water system

There are properties that are not connected to a municipal water main system or are not serviced singularly by a well. Instead, these properties are connected to a private water system that services more than one residence.

The *Safe Drinking Water Act, 2002* provides for regulation of drinking water systems and drinking water testing. The Director can respond to drinking water health hazards on an emergency basis and issue an order for costs against an owner of a drinking water system, and these costs can be added to taxes (s. 124(1)).

2.3 Septic tank or sewage systems

Effective April 1998, the Ontario *Building Code* was amended to incorporate a new Part 8, which applies to the construction, operation, and maintenance of all sewage systems and to the construction of buildings in the vicinity of sewage systems. The Ministry of Municipal Affairs and Housing, through a municipality, county, board of health, or conservation authority, as the case may be, became responsible for the enforcement of the provisions of Part 8 that related to sewage systems.

The requirement, pursuant to the legislation, is that every homeowner must have a sewage system for both toilet waste and "grey water," that is, water from sinks, bathtubs, laundry, etc.

The installation of such a sewage system must be by an installer licensed under the Ontario *Building Code Act, 1992*. A permit is required from the chief building official for such installation, and inspections are required during the course of construction. A final inspection must be made before the sewage system is used.

To obtain information regarding an existing sewage system installed after April 6, 1998, direct the enquiries either to the local public health unit or to the chief building official or building department of a municipality.

If the system was installed before April 6, 1998, enquiries may be made to the local public health unit, the local office of the Ministry of Environment, or other local authority holding the records for systems installed before April 6, 1998. The information that the lawyer may obtain will be for systems installed after 1972.

2.4 Hydro arrears and work orders

The above comments regarding the change in practice of hydro arrears searches similarly apply to farm properties.

This change in practice does not affect the search for any outstanding hydro work orders for which the lawyer will write to the local Electrical Safety Authority.

2.5 Unregistered hydro easements

The above comments regarding a letter search for unregistered hydro easements apply to farm properties.

2.6 Tile Drainage Act

Section 8 of the *Tile Drainage Act* imposes a lien on a property where tiles have to be installed to permit run-off water. If the property is located within a municipality, the charges are added to the municipal tax bill. Accordingly, when writing for a tax certificate, also include a specific enquiry about any outstanding charges or levies under the *Tile Drainage Act*.

2.7 Bank Act

Section 427 of the *Bank Act* provides that a bank may advance moneys to (1) wholesale or retail purchasers of, shippers of, and dealers in products of agriculture, products of aquaculture, products of the forest, products of the quarry and mine, products of the sea, lakes, and rivers, or goods, wares, and merchandise, manufactured or otherwise, on the security of such products or goods, wares, and merchandise used in or procured for the packing of such products or goods, wares, and merchandise; and (2) any person engaged in business as a manufacturer, any person engaged in forestry, mines, sea, and industry, and farmers and fishermen, on the security of their manufactured goods, wares, or merchandise, aquacultural stock, crops, livestock, and agricultural equipment or implements.

Under this statute, delivery of a document giving security on property to a bank under the authority of s. 427(1) vests in such bank in respect of the property described in such document as a first and preferential lien and claim for the sum secured and interest thereon. This preferential lien and claim covers crops before and after their severance from the soil, harvesting, or threshing. In addition, the bank has the same rights and powers as if it had a warehouse receipt or bill of landing with respect to encumbered property.

The rights and powers of the bank apply to real property, even though the property is affixed to real property and even though the person giving the security is not the owner of that real property.

Bank searches may be conducted personally at the Bank of Canada in Toronto or in writing by requesting a certificate upon payment of the prescribed fee. If there is a loan under the *Bank Act*, requisition for its discharge and payment.

2.8 Farm property tax program

Farms that are eligible to be assessed in the Farm Property Class will be eligible for a property tax rate of 25% of the municipal residential tax rate for the applicable taxation year.

To be eligible for the Farm Property Class farmland property tax rate of 25%, the property must be assessed as farmland, a farm business generating over $7,000 of gross farm income must be carried out on the farmland, a valid Farm Business Registration number must be existing, and the property must be owned by a Canadian citizen or a permanent resident of Canada.

If the gross farm income is less than $7,000, eligibility may still be available if one of the exceptions are met and applied for. The exceptions are the following:

- In the opinion of the Minister of Agriculture and Food, the farmer was not required to register because the applicable year was not a normal production year but, if it had been, the gross farm income would have been over $7,000.
- As a result of the age or illness of the owner or the age, illness, or death of the owner's spouse, gross farm income fell below $7,000 in the applicable year, provided that the person carrying on the farm business is the property owner, the farm business generates gross farm income greater than zero, the farm business has been operated by the owner or spouse of the owner for at least 10 years, and the owner qualified for the farm tax rebate during this period.

Lawyers who are acting for purchasers of farmland should obtain a representation from the vendor that the farmland is assessed as Farm Property Class and evidence of such assessment.

In addition, purchasers' lawyers should advise purchasers who will operate a farm business for the first time of the requirement to contact the Municipal Property Assessment Corporation and the Ontario Ministry of Agriculture, Food and Rural Affairs. This Ministry can also provide further information regarding the tax programs administered by the Ministry.

2.9 Highway entrance

If the farm property fronts onto a provincial highway, write to the Ministry of Transportation and Communications to enquire if the entrance to the highway is a legal entrance and if a permit has been issued under s. 34 of the *Public Transportation and Highway Improvement Act*.

Under s. 34(2), there are certain listed situations for which a permit is required, such as the placing, erecting, or altering of any building, fence, gasoline pump, other structure, or road or the placing of any tree, shrub, or hedge within 45 metres of any limit of the Queen's Highway or within 180 metres of the centre-point of an intersection; displaying any sign, notice, or advertising device within 400 metres of any limit of the Queen's Highway; or using any land that lies within 800 metres of any limit of the Queen's Highway for a shopping centre, stadium, fair ground, race track, drive-in theatre, or any other purpose that would cause people to congregate in large numbers. If no such permit is issued, requisition the vendor's lawyer to obtain such a permit.

If the farm property fronts onto a regional highway, write to the regional or local municipality dealing with private approaches for the same type of enquiry.

2.10 Controlled access highway

If the property being purchased is located within certain distances of a controlled access highway, write to the Ministry of Transportation and Communications to enquire if a permit has been issued for the purposes set out in s. 38 of the *Public Transportation and Highway Improvement Act*, which is similar to s. 34 of that *Act* discussed above.

2.11 Ontario Heritage Act enquiry

As in urban properties, the lawyer should enquire whether the subject property is a designated property within the meaning of the *Ontario Heritage Act*.

2.12 Cemeteries Act (Revised)

If the lawyer is dealing with farm property that the client wishes to subdivide or merely acquire, the lawyer may consider writing to the clerk of the local municipality or the Cemeteries Branch of the Ministry of Government Services to determine whether its records indicate that the subject property has been used as a "cemetery."

The letter of enquiry should be accompanied by a plan of survey and a legal description of the property.

Unfortunately, the records of the Ministry are not precise. They provide only information as to whether a cemetery has ever been located in a particular lot in a concession in a particular municipality. The letter will then refer the lawyer to the local municipality. Unless the lawyer has reason to believe that the subject farm property may contain a burial site or unless the client is

acquiring church lands, this is not a standard search that he or she needs to do.

Under the *Cemeteries Act (Revised)*, a "cemetery" means land set aside to be used for the interment of human remains, and a "burial site" is defined as land containing human remains that has not been approved as a "cemetery." If the client has the misfortune of finding human remains or has reason to believe that an area of land may have been used for a burial site, s. 68 of the *Cemeteries Act (Revised)* states that no person shall disturb or order the disturbance of a burial site except on the instruction of a coroner or pursuant to a site disposition agreement.

2.13 Airport zoning regulations

The previous comments regarding development charges similarly apply to farm properties. As earlier noted, the regulations should be drawn to the attention of the client. In particular, the height restrictions imposed by airport zoning regulations would apply to farm structures, such as silos or other storage areas on farm properties located near an airport.

2.14 Conservation Authorities Act

If the property includes any water courses or if there are substantial variations in grade in or about the area where the property is located, consider the provisions of the *Conservation Authorities Act*. Conservation authorities under this *Act* are empowered to make regulations under s. 28(1) to, among other things, prohibit, regulate, or require the permission of the authority for any development, if such development may affect the control of flooding, erosion, pollution, or conservation of land.

There are two types of enquiries that can be made to a conservation authority. One is an on-site inspection whereby an official will visit the site and identify what regulations or restrictions may affect the site. The second is a letter enquiry which confirms whether the subject property is within the jurisdiction of the conservation authority and, if so, the general restrictions that would apply.

Conservation authorities should also be contacted if the client is considering installing a septic system, since it will identify the area in which a septic system cannot be installed.

2.15 Weed control

Under s. 13 of the *Weed Control Act*, an inspector finding noxious weeds or weed seeds on land may order the person in possession of the land to destroy the noxious weeds or weed seeds.

Under s. 15, if the person does not comply with the order, the inspector can have the noxious weeds or weed seeds destroyed in the manner prescribed by the regulations and shall render a statement to the person in possession of the lands and the owner for the expenses incurred by him or her.

If the person for whom the statement was given fails to pay the amount, the inspector can give the statement to the council of the municipality in which the land is located, and the council shall order it to be paid out of the general funds of the municipality. The council can then collect this amount in the same manner as taxes under the *Municipal Act, 2001* or the *City of Toronto Act, 2006* (*Weed Control Act*, s. 15(6)).

Accordingly, consider including this enquiry in the request for a tax certificate.

2.16 Beds of Navigable Waters Act

If the subject property borders on a body of water or stream or is one on which the whole or part of a body of water or stream is situated or is one through which a body of water or stream flows, the lawyer may consider inquiring whether that body of water is "navigable" under the *Beds of Navigable Waters Act*.

If the body of water or stream is "navigable," then in the absence of an express grant of the beds in the Crown patent, it is deemed that the bed of such body of water was not intended to pass and did not pass to the grantee of such Crown patent.

To enquire whether a body of water is "navigable," write to the local office of the Ministry of Natural Resources.

2.17 Local improvements

The prior comments regarding local improvements apply to farm properties as well.

2.18 Drainage Act

"Drainage works" under s. 1 of the *Drainage Act* includes a drain constructed by any means, including the improving of a natural water course, and includes works necessary to regulate the water table or water level within or on any lands or to regulate the level of the waters of a drain, reservoir, lake, or pond, and includes a dam, embankment, wall, protective works, or any combination thereof.

Improvements under this *Act* work in the same way as local improvements. Special assessments are passed onto property owners much like local improvement assessments. Any enquiry under this *Act* should be made to the clerk of the municipality.

2.19 Corporate status

The prior comments similarly apply to farm properties.

2.20 Underground fuel oil tanks

The prior comments regarding the search for underground fuel oil tanks with the TSSA are applicable to farm properties.

3. Cottage properties

The following searches would similarly apply to cottage properties:

- realty taxes;
- hydro arrears and work orders;
- wells as to potability and quantity of flow of water;
- sewage systems, permits, and outstanding work orders;
- unregistered hydro easements;
- highway entrances;
- controlled access to highways;
- *Conservation Authorities Act*;
- *Drainage Act*;
- *Beds of Navigable Waters Act*; and
- corporate status.

In addition to the aforementioned searches, the following searches for cottage properties are suggested.

3.1 Zoning

Check zoning to find out whether there are any land-use restrictions affecting the subject property. For example, there may be a zoning by-law restricting the seasonal use of the cottage.

Many clients may want to add to the cottage structure or add accessory structures such as boathouses or docks. The client should be advised to obtain a copy of the by-law as soon as possible. In addition, if the client wants to build on or develop the property, the lawyer or the client should check the zoning by-law. The restrictions or limitations to any improvement or development of a property will be identified, such as, whether the property is in a flood plain or environmental or hazard zone.

3.2 66-foot reservation

For cottage owners whose properties are waterfront properties, ownership of the 66 feet (equal to one chain) running back from the water's edge may or may not be referred to in the Crown grant. The two most frequent types of the 66-foot strip are the following:

- a reservation by the Crown for a grant to the original patentee of the land of 66 feet running along the shoreline back from the water's edge for the purpose of access. Title to this 66 feet remains in the Crown.
- a Crown grant that grants the whole of the land described in the patent that does not extend to the water's edge. The 66 feet between the lot line described in the grant and the water's edge was laid out in the original survey as the road allowance. In 1913, title to all such road allowances was by statute vested in the local municipalities.

If the water line has changed, it is now necessary to ascertain where the current water line is, in order to determine the location of the 66-foot strip.

To determine the ownership or the existence of this 66-foot reservation from the water's edge, contact the Ministry of Natural Resources or its local branch.

3.3 Other reservations in Crown patent

In addition to the 66-foot reservation from the water's edge, there may be other reservations in the Crown patent, such as for mines and minerals, the obligation to build, etc.

Check the *Public Lands Act* to determine whether the reservations are still in effect. If they are, check the agreement of purchase and sale to see if the parties have agreed that the land being sold is subject to these reservations. If not, requisition the release of the reservations at the expense of the vendor. If this cannot be negotiated, discuss options with the client, which must include an abatement of the purchase price.

For copies of Crown patents, write to the Ministry of Government Services, Official Documents Office, Toronto, Ontario, and send the requisite fee with your letter.

3.4 Installation of boathouses, docks, etc. in water

Where there are structures located in water, such as a boathouse, docks, or piers, check whether the necessary approvals have been obtained for such structures.

Also, check if the bed of the water upon which the structure is located belongs to the riparian owner, and if it does not, obtain permission from the owner of the bed.

In the case of navigable waters in Ontario, the owner of the bed would be the Province of Ontario. Under s. 24 of the *Public Lands Act*, the Crown is automatically the owner of any structure placed or left without authority on public lands. The Ministry may remove or destroy the offending structure and charge the cost of removal to the persons who installed or left it. Further, there is a penalty for unlawful occupation of public land equal to twice its value (see s. 26).

If the owner of the bed is the Crown, a lease or a licence of occupation must be obtained under the *Public Lands Act*. If there is anything constructed in navigable water, check that a permit was issued for such a structure by writing to the provincial Ministry of Natural Resources.

In addition, if the water is navigable water, a permit is required from the Ministry of Transportation under the federal *Navigable Waters Protection Act*. Section 5 of the *Act* prohibits any "work" (defined under s. 3 to include dams, wharfs, docks, and the dumping of any fill) without the prior approval of the Ministry. The approval is valid for 50 years. Without the approval, the Ministry is empowered to remove the work and seek fines. The *Act* provides for obtaining approval retroactively to cure an omission.

Except for a bridge, boom, dam, or causeway, if the structure on the water does not substantially interfere with navigation, the lawyer can apply for and obtain a "declaration of exemption" from the Minister. The application is made to the nearest district office of the Coast Guard. District offices are located in Toronto, Prescott, Parry Sound, and Kenora. No fees are charged.

If the cottager owns the bed, consideration should be given to s. 29(3) of the *Ontario Water Resources Act* that prohibits the placing in water of material or anything that may impair the quality of water in certain defined areas.

In addition, for properties within a conservation area designated under s. 28 of the *Conservation Authorities Act*, permission is required from the local conservation authority for the construction of any building or structure and the placing of any fill in certain areas.

Lastly, any person undertaking construction of a structure on water will have to comply with the local applicable zoning and building by-laws and obtain a building permit, if required.

3.5 Shoreline Property Assistance Act

An owner can apply to the council of a municipality for a loan pursuant to s. 4 of the *Shoreline Property Assistance Act* if the owner wishes to construct retaining walls, dykes, breakwaters, groynes, cribs, or other structures designed for the rehabilitation or protection or both of properties located on the shores of lakes, rivers, or other bodies of water that have been damaged or eroded by the elements.

If approved, a loan for the construction of the works or the repair of the works shall not exceed the amount prescribed, pursuant to s. 4(7). The council then issues a debenture payable to the Treasurer of Ontario with respect to the moneys loaned by the municipality, and a by-law authorizing the debenture would then be registered on title.

Under s. 11, where part of the land in respect of which money has been lent under the *Act* is sold, the council of the municipality apportions the special annual rate between the part sold and the part remaining.

Under s. 12, a discharge of the indebtedness can then be made by paying to the treasurer of the municipality the amount owing together with accrued interest.

If a by-law is registered on title with respect to this *Act*, write to the clerk of the municipality to find out what is the amount outstanding, and then requisition the vendor's lawyer for the payment and discharge of the indebtedness.

3.6 Local improvements

Retaining walls, dykes, breakwaters, groynes, cribs, and other shore protection are also local improvements, and the earlier comments regarding local improvements apply to cottage properties as well as urban and farmland properties.

3.7 Underground fuel oil tanks

The prior comments regarding the search for underground fuel oil tanks with the TSSA is applicable to cottage properties.

4. Vacant land

Depending on the area where the vacant land is situated, earlier comments about the following searches apply:

- Crown reservations;
- corporate status;
- taxes;
- local improvements;
- unregistered hydro easement;
- *Cemeteries Act (Revised)*;
- *Conservation Authorities Act*;
- *Beds of Navigable Waters Act*;
- *Weed Control Act*; and
- *Drainage Act*.

In addition, consider conducting the following environmental searches:

- **Section 18 searches:** Under the *Environmental Protection Act*, the Director is given the power to make clean up orders and issue certain certificates of approval. A list of these approvals and orders is kept on file at the Ministry of Environment in an alphabetical index of names. The list of names is compiled from 1970. A letter can be sent to the regional office of the Ministry of Environment

requesting information on whether the names submitted appear on the index record maintained under s. 18. The orders are not filed by property address or lot and plan description; and therefore, a review of the chain of title on both the property being purchased and the adjoining properties should be made to compile a list of names of title holders. Corporate searches should also be done for corporations appearing on title to determine whether they have changed their names or amalgamated. It is also recommended that the names of current and prior tenants/users of the property be acquired from the client, if available.

- **Waste disposal sites:** The Ministry of Environment has compiled a list of waste disposal sites and, upon request, will provide advice as to whether a certain property appears on its list. The lists are organized by lot and concession number. It is also helpful to provide a sketch locating the property in relation to concession roads and other main roads.
- **Municipal inquiries:** The Ministry of Environment suggests that municipal records be consulted for the period prior to 1971. Generally, municipalities are not prepared to entertain this type of letter enquiry, and it is more useful to speak with a planner to determine the previous land uses for the property or the adjacent property.

The above enquiries will only provide information contained in government records and responses and will not provide the client with assurance about the state of the property or any potential environmental liability.

Speak to the client about conducting an environmental inspection and audit, as well as including environmental representations and warranties in the agreement of purchase and sale. Representations and warranties are only as good as the party that gives them, and the ability to obtain appropriate compensation in the event of a breach of the representation or warranty may be difficult.

Advise the client that responses from the Ministry of Environment or other municipal departments may not be received in time for closing.

There does not seem to be a standard practice among practitioners as to what environmental inquiries should be made. At a minimum, advise the client about the types of due diligence enquiries that can be made, the cost of each type of enquiry, and the risk inherent in the transaction, and the client's instructions should be documented in writing.

The *Brownfields Statute Law Amendment Act, 2001* is intended to encourage the revitalization, development, and clean up of abandoned and contaminated lands known as "Brownfields."

When searching the title to these types of properties, the lawyer may find a certificate of property use registered by the Ministry of Environment. This certificate may require an owner to take action to prevent, eliminate, or ameliorate adverse conditions on the subject property, or may require an owner to refrain from certain uses of the property and/or construction on the property.

If the lawyer finds a certificate of property use or a Ministry of Environment order registered on title, enquire with the Ministry of Environment to determine if the property is in compliance. If the property is not in compliance, requisition compliance by the vendor and review the agreement of purchase and sale to determine what course of action the client should take in the event that the vendor is unwilling or unable to comply.

In addition to discussing this matter with the client, the lawyer should also notify the mortgage company and/or the title insurer of this non-compliance to determine their respective requirements.

5. Unorganized territories

Territories that have not yet been organized as a municipality are "unorganized territories." Properties located in these territories are subject to specific legislation, some of which are set out below.

5.1 Zoning

Under s. 13 of the *Public Lands Act*, the Minister of Natural Resources has authority to designate any area and territory without municipal organization as a restricted area and, subsequently, can issue building permits on such terms and conditions as the Minister considers proper.

Accordingly, when an area has been designated by the Minister, a permit is required for the construction of any building or the making of any improvement on lands in that area. If the lawyer wants to find out what restrictions are applicable to a property located in such an area, enquire at the local office of the Ministry of Natural Resources. See s. 14 of the *Public Lands Act*, which contains further restrictions.

5.2 Taxes

Under s. 2(1) of the *Provincial Land Tax Act, 2006*, all land situated in unorganized territories subject to exemptions are liable to assessment and taxation.

The Minister prepares a tax roll for non-municipal territory.

5.3 Tile Drainage Act

Subsection 11(2) of the *Tile Drainage Act* governs loans and liens given in territory without municipal organization.

5.4 Local Roads Boards Act

Under the *Local Roads Boards Act*, a majority of the owners at a special meeting can petition the Minister of Transportation to establish a "local roads area." Once such an area has been defined, a local roads board will be established to determine what roads to create or to repair.

The local roads board also establishes an annual levy against all of the taxable land lying within the local roads area. The levy is a land tax against all property owners and is collectible in the same manner as taxes under the *Provincial Land Tax Act, 2006* if delegation occurs by way of agreement with the Minister of Finance. If the tax remains unpaid for two years or more and remains so unpaid for 12 months after the mailing of a notice and the secretary treasurer of the board so certifies, the Minister of Natural Resources can declare the land forfeited.

The *Act* makes specific reference to the return of lands that have been forfeited in error but does not provide a mechanism whereby a delinquent taxpayer can pay up and get the property back.

5.5 Northern Services Boards Act

A local services board created under the *Northern Services Boards Act* deals with matters such as water supply, fire protection, garbage collection, sewage, street or area lighting, and recreation. If such services are supplied, then the costs are passed onto the property owners within the local services area in the same manner as taxes under the *Provincial Land Tax Act, 2006*.

5.6 Shoreline Property Assistance Act

For enquiries under the *Shoreline Property Assistance Act*, write to the relevant municipality.

6. Conclusion

The aforementioned searches are by no means exhaustive of the searches that can apply to the purchase of a property, but they are the most frequently applicable.

Know as much about the property from the client, the vendor, or the real estate agent as possible, particularly in areas not located within a registered plan of subdivision. Only in this manner can the lawyer become aware of what searches to conduct.

Finally, in the case of a client who is applying for title insurance, if the lawyer performs any enquiries on behalf of the title insurer and the title insurer will accept verbal responses to an enquiry, ensure that the verbal response that is obtained is documented in writing, as well as the name of the person who provided the response and the date and time that the conversation took place.

Chapter 48

Electronic registration of land titles documents

1. Background

The Ministry of Government Services and Teranet Land Information Inc. have been working on the development of electronic delivery of land registration services for a number of years. The first phase of these services began with the automation of the land registration records and the conversion of registry system properties to the land titles system. This process is ongoing with automation having been introduced and, in many cases, completed.

With this automation, came the introduction of electronic remote search services through the Teranet gateway software known as Teraview®. Now, users of the land registration system are able to remotely register land titles documents. This service, known as e-reg™, is done through the Teraview gateway.

The *Land Registration Reform Act* (*LRRA*) is the legislation that has introduced most of the recent reforms to the land registration system. The *LRRA* was passed in 1984 and at that time contained two parts. Part I of the *LRRA* introduced the concept of streamlined forms—known as POLARIS forms—implied covenants, and standard charge terms. Part II established the framework for automating the land registration records.

The *LRRA* was amended in 1994 by introducing Part III, which provides for the electronic registration of documents. This legislation set the framework for electronic document registration and provided that the registration requirements were to be dealt with by regulation.

2. Part III — Land Registration Reform Act

Although this portion of the *LRRA* is not lengthy, it has a significant impact on the way documents are registered in the land titles system. The key concepts of this part of the *LRRA* are the following:

- The requirement that a document be in writing and signed was removed. The *LRRA* provides that an electronic document that creates, transfers, or otherwise disposes of an estate or interest in land is not required to be in writing or signed (*LRRA*, s. 21).
- The authority for direct electronic transmission to the land registration database was created (s. 23).
- A document registered in electronic format prevails over any copy of the document that exists in written form that is not a printed copy of the electronic document (s. 22).

Section 40 of *Electronic Registration*, O. Reg. 19/99, made under the *LRRA*, introduced another key concept of "law statements." The electronic document registration system allows for the use of law statements, which replace the need for the registrant to provide evidence of the matter dealt with by the statement. Land registrars may rely on these statements and give effect to the registration if the electronic document is otherwise capable of registration.

In the electronic registration system, it is the information required in a document that is prescribed, not the form. Therefore, the POLARIS forms introduced under the *LRRA* in 1984 do not apply to the electronic document registration system.

3. Introduction of electronic registration of land titles documents

The electronic registration system was being introduced in a phased manner, both with respect to "functionality" (i.e., what the system can do electronically) and with respect to the counties in which the system is available. For example, with respect to functionality, the system is now built so documents can be receipted electronically but must still be reviewed by LRO staff for the purposes of certification of the document and title.

The Ministry has now implemented the electronic registration system in all counties. Historically, the plan was to introduce electronic registration first on an optional basis, and after a transition period, a second regulation would be filed for the purposes of requiring the electronic registration of most land titles documents.

The electronic registration system has only been introduced in the land titles system. In the land titles system, documents are applications to the land registrar, and based on these documents or "applications," title is given to the applicant or an interest is registered. Because it is the land titles system, those searching the record can rely on it, subject only to the qualifiers listed on the parcel register and those exceptions in the legislation. The *Land Titles Act* is also governed by the concept of actual notice, which should be considered when reviewing title.

3.1 Law statements

Section 40 of O. Reg. 19/99 prescribes those documents where a law statement may be used. A law statement may only be made by a person who is entitled to practise law in Ontario. These statements apply to the following documents (all sections below refer to O. Reg. 19/99):

- a transfer (s. 5)
- a transmission application by an estate trustee (s. 14);
- a transmission application by a devisee or heir-at-law (s. 15);
- an application to register a chargee as owner under a foreclosure order (s. 19);
- a transfer under power-of-sale (s. 20);
- a notice of determination of lease (s. 25(2));
- an application to register an order that requires a statement that the order is still in full force and effect (s. 28(d));
- an application to amend the register based on a court order (s. 30);
- an application to delete a claim for a construction lien, which requires a statement that there is no sheltering under the certificate of action (s. 33(1)(b)(ii)); and
- an application to delete a writ of execution where
  - a statement that the execution debtor has obtained a complete, unconditional, and unqualified release from the execution creditor (s. 34(2)(b)); or
  - a statement that the registered owner of the land immediately before the land registrar recorded the writ against the land is not the execution debtor (s. 34(2)(c)).

The electronic registration system will only permit registrants with the proper authority and an active Law Society of Upper Canada member number to complete these law statements. The list of active solicitors will be regularly updated by the Law Society database.

A document is usually signed electronically by a lawyer when law statements need to be made. The electronic signing is a two-step process. First, the lawyer or person who has been given authority by the lawyer signs for completeness. If law statements are required, then only the lawyer can sign for completeness. If no law statements are required, then the person who has been given authority by the lawyer can sign for completeness.

Then the document must be signed for release. This can be done by either the lawyer or the person who has been given authority by the lawyer. Even a document where law statements are required, provided the lawyer has signed for completeness, can be signed for release by the appropriate person in the lawyer's office.

3.2 Effect of statements

Subsection 40(2) of O. Reg. 19/99 states that a person who makes the law statements (the lawyer) that is also a statement of fact must do so on the advice of the party to the document who has knowledge of the fact. Furthermore, the lawyer is not deemed to be the person on whose application the registration of the document is being made. For example, a lawyer making the *Planning Act* statements in a Transfer is not deemed to be the person applying to have it registered.

The lawyer ensures that he or she registers the document electronically in accordance with an "acknowledgement and direction," which is produced by the Teraview software, signed by the client. Briefly, that document authorizes and directs the lawyer on behalf of the client to register electronically the documents described in the acknowledgement and direction. It is imperative that the lawyer has the client sign this document prior to signing the document for completeness and release.

4. General requirement for documents in the electronic registration system

As in the POLARIS system, the electronic registration documents must have certain requirements in order to be accepted for registration. In the electronic system, the statements are programmed into the system. For example, lawyers are permitted to choose various statements relating to spousal status, rather than inputting them on their own. These were designed to comply with the regulations.

Those registered with the Teraview electronic registration system, create and register documents from their personal computer. A Windows-based program is used that has the specific documents in the system and prompts the user to complete the documents with the necessary statements.

The program has a detailed logic table that allows for a lot of the information contained in the documents to be checked electronically before registration and prompts the user to make corrections, if necessary.

Each user has a disk or USB key with his or her information, which allows them to enter the system. It is very important that lawyers do not lend or allow anyone else the use of their passwords and disks or USB keys, since this may potentially create numerous problems, including, but not limited to, fraud.

5. Exemptions from registering electronically

There are a small number of documents that do not need to be registered electronically and have been exempted by the regulations made under the *LRRA*. These are: plans; Crown grants; first applications under the *Land Titles Act*; a declaration and description under the *Condominium Act, 1998*; and registrations in other indices such as the Highways Register, the Trans-Canada Pipelines Register, and the Canada Lands Index. They cannot be registered electronically and must be submitted in a paper form at the land registry office.

Documents that cannot be accommodated by the electronic system because of systems limitations (i.e., the number and/or size of the documents cannot be electronically accepted, such as an airport regulation that affects thousands of properties) or because they are not required by the regulations to be electronically submitted, are to be submitted on a POLARIS form.

Documents that have been executed prior to the filing of a second regulation on the forms prescribed under the *LRRA* (POLARIS forms) may still be registered in that form after the filing of that regulation.

6. Client ID and verification requirements — execution of the acknowledgement and direction

In order to prevent, amongst other things, fraudulent activity, the Law Society has amended By-Law 7.1 (operational obligations and responsibilities), made under the *Law Society Act*. Essentially, when a lawyer is retained, the lawyer must obtain basic information, such as the client's home and business addresses, and must photocopy at least one piece of identification such as a driver's licence, passport, or birth certificate (By-Law 7.1, ss. 23(5) and (7)). Reference should be made to the by-law to ensure compliance. These records must be retained in your files.

7. The two-lawyer rule for transfers — Rules of Professional Conduct, r. 2.04.1

In the preparation of a Transfer electronically, all lawyers must complete a law statement with respect to whom he or she acts for. An individual lawyer cannot act for or otherwise represent both the transferor and the transferee with respect to a transfer except in certain circumstances and only if the lawyer is able to comply with r. 2.04 of the *Rules of Professional Conduct* regarding conflicts of interest. The exceptions are set out in the rules and will assist the lawyer in choosing which box to electronically choose in the "Statement" section of the Transfer.

Chapter 49

Subdivision control: Section 50 of the Planning Act

1. Purpose of s. 50

The purpose of s. 50 of the *Planning Act* (*Act*) is to control the manner in which land can be divided and used. Non-compliance is fatal to any intended transaction. The legislation is necessary because at common law, the owner was not restricted as to the use of the land, subject to possible nuisance actions, and such absolute control by the owner is inconsistent with good municipal planning.

The provincial government does not, in most cases, exercise direct control over development; rather, the legislation is designed to allow development decisions to be made by municipalities and be overseen by the Ontario Municipal Board. As of late, the focus has been on restoring local accountability and transparency to land-use planning. The *Strong Communities (Planning Amendment) Act, 2004* strengthens planning at the municipal level, and the *Planning and Conservation Land Statute Law Amendment Act, 2006* limits the Ontario Municipal Board to acting as a true appeal body.

There is a substantial body of case law regarding s. 50 of the *Act*. Many of the reported decisions have arisen in the context of vendor and purchaser applications where the two sides of an issue are often not strenuously argued since the parties may be intent only on solving a mutual problem as quickly and cheaply as possible. Thus, inconsistent judicial decisions are not uncommon. As a result, it is important to understand the plain wording of the subsections and to appreciate the case law in the context in which the decisions have been rendered.

2. Effect of contraventions: s. 50(21)

Subsection 50(21) provides that any transaction prohibited under s. 50 (or the equivalent section in an earlier statute) "does not create or convey any interest in land." The types of documents specified in the subsection include agreements, conveyances, mortgages, and charges. In the event that s. 50 is contravened, the contravening document does not create or convey an interest in land, and as a result, the purpose of any such document (i.e., to convey or charge) is substantially undermined, since in each case the essence of the document is to create or convey an interest in land.

Since the effect of a contravention is to negate the document's ability to create or convey an interest in land, it is essential that one ensure compliance with s. 50.

Subsection 50(21) does, however, contain a provision that is available to protect the interest in land created by an agreement of purchase and sale, where the agreement at the outset is in contravention of s. 50 but the contravention can be cured prior to closing. As long as the agreement entered into is "subject to the express condition contained therein that such agreement is to be effective only if the provisions of this section are complied with" (as all real estate boards' forms are), the agreement is valid and fully enforceable, pending the resolution of the problem under the *Act*. If the express condition is included, neither party can immediately declare the agreement ineffective on the ground that the agreement creates no interest in the land due to the contravention of the *Act*.

Such an explicit provision should be included in every agreement of purchase and sale, option to purchase agreement, lease for more than 21 years, or other document involving an interest in land in order to guarantee protection for the agreement from the effect of s. 50(21) in the event that an unexpected problem under the *Act* arises. Without the express condition permitted by the *Act*, a document contravening the section would not create an interest in land.

3. The basic prohibition: s. 50(3)

Subsection 50(3), in its preamble, prohibits a broad variety of transactions relating to land or interests in land. The subsection applies to everyone.

3.1 Lands subject to s. 50(3)

A preliminary point: because of s. 50(3)(a), it can be stated in general terms that the prohibitions in s. 50(3) apply to any land except land that is within a registered plan of subdivision.

In other words, s. 50(3) applies to lots on concessions, unregistered plans, deregistered plans, and so on. Subsection 50(3), other than s. 50(3)(a), can be disregarded when dealing with land that is within a registered plan of subdivision. Clause 50(3)(a) and s. 50(5) are the operative and relevant portions of s. 50 in this latter situation.

3.1.1 Concessions v. registered plans

Because of this distinction between ss. 50(3) and (5), it is especially important to understand the difference between a concession and a registered plan of subdivision. Ontario was originally divided into counties. Counties were divided into townships, townships into concessions, and concessions into, typically, 200 acre lots. Thus, a legal description of land might consist, for example, of lot 5, concession 12, Township of Greenacre. For over 200 years, this has been and remains today the underlying method of legal description for all land in Ontario, regardless of whether the land is under the land titles system or under the registry system.

Registered plans of subdivision (the subject of s. 50(5)) where they exist are superimposed on top of these original legal descriptions. Where there is no registered plan of subdivision, the land will be the subject of s. 50(3) and will consist of one or more lots on a concession or of part of an unregistered or deregistered plan or other forms of description that get the same treatment under s. 50(3)(a) as lots on concessions.

3.2 Prohibited transactions under s. 50(3)

The following are transactions prohibited in the preamble of s. 50(3):

- conveying land by deed or transfer.
- granting, assigning, or exercising a power of appointment (a power to appoint is equivalent to a power to convey with respect to land—the land is held by an owner "to uses" (primarily seen in conveyancing before 1985) and includes a power of appointment).
- mortgaging or charging land.
- entering into an agreement of sale and purchase of land.
- entering into any agreement that has the effect of granting the use of or right in land, directly or indirectly, by entitlement to renewal for a period of 21 years or more. For example, this would include
  - granting a right-of-way or easement in perpetuity;
  - granting a lease with a term of 21 years or more;
  - granting a 15-year lease with an option to renew for 10 years; or
  - granting an option to purchase.

Section 50 is extremely broad and virtually all common transactions, except perhaps short-term leases without options to purchase or renew, are caught by the prohibition.

The courts have interpreted the proscribed and enumerated transactions very narrowly, with the result that other types of procedures that have the effect of dividing land but that are not specifically prohibited are not affected by the section, such as

- vesting orders under the *Trustee Act*; and
- vesting orders under the *Family Law Act*.

4. Exceptions to the prohibition in s. 50(3)

There are nine situations in which the basic prohibition is not applicable. Compliance with any one of these nine exceptions makes a transaction permissible. Each exception involves either a transaction where land is not being divided or a transaction in which government consideration of planning issues is present. Thus, if any of these nine situations applies to a transaction, the application of s. 50 has no legal consequence.

4.1 Plans of subdivision: s. 50(3)(a)

As stated above, a transaction is not prohibited by s. 50(3) of the *Act* if the land being conveyed is "described in accordance with and is within a registered plan of subdivision." This is a logical exception, since prior government approval would already have been granted to the pattern of land division laid out on the registered plan. Thus, the underlying purpose of s. 50(3) has already been served and need not hinder or prevent the conveyance of or other dealings with whole lots or blocks within the registered plan.

While land within a registered plan of subdivision will not be affected by s. 50(3), this does not mean that the *Act* has nothing to say about such land. There is still the possibility of subdivision of land that is within a registered plan. Any whole lot or block excepted from s. 50(3)(a) can still be severed into part lots or part blocks. This potential dividing of whole lots or blocks into smaller parcels is what is regulated by the "part-lot" control provisions contained in s. 50(5) of the *Act*.

4.1.1 Deregistered plans of subdivision: s. 50(4)

It is also possible for a municipality, for the purposes of s. 50, to deem a plan of subdivision that has been registered for eight years or more not to be a registered plan of subdivision, pursuant to s. 50(4). Presumably, a municipality would choose to pass such a by-law where it wanted to regain planning control over an established area, perhaps because of changes in patterns of development or municipal policy where the previously approved plan is considered obsolete. Note that the plan remains a plan of subdivision for all purposes but one: it will no longer fall under the exception in s. 50(3)(a).

4.2 The "no abutting lands" exception: s. 50(3)(b)

Clause 50(3)(b) constitutes the second major exception to the prohibitions in the preamble of s. 50(3) and is the subsection that applies to most routine conveyancing transactions. This exception allows a person to carry out the transaction if he or she does not retain the fee (ownership) or the equity of redemption (the right to recover unencumbered ownership upon repayment of a mortgage loan) in any land "abutting the land that is being conveyed or otherwise dealt with."

Clause 50(3)(b) also creates an "exception to the exception": the person can carry out the transaction even if he or she owns abutting land if the abutting land consists of the whole of a lot or block on a registered plan of subdivision.

If a person deals with all of the land owned and retains no ownership interest in any land having a common boundary with the land being dealt with, such dealing is permitted since it complies with s. 50(3)(b). Dealing with only a part of a parcel of land while retaining ownership of abutting land is prohibited, because it would have the effect of dividing the parcel into two parcels. Again, note the exception to the rule: where the retained abutting land is the whole of a lot or block on a registered plan of subdivision, the prohibition does not apply. From a planning perspective, this situation should not be prohibited; if the whole lot or block is exempt in any event because it is on a plan of subdivision (and not subject to the part-lot control rule), the remaining parcel should be similarly considered a separate parcel.

The following examples will assist in appreciating the practical manner in which this basic exception to the prohibition operates and how the Act can be contravened. Assume Owner owns various parts of this parcel of land and that *none of the parcels is the whole of a lot or block on a registered plan of subdivision*.

In Figure 1, if Owner owns only parcel B, Owner is able to sell it and rely on the "no abutting lands" exception to avoid a contravention of s. 50. However, if Owner owns parcels B and C and only wants to sell parcel B, retaining parcel C, the transaction will fall outside the "no abutting lands" exception, because Owner retains parcel C, which is abutting land. Owner will have to find some other exception to the prohibition for the interest to pass. The same analysis would apply if Owner were mortgaging the land or granting an option to purchase or a lease with a term of 21 years or more, etc.

Figure 1

A	B	C
D	E	F

Variations on the above fact situation give some idea as to how the subsection has been interpreted and applied:

- Owner acquired parcel B in May 1985 and parcel C in June 1985. Historically, they had been separate properties. Can Owner now sell parcel B alone and rely on the "no abutting lands" exception even though, historically, there is no planning issue involved?

  Subsection 50(3) does not give any consideration to the prior history of the lands in question. For purposes under the *Act*, all abutting land under the same ownership "merges" into one parcel, and the transaction is prohibited.
- If Owner owned parcels B and F, can Owner sell B and retain F? Lands that only meet at a point have been held not to abut, and therefore Owner can sell B and retain F.
- Could Owner sell the mineral rights to parcel B and still retain the surface rights without the transaction contravening s. 50?

  Subsection 50(2) provides that interests in lands do not abut when they meet on a horizontal plane only. As of December 9, 1994, s. 50(2.1) deems land to exclude mining rights in or under land, but not mining rights on the land.
- If Owner owns parcels B and C, with C being a separate lot on a plan of subdivision, can Owner sell B only and have the conveyance remain within the "no abutting lands" exception?

  The last phrase of s. 50(3)(b) provides that the "no abutting lands" exception applies if the abutting land is "the whole of one or more lots or blocks within one or more registered plans of subdivision."

4.3 Consent obtained: s. 50(3)(f)

The third major exception to the prohibition set out in s. 50(3) occurs if the transaction is effected with the consent of the relevant government body. In practical terms, obtaining consent is the most common manner in which an owner may deal with part of his or her land while retaining an interest in abutting land under s. 50(3).

"Consent" is defined in s. 50(1) of the *Act*. Approval of an otherwise prohibited transaction may be given by the appropriate municipal, city, or county council or the Ministry of Municipal Affairs and Housing, depending on the location of the land, once it has determined that

planning principles will not be sacrificed or may be compensated for in some way. Often the consent will be granted by a committee of adjustment or land division committee, which are simply bodies to which powers to grant consent have been delegated.

Regulation of the consent process is set out in s. 53. Pursuant to s. 53(43), a consent lapses on the expiry of two years following the date on which the certificate of decision of consent was given if the transaction approved for consent has not been carried out. The body granting consent can also shorten the lapse date or impose conditions on the grant of consent. Finally, the governing body can grant its consent subject to conditions that must be satisfied before the consent takes effect. Failure to satisfy the conditions renders the consent void under s. 53(41).

For example, obtaining the necessary consent for the division of a parcel of land in half to sell the eastern half and then satisfying all conditions that are imposed upon the granting of the consent allows the owner to sell the eastern half within two years after the date on which the consent was given while continuing to own the western half, without contravention of s. 50. The transfer of the eastern half will have attached to it a certificate under s. 53(42) that consent to the transaction has been given.

4.4 Transactions involving government: ss. 50(3)(c)–(e) and (g)–(h)

The rationale for these exceptions is identical. If the government or a government agency wishes to acquire or dispose of lands in such a way that additional parcels will be created or that land will be divided, one can only assume that it, as the body with control over planning, has considered the planning implications of the transaction and found them to be satisfied.

Clause 50(3)(c) creates an exception to the general prohibition for the acquisition or disposition of land by federal, provincial, and municipal governments. As a result, for example, there can be no contravention of the Act regarding conveyances to municipalities for road widening purposes.

Clauses 50(3)(d) and (g) relate more specifically to the acquisition of land or rights in land for the purpose of transmission lines pursuant to Part VI of the Ontario Energy Board Act, 1998. Clause 50(3)(e) creates an exception for the acquisition of land or rights in land for purposes of flood control, erosion control, bank stabilization, shoreline management, or the preservation of environmentally sensitive lands. Clause 50(3)(h) excepts the grant of an easement or covenant under the Conservation Land Act.

Clause 50(3)(d.1) creates an exception where a parcel of land or any use of or right therein is being acquired, directly or by entitlement to renewal for a period of 21 or more years but not more than 50 years (in effect, the exception is for leases having terms greater than 21 years to a maximum of 50 years), for the purpose of a renewable energy generation facility or renewable energy project, provided that the party acquiring such land make a declaration that the land is being acquired for such purpose.

5. Lots within a registered plan of subdivision: s. 50(5)

5.1 General principles

Clause 50(3)(a) allows a transaction to proceed without being in contravention of the *Act* as long as the land being dealt with is "within a registered plan of subdivision." Subsection 50(5), however, was enacted to deal with the further problem of the owner who wants division of a registered lot or block already within a plan of subdivision.

A plan of subdivision essentially takes a large parcel of land and, through a planning process, divides the parcel into many smaller parcels called lots or blocks. These lots or blocks are conveyable parcels. Under s. 50(3)(a), they are exempted from the general prohibition imposed by the preamble of s. 50(3), because they have been recognized for planning purposes as lots that may be dealt with without regard to s. 50 of the *Act*.

5.2 Problems arising from the word "lot"

The phrase "lot or block on a registered plan of subdivision" has a technical meaning that cannot be ignored. The terms "lot," "parcel," and "part" often arise in the description of land, but not every lot, parcel, or part is a "lot" on a registered plan of subdivision. Therefore one cannot always rely on the conveyance of land described as a "lot," "parcel," or "part" being protected under s. 50(3)(a). The following are some examples of land description involving a whole lot that are not the subject of s. 50(3)(a) because they are not whole lots on a registered plan of subdivision:

- the whole or any part of a lot on a concession
- the whole of a "parcel" registered in the land titles system
- the whole of a lot on a registrar's compiled plan
- the whole of a lot on a deregistered plan
- the whole of a numbered "part" on a reference plan.

5.3 Controlling the division of whole lots into part lots: s. 50(5)

If an owner of a whole lot or block on a registered plan of subdivision wants to convey only a part of such lot or block, such a transaction will be contrary to the original pattern of land division created when the plan of subdivision was approved. Subsection 50(5) regulates "part lot" transactions such as this.

Identical in structure to s. 50(3), s. 50(5) prohibits a person from dealing with "a part of any lot or block of the land" where the land is within a registered plan of subdivision, unless the transaction may be brought within one or more of the eight specific exceptions set out in s. 50(5)(a)–(h).

Accordingly, one can rely on the s. 50(3)(a) plan of subdivision exception only if the land being dealt with is the whole of a lot or block on a plan of subdivision. If one is not dealing with the entire lot or block as found on the plan of subdivision, s. 50(3)(a) is of no assistance, and one must proceed to find a further exception from the list in s. 50(5).

Assume that Owner owns the whole of lots 1 and 2 on a registered plan of subdivision as in Figure 2 below. Owner may sell all of lot 1 (that is, the west and east halves) or lot 2 without contravening s. 50(3) due to the combined protection of s. 50(3)(a) (within and described on a plan of subdivision) and s. 50(5) (land is not part only of a lot or block on a plan of subdivision). In either conveyance, Owner would be dealing with the whole of a lot on a registered plan of subdivision.

Figure 2

WEST ½ LOT 1	EAST ½ LOT 1	WEST ½ LOT 2	EAST ½ LOT 2

However, if Owner builds four houses, consisting of one house on each part lot as in Figure 2, Owner could not sell any one of the houses individually without being in breach of s. 50. In the case of each such part lot, even though Owner is dealing with land within a registered plan of subdivision, Owner runs afoul of s. 50(5)(a) because Owner retains ownership of abutting land that is not the whole of a lot or block.

5.4 Exceptions allowing conveyances of part of a lot or block

5.4.1 Clauses 50(5)(a)–(h) and the special case of s. 50(5)(e)

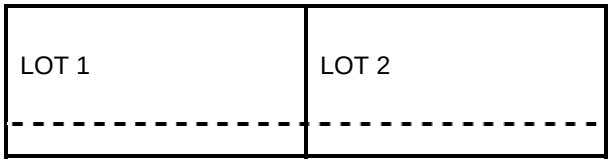
If one wishes to sell or otherwise deal with a part of a lot within a registered plan of subdivision, one must look to s. 50(5) for exceptions to the general prohibition.

The exceptions are essentially the same as those set out in ss. 50(3)(b)–(h). Clause 50(5)(c.1) is essentially the same as s. 50(3)(d.1). To deal with part of a lot or block on a plan of subdivision, one must retain no ownership interest in abutting land, obtain a consent to the transaction, or deal with government.

The novel exception, applicable to transactions on or after August 1, 1983, is s. 50(5)(e), which applies to dealings with the remainder of the lot or block after part of a lot has been "acquired by a body that has vested in it the right to acquire land by expropriation."

Assume that Owner owns all of lots 1 and 2 on a registered plan of subdivision. Owner has conveyed a strip of land from lots 1 and 2 to the municipality for road widening purposes (Figure 3). If Owner later wants to sell the remainder of lot 1 (being the part of lot 1 that was not conveyed to the municipality), the transaction would appear to be prohibited by s. 50(5), which prohibits dealing with part of a lot (in this example, the remainder of lot 1) while retaining ownership of abutting land that is not the whole of a lot or block on a registered plan of subdivision (in this example the remainder of lot 2).

Figure 3



However, Owner will be able to rely on the exception contained in clause (e) to protect the transaction, since Owner will be dealing with all of lot 1 except a portion owned by the municipality, which has the power of expropriation.

5.4.2 Exempting by-law under s. 50(7)

A municipality can pass a by-law pursuant to ss. 50(7)–50(7.5) that exempts specified lands from the part-lot control provisions (i.e., s. 50(5) of the *Act*). In such an instance, part-lot transactions are permitted, since the land is described within a plan of subdivision (a s. 50(3)(a) exception), and s. 50(5) is not applicable. It is

important to review such a by-law to determine the exact parameters of the permission.

6. Statutory responses: new exceptions and closing loopholes

Section 50 contains many subsections that are highly specific in focus. One can come to grips with their effects by classifying them according to two groupings: subsections that plug loopholes, and subsections that create loopholes so that desirable transactions not be caught by the sweeping effect of the prohibition.

6.1 Creating new exceptions

- Subsection 50(8) allows vendor take-back mortgages as part or all of the consideration for the purchase of land, provided that the mortgage applies to all of the land purchased. If the owner of B purchases neighbouring parcel A and gives a mortgage of all of A to his vendor as part of the purchase price, the mortgage would contravene the *Act* since he would be mortgaging A while retaining B. Subsection 50(8) permits this vendor take-back mortgage. Note that the mortgage must be applicable to all of A and the mortgage must be given to the vendor and not to a third party.
- Subsection 50(9) allows leases for any period of years where only "part of a building or structure" is being rented. Ordinarily, a lease of part of a building for a term of 21 years or more contravenes s. 50(3). It is recognized that leases of existing buildings for long terms do not compromise planning principles. The subsection, however, does not consider the effect of the exception on a grant of outdoor rights for more than 21 years (i.e., parking lots, patios) that accompany a lease of a portion of a building.
- Subsection 50(10) allows owners of adjacent lands who wish to co-operate in the building and maintenance of drainage systems to make the necessary agreements regarding easements and mutual rights-of-way, etc., without contravening s. 50.
- Subsection 50(11) allows the Agricultural Rehabilitation and Development Directorate of Ontario to deal with lands acquired separately as individual parcels, despite the fact that they may abut.

6.2 Closing loopholes

The following subsections were enacted over a period of years to close loopholes:

- Subsection 50(15) prevents subdivision of land by means of simultaneous conveyances. This was inserted to prevent schemes whereby the owner would theoretically convey the two halves of his or her land at the same instant, so that at the time of either conveyance he or she could not be said to retain the fee in abutting land.
- Subsection 50(16) prevents partial discharge of a mortgage (i.e., releasing or discharging a part of the land described in the mortgage) by deeming the mortgagee to "hold the fee" in the lands subject to the mortgage and to be "conveying" the part that is the subject of the partial discharge. Subsection 50(17) contains several logical exceptions to the rule.
- Subsection 50(18) requires Ministerial approval for foreclosures and power of sale proceedings where not all of the land that is the subject of the mortgage will be affected, subject to certain exceptions. Otherwise, instead of seeking consent to division, an owner could grant a mortgage to a mortgagee-purchaser, not make mortgage payments, and simply wait for the mortgagee-purchaser to "foreclose" on a pre-arranged portion of the land. The foreclosure order itself is not a prohibited transfer under s. 50(3) and is otherwise effective to divide the parcel. The permitted exceptions are logical, given that planning principles are not compromised.
- Subsection 50(19) prevents joint tenants and tenants in common from changing the ownership of the land through a "release" of one owner's interest as a preliminary to what would otherwise be a prohibited transaction, that is, where the joint tenant or tenant in common is releasing his or her interest so that the adjacent lands will be owned by different legal entities.
- Subsection 50(20) destroys the usefulness of orders under the *Partition Act* for dividing land without consent by requiring consents for such orders unless each part of land described in the order could be conveyed without contravening s. 50.
- Section 50.1, deemed in force July 26, 1990, prevents lands from being divided by will. Any division of land by will creates a tenancy in common in all of the land unless the *Act* has been complied with.

7. Identifying Planning Act contraventions

In order to determine the validity of title to the approximately 35,000 parcels of land in Ontario that are still registered under the *Registry Act*, it is essential that there has been no prior contravention of the *Act* that would have had the effect of preventing the conveyance or creation of an interest in land. Several factors are involved in this investigation.

7.1 The importance of timing

The *Act* has seen an evolutionary change in its provisions. The following constitutes some of the more significant dates of substantive changes in the law under the *Act* that may serve to satisfy objections to title based on a contravention of the *Act*.

June 15, 1967 — Planning Amendment Act, 1967, S.O. 1967, c. 75

Any contravention of the *Act* occurring prior to June 15, 1967, does not have and shall be deemed never to have had the effect of preventing the conveyance or creation of any interest in land. As a result, any alleged contravention of the *Act* regarding land that was then subject to the *Act* is deemed not to have been a contravention. Until June 27, 1970, the *Act* only applied to land if the municipality in which the land was situate had designated by by-law the land as being within an area of subdivision control. For transactions occurring after June 15, 1967, the section is of concern only if a by-law had been enacted prior to the date of the transaction. If there is no such by-law registered against title, one need not be concerned with contraventions of the *Act* until June 27, 1970, when all land in Ontario became subject to the application of the *Act*.

The following examples help one appreciate the timing problem. Assume that a parcel of land was conveyed in the year indicated and the grantor had owned abutting land

(a) No by-law ever passed; conveyance in 1968 — No violation

(b) By-law passed 1960; conveyance in 1968 — Violation

(c) By-law passed 1960; conveyance in 1965 — No violation

(d) No by-law ever passed; conveyance in 1971 — Violation

(e) By-law passed 1969; conveyance in 1968 — No violation

(f) By-law passed 1969; conveyance in 1970 — Violation

May 3, 1968 — Planning Amendment Act, 1968, S.O. 1968, c. 96

Prior to this date, it was permissible to deal with 10 or more acres of land if the vendor retained the fee in 10 or more acres of abutting land. From and after this date, the 10-acre rule was abolished.

June 27, 1970 — Planning Amendment Act, 1970, S.O. 1970, c. 72

A new s. 26 was enacted and made the *Act* applicable to all transactions throughout Ontario. Prior to this date, the *Act* applied only in the event that a municipality had passed a by-law designating the lands as within an area of subdivision control.

Part-lot control provisions were also changed. Prior to this date, land on a plan of subdivision was exempt from the *Act* unless the municipality passed a by-law making subdivision control applicable. The new *Act* reversed the process and made part-lot control applicable, unless the municipality exempted the plan of subdivision from the prohibitions.

December 17, 1973 — Planning Amendment Act, 1973, S.O. 1973, c. 168

Subsections (5b) (now s. 50(16)) and (5c) were added to the *Act* to prevent a partial discharge of a mortgage from being used to avoid the provisions of the *Act*. A person giving a partial discharge of mortgage is deemed to hold the fee in lands mentioned in the mortgage and to retain the fee in the balance of the lands and is deemed to convey the lands mentioned in the partial discharge. The rule does not apply if you are dealing with the whole of a lot or block on a plan of subdivision.

June 28, 1974 — Planning Amendment Act, 1974, S.O. 1974, c. 53

The exception regarding partial discharges was expanded to exclude from the rule partial discharges in respect of land for which a consent to convey has been given or where such land is owned by the Crown. The provision is now found in ss. 50(16)–(17).

Subsection (1a) (now s. 50(2)) was added to deem that land does not abut if it abuts on a horizontal plane only. This permits the conveying of rights in land strata (i.e., the conveying of underground mineral rights) while retaining the ownership of the land itself.

In addition, subsection (4e) (now s. 50(8)) was added to create an exception to the general prohibition and permits vendor take-back mortgages provided that all of the land that is purchased is made subject to the mortgage. Pursuant to the provision, the vendor is required to take the mortgage back, and there might be some question as to the validity of such a mortgage if the mortgage is registered in favour of some other party. Notwithstanding this amendment, *Drewery v. Century City Developments Ltd. (No. 2)* confirmed that the giving back of mortgages did not offend the *Act* in any event, since the section dealt with land-use control and did not cover the situation of contemporaneous sales and purchase-money mortgages given back.

December 18, 1975 — Planning Amendment Act, 1975 (2nd Sess.), S.O. 1975 (2nd Session) c. 18

Subsection (5e) was added to prohibit foreclosures or power of sale transactions without the approval of the Minister unless all of the land referred to in the mortgage is included in the foreclosure or exercise of power of sale. Prior to this amendment, foreclosures, at least, were an effective way of avoiding the statute.

June 7, 1976 — Planning Amendment Act, 1976, S.O. 1976, c. 38

Further amendment was made to the rule regarding foreclosures or powers of sale to permit such transactions where land being foreclosed consists of one or more lots or blocks on a plan of subdivision or a parcel of land that does not abut another parcel of land that is subject to the same mortgage (now s. 50(18)). This provision was deemed to have come into effect on December 18, 1975, by s. 5(2).

December 15, 1978 — Planning Amendment Act, 1978, S.O. 1978, c. 93

Subsection (4d) has the effect of curing contraventions that occurred prior to the registration of a plan of subdivision, a condominium description, or a conveyance made with consent (now s. 50(14)). It is dealt with in greater detail in "The retroactive effect of a consent," below.

Subsection (5f), deemed in force on November 23, 1978, was added to provide that any release by a joint tenant or tenant in common of an interest to one or more of the other joint tenants or tenants in common while retaining the fee in abutting lands is deemed to constitute a conveyance of his or her interest by deed while retaining the fee in abutting lands (now s. 50(19)). This amendment overturns *Re Gerace and Thompson et al.*

Subsection 33(a) of the *Act* was added to require notice to be given to the Minister of Housing in a partition action. Prior to this time, partition orders, being vesting orders and not conveyances by deed or transfer, were excluded from the *Act*'s application. This provision was replaced in 1983 by what is now s. 50(20).

Effective March 31, 1979, subsections (4b)–(4c) (now ss. 50(12)–(13)) were added to provide that where a parcel was created by consent and subsequently it was obtained by an owner of abutting land, a further consent would not be required on a subsequent sale of the same parcel provided the land division committee has not stipulated otherwise. This is often referred to as the "once a consent, always a consent" rule and applies so long as the identical parcel of land conveyed with consent is being dealt with. Refer to the following section for further details.

June 26, 1981 — Planning Amendment Act, 1981, S.O. 1981, c. 15

Partition Act orders require consent, or otherwise each part of the land described in the order must have been conveyable without contravening the section (s. 50(20)).

August 1, 1983 — Planning Act, 1983, S.O. 1983, c. 1

Section 50 was amended to add new provisions regarding

- the ability to convey part of a lot on a plan of subdivision where the abutting land is the whole of a lot on a plan of subdivision (ss. 50(3)(b) and (5)(a));
- the ability to deal with part lots on a plan of subdivision if the only other part of the lot is owned by an expropriating authority (s. 50(5)(e));
- exceptions for Ontario Hydro, transmission lines, and conservation authorities (ss. 50(3) and (5));
- exception for dealings with parts of a building (s. 50(9));
- new exception for simultaneous conveyances (s. 50(15)).

July 26, 1990 — Planning Amendment Act, 1991, S.O. 1991 c. 9 s. 1

The previous loophole permitting land divisions by a will is addressed, and as a result, no provision in any will made before or after July 26, 1990, that purports to divide land is of any effect unless each parcel of land could be conveyed without contravening s. 50. The only exception to the prohibition would be if the testator died prior to July 26, 1990.

December 9, 1994 — Planning and Municipal Statute Law Amendment Act, S.O. 1994, c. 23

Amendments were made to subsection (14) permitting the application of the subsection to mortgages with consent. Subsection (18) was amended to add two further exceptions to the prohibition.

7.2 The subsequent effect of a prior consent: ss. 50(12) and (13)

Prior to March 1979, it was generally held that a consent to convey had no effect on any subsequent transaction and was only effective for the one transaction for which it was sought and given. A consent to convey or mortgage Parcel A validated only that particular transaction in question and conferred no future or subsequent benefit on the parcel.

In March 1979, s. 50(12) was added to the *Planning Act*. Where a parcel of land is conveyed with consent, the prohibitions in ss. 50(3) and (5) do not apply to subsequent conveyances or other transactions involving the identical parcel of land, unless it is stipulated otherwise when the consent is granted.

Figure 4

In Figure 4, assume Parcels A, B, and C are parts of a lot on a concession and that Owner 1 owns parcels A and B and Owner 2 owns Parcel C. Owner 1 conveys parcel B to Owner 2 with consent. Owner 2 later wishes to sell Parcel B to a third party.

In this example, assuming the consent was obtained after March 1979, Owner 2 would be free to convey parcel B without obtaining another consent, since the identical parcel for which a previous consent to convey had been obtained is being conveyed again and there was no stipulation in the earlier consent that it was to be applicable to the first conveyance only. While there have been cases indicating that this section is also applicable in respect of consents granted prior to March 1979, care should be taken in relying on these cases.

It should also be noted that it is only a consent to a conveyance that has this lasting effect. A consent given to a mortgage, for instance, has no lasting or future effect, and s. 50(12) is not applicable. Similarly, where land is divided and one parcel is conveyed away with consent and the remainder parcel is conveyed later, only the consented parcel gets the benefit of the subsection even though the committee granting the consent considered that two new parcels of land were being created. The subsection affords the benefits only on the parcel conveyed with consent. The remainder parcel gets no such protection or benefit.

Note that s. 50(12) applies only where land has been conveyed with a consent. A mortgage with consent confers no future benefit to the property. Subsection 50(14) on the other hand provides a retroactive curing of title where the land is not only conveyed but also charged or mortgaged with consent.

In Figure 4, therefore, where Owner owns Parcels A and B and Parcel B has previously been conveyed with consent, Owner can convey or mortgage Parcel B without concern for the ownership of abutting land because Parcel B was previously conveyed with consent. Although s. 50(12) provides relief, Owner cannot convey or mortgage Parcel A because it was never previously conveyed with consent. Owner would be dealing with Parcel A and own abutting land, and such a transaction would contravene the *Act*. There is no exception under ss. 50(3) and (5) to dealings with land where the abutting land was previously conveyed with a consent.

7.3 The retroactive effect of a consent

Subsection 50(14), effective December 15, 1978, and revised December 9, 1994, provides that "where land is conveyed, mortgaged or charged with a consent ... any contravention of this section or a predecessor thereof ... that occurred ... prior to the conveyance ... does not and shall be deemed never to have had the effect of preventing the conveyance of or creation of any interest in the land." This section appears to make every consent to a conveyance or mortgage curative of all prior contraventions of the *Act* dealing with the land that was the subject matter of the consent.

Note that this subsection also has the effect of curing contraventions of the section occurring prior to the registration of a registered plan of subdivision or a description registered under the *Condominium Act, 1998*. In each case, planning issues would have been dealt with prior to the plan or description so that for planning purposes any prior contravention would seem irrelevant.

The presence of a consent to a conveyance, mortgage, or charge on title can function to erase contraventions prior to the consent, if the consent was granted after December 15, 1978, by virtue of s. 50(14).

7.4 The effect of the three statements: s. 50(22)

The *Land Registration Reform Act* added a new curative provision to the *Act* by providing that if a deed or transfer contains the three statements set out in s. 50(22) by the grantor, the grantor's solicitor, and the grantee's solicitor, any contravention of s. 50 or its predecessors does not and shall be deemed never to have had the effect of preventing the conveyance of any interest in land.

As a result, if the three statements in the deed or transfer are completed, then the chain of title (not all prior transactions but conveyances only) of the property will not be affected by any contravention of the *Act* up to the registration of that deed or transfer and, arguably, any contravention in that conveyance.

Therefore, it appears that if in the course of a title search to a particular parcel of land, one encounters a deed or transfer containing the three statements, one need not search for contraventions of the *Act* prior to that particular conveyance.

7.5 The effect of conversion to land titles

Bear in mind when reading the remaining material that for the vast majority of parcels of land in Ontario which are now in the land titles system, references to chains of title, "start dates," and other *Registry Act* concepts are

meaningless. These concepts pertain only to land registered under the *Registry Act*. All but about 35,000 parcels (which have defective titles and have therefore been left in the registry system) of land in Ontario have been converted to the land titles system.

The process by which lands registered in the registry system have been converted to the land titles system has had a curative effect on breaches of the *Act* that occurred prior to the conversion of the lands to a Land Titles Conversion Qualified Title (LTCQ).

Under the *Land Registration Reform Act*, lands registered in the registry system have been converted to land titles with almost all of the benefits that accrue to a land titles parcel of land. Once land is registered in the land titles system, one is generally entitled to rely on the statement of the title that is shown on the parcel register and, as well, on the qualifications and restrictions set out on the parcel register.

For land registered in the land titles system, the general rule is that one must always review the restrictions and limitations on the land titles parcel, which typically indicates that the land titles title is subject to the liabilities, rights, and interests that are itemized in s. 44(1) of the *Land Titles Act* and which ordinarily do not have to be shown on the registered title. "[U]nless the contrary is expressed on the register," this itemized list of liabilities, rights, and interests includes such items as provincial taxes, certain types of leases, highways, and ss. 50–50.1 of the *Act*.

However, when land is being converted from the registry system into the land titles system, the land is converted with the expressed statement that the land is not subject on first registration as a converted title under the land titles system to s. 44(1)11 of the *Land Titles Act*. The result is that once land is registered in the land titles system as LTCQ and provided that the statement of the title includes the exclusion of the application of para. 11 of s. 44(1), any contravention of the *Act* that occurred prior to the date of conversion is deemed not to have been a contravention of the *Act*.

8. Searching title to abutting lands

8.1 What to search

In order to determine if the property title has any prior contraventions of the *Act* that would nullify the owner's title or the owner's ability to convey or otherwise deal with the land, one must search the ownership of all abutting lands backwards to the first to be encountered in the owner's chain of title of the following possible "start dates," prior to which contraventions of the *Act* are irrelevant:

- the date that the lands became LTCQ and provided that the parcel register specifically excepts s. 44(1)11 of the *Land Titles Act*;
- a transfer or deed with the three s. 50(22) statements;
- the registration of a plan of subdivision (assuming the land is not the whole lot or block and the plan is not deemed "deregistered" under s. 50(4));
- a consent, provided its reliability is assured under ss. 50(12) and (14);
- June 27, 1970, provided that no subdivision control by-law has been passed prior to this date;
- the date of the passage of a subdivision control by-law passed between June 15, 1967, and June 27, 1970; and
- June 15, 1967, if a subdivision control by-law was passed prior to June 15, 1967.

The above dates are significant in that in each case, contraventions of the *Act* for a particular parcel of land are irrelevant if they occurred prior to the most recent start date. Once you determine the start date for your title search, you search the chain of title of all abutting lands from the start date to the present. If no past owner of your land also simultaneously owned abutting land, you can be assured that there has never been a conveyance or other dealing with the land while abutting lands were under the same ownership or control, and therefore you can rely on s. 50(3)(b) as protecting any prior dealings from being contraventions of the *Act*.

Where similarity of ownership arises at the time of a conveyance or other transaction, you must look to the other exceptions or otherwise requisition compliance.

8.2 Considerations when searching for contraventions

Upon discovery of what appears to be a contravention of the *Act*, a review of the following questions may make it disappear:

- Has any conveyance included the three statements for which provision is made in s. 50(22)? If so, the chain of title cannot be affected by any contravention of the *Act* occurring at any time up to the registration of this conveyance and, arguably, by any contravention in that conveyance itself.
- Did the transaction involve the whole of a lot or block on a registered plan of subdivision? If it did, there is no contravention of s. 50. Given the scheme of exemptions, there is no need to search abutting lands where only the whole of a lot or block on a plan of subdivision is involved, since it is absolutely exempt unless a municipality has passed a by-law "deregistering" the plan pursuant to s. 50(4). Note: pursuant to s. 50(14), once a plan of subdivision has been registered, any contravention of the planning

legislation that occurred prior to the registration is declared not to prevent the conveyance or creation of an interest in the land. This appears to indicate that one need never search behind the registration of a plan of subdivision.

- Has any conveyance, mortgage, or charge been made with a consent? If so, the consent may have several consequences. Any contravention of s. 50 that occurred before the registration of the consent can be ignored as cured, except to the extent that a court order regarding such contravention was made before December 15, 1978. If you are dealing with land that appears to involve a contravention of the *Act* occurring after a transfer with consent, as long as you are dealing with a parcel of land identical to that which was the subject matter of the consent, such contravention may be inapplicable because of s. 50(12).
- Has a certificate of title been registered on the land pursuant to s. 13 of the *Certification of Titles Act* (which was repealed in 2009)? If so, such certificate of title is conclusive that the owner's title at the time of the registration was absolute, subject only to exceptions mentioned in the certificate. As a result, such a certificate will cure all prior defects.
- Did it occur between June 15, 1967, and June 27, 1970? If so, has a subdivision control by-law been passed prior to the alleged contravention? If none was passed prior to the date of the transaction in question, the *Act* will not apply. If a by-law was previously passed, the *Act* would be applicable.
- Is the date of the contravening conveyance or transaction prior to June 15, 1967? All contraventions of the *Act* occurring prior to June 15, 1967, were cured by statute.
- If a review of the above questions has failed to resolve a suspected contravention, one must attempt to fit the transaction within one of the s. 50(3) exceptions, the most notable being the "no abutting lands" exception.

There have been many amendments to the *Act* since 1967, especially since the Legislature has struggled to close loopholes. A transaction that appears to be a contravention under the current version of the *Act* may not have been prohibited under the legislation in force when it was completed. Therefore, one must consider the effective dates of the amendments, as well as case law, in order to determine the validity of a transaction according to the form of the legislation or the common law at that earlier time.

Chapter 50
The survey

1. What is a survey?

The only document that can be called a "survey" is a two-part report prepared by a qualified Ontario land surveyor pursuant to the *Surveys Act*. The report must bear the seal of the surveyor. A survey describes the quantity of the title the client is dealing with.

The survey consists of a plan showing the features of the land, such as buildings, fences, improvements, and natural features, and a written report (often endorsed on the plan) indicating any encroachments or other problems revealed by the surveying process. It also will disclose the extent of title by showing the frontage, depth, and area occupied. The location of the land relative to adjoining property will also be shown.

It is extremely important to remember that a survey is similar to a photograph, in that it represents the property at a specific point in time, namely, the date of preparation shown on the survey. Any feature shown on a survey could change or be eliminated immediately following the preparation of the survey. For example, fences could be relocated, additions could be made to buildings, or buildings could be demolished and new ones constructed. The older a survey, the more suspect its accuracy.

It is common practice for purchasers and mortgagees to accept surveys that are not current provided a vendor or mortgagor provides a declaration that the survey still accurately represents the property and its features (usually buildings) and that no new buildings, decks, patios, pools, etc., have been erected since the date of preparation of the survey. While it is understandable that parties wish to save the cost of a new survey, this practice should be treated with caution. In the first place, such declarations are self-serving when made by vendors or mortgagors, and in most cases the deponent is not qualified to make such representations or statements. If this practice is followed, it is advisable to obtain a client's written authorization to obtain and rely on such a declaration. Mortgage institutions often set out their requirement with respect to a survey in their initial instructions to solicitors.

There are many different types of sketches or plans that also describe the quantity of title, and the solicitor must be aware of this when deciding whether what has been provided is suitable. Some sketches or plans may show the foundation of a building, whereas the client may be purchasing a completed building. Various overhangs or protrusions may have the effect of causing a breach of zoning regulations, and of course, this would not be disclosed by a foundation plan. A reference plan is generally used for registration purposes. Instead of land being described by way of a metes and bounds description, it will be described as a part on the reference plan. This procedure is often followed where land is newly severed or where the registry office personnel will not accept an existing complicated or difficult metes and bounds description. While buildings may be depicted on a reference plan, it may not be a suitable document to rely upon for purposes other than boundary location. Site plans, building permit sketches, plot plans, and many other plans may be offered, but solicitors should be on guard to accept nothing less than a properly prepared and current dated survey.

Solicitors should also note that the making of copies of a survey without the surveyor's consent is an infringement of copyright. More importantly, the surveyor would likely not be liable for errors in the survey either on the basis of negligence or contract where the injured party has relied upon a photocopy of a survey originally prepared for someone else.

Finally, it is clear that while a review of the registered title and other documents will allow the solicitor to determine the quality of title, only a surveyor can determine the extent or quantity of title. Until both are available, a solicitor should not provide an opinion as to title, or if an opinion is offered, it must be qualified accordingly.

2. No survey available

If a survey is not available, it is advisable for the solicitor to send a letter to the client advising that a survey is not available and that one should be obtained. The letter should set out the matters that can only be assessed with the benefit of a survey. The client's instructions to proceed without a survey, notwithstanding the solicitor's advice, should be obtained in writing. There is case law to suggest that a solicitor's standard practice should include a warning to clients of the dangers of proceeding with a transaction in the absence of a survey (*Case Lac Mortgage Company v. Tolton*).

3. Reviewing a survey

We now focus on the survey itself and review the various features and its implications for the solicitor. Before proceeding, it is worth noting that, as with all aspects of the transaction, the solicitor has an obligation to exercise care in reviewing the survey. This obligation is clearly expressed in the case of *Nielson v. Watson et al.*

The survey should always be reviewed with the client, either in the solicitor's office or by sending a copy to the client. Clients can often point out discrepancies between features on older surveys and current features. The client may also know about encroachments, rights of way, and easements that are either not shown on the survey or have not been observed. Mortgagees should be advised of any matters revealed by the survey; particularly those that, in the opinion of the solicitor, will affect value, marketability, or title. Again, reference to mortgage instructions will often provide an outline of what is expected of the solicitor in this regard. As with any client, written instructions should be obtained from mortgagees in appropriate circumstances.

3.1 Boundaries/fences

Start with the apparent boundaries of the land. This may often be the lot limits shown on a plan of subdivision. The survey will show these boundary limits and then detail the location of fences, which often do not follow the boundary. If the fence is inside the boundary, it may indicate that the adjoining owner occupies a portion of the land being purchased or mortgaged. If the fence is located outside the boundary, it may indicate that the vendor or mortgagor occupies a portion of the neighbour's land. In most cases the discrepancy between fence and boundary lines is *de minimis*, in other words, small, and clients will authorize the solicitor to proceed without objection to the discrepancy. Where the discrepancy is substantial or of particular concern to the client, the true boundary line must be determined. It may be that the registered title incorrectly describes the boundary. Alternatively, the fence may not be on the proper line, and the registered title may be accurate. Subject to obtaining instructions from the client with respect to costs, the lawyer should obtain a surveyor's assistance in making this determination rather than taking the position that the adjoining owner should give up title to an appropriate strip of land. The survey generally indicates the location of stakes, usually at the lot corners, which have been used by the surveyor in determining distances, angles, and so on. While the client may not be concerned with the small deviations between fence and boundary lines, it is worth noting that there would be some cost and inconvenience should a dispute arise between adjoining land owners culminating in one party being forced to relocate the fence to the proper line. Should the discrepancy be serious, the parties may be able to negotiate and mutually agree upon an abatement in the purchase price. If the discrepancy has a major impact on the purchaser's declared use for the property, the purchaser may have a legitimate basis for ending the transaction. A major discrepancy may effect a lender's decision to lend, and written instructions must be sought in this regard.

Do not always assume that strips of land involved in such encroachments belong to the occupier who can invoke the rules of possessory title. In the first place, these rules may not apply to lands subject to the *Land Titles Act* nor might they apply to lands owned by the Crown or municipalities. Further, possessory title is often not available because the applicable parts of the test cannot be met. With respect to the quality of possession, there are six parts to proving adverse possession. The possessor must prove that the possession is actual, continuous, open, visible, notorious, and exclusive. The proof of the claim can fail for any part of the test or for general equitable principles. A solicitor can assist through the title search and other investigations such as speaking with adjoining owners in assessing the merits of a possessory claim.

3.2 Buildings/structures

The location of buildings and other structures as shown on the survey is extremely important for a number of reasons.

3.2.1 Zoning

Municipal by-laws usually provide for minimum setbacks from street lines, minimum clearances from sides of buildings or foundation walls to lot lines or boundaries, maximum lot coverage by buildings (that is, the number of square metres the building can be relative to the size of the lot) and many other standards and requirements. This information may be obtained by making a simple enquiry of the municipality and submitting the appropriate fee together with the survey to obtain this information. Some municipalities will not comment on surveys. In this case, the appropriate sections of the zoning by-law can be reviewed. It is often discovered that older buildings do not conform to the current zoning by-law because they were built before the by-law was enacted. Such situations are known as "legal non-conforming" uses. However, this status is only available where there is appropriate evidence that the non-compliance existed pre-by-law and continued uninterrupted to date. The same rules apply as to use of buildings.

3.2.2 Utilities/rights of way

If a building encroaches upon a right of way or utility easement, it will be necessary to secure the consent of the party enjoying the benefit of the easement to allow it to continue. Utility commissions and municipalities will usually either issue such consent letters or require the landowner to enter into an encroachment agreement, which has the same legal effect but often includes a provision requiring the encroachment to be removed upon demand. This approach is often used where the encroachment is onto a public street or highway.

3.2.3 Adjoining land

The building may actually straddle the boundary with adjoining land, and of course, the only proper way to deal with this major problem is to acquire title to the land under the building from the adjoining owner. In addition, it would be necessary to acquire sufficient land to allow access to maintain the walls of the building. This should either be an outright purchase or an easement. If this course becomes necessary, it should be remembered that the *Planning Act* requires a consent to sever the land in question, and a reference plan of the area will need to be prepared and registered. Costs for such an exercise can be considerable. In the case where a *Planning Act* consent is required in order to remedy the situation, the purchaser's lawyer should requisition that the vendor obtain the consent at his or her own expense, and this should be done before closing. The agreement of purchase and sale may need to be amended in order to accommodate this situation. The purchaser's lawyer must get the client's instructions with respect to these issues.

Where a building on an adjoining property encroaches upon the property being purchased or mortgaged, the ideal remedy is for the building to be removed. This option is rarely available, and a purchaser will often require an abatement in the purchase price accompanied by an acknowledgement from the adjoining owner that title is not claimed with respect to the land under the encroaching building.

3.3 Public access

It is extremely important to ensure that the property enjoys the benefit of access to a public street or highway. It is often necessary to review the survey in conjunction with a subdivision plan to ensure that such access is available. Typically, in an attempt to control access to uncompleted subdivisions, municipalities will demand that strips of lands at the end of streets be created, called "reserves," and then be transferred to the municipality. Often these strips are only one foot wide but they have the technical legal effect of denying access from the subdivision to a public highway. Occasionally there will be a reserve across the front of a lot. In these circumstances, it is necessary to ensure that the municipality passes a by-law dedicating these reserves as a public highway (unless that was already done by the subdivider and endorsed on the plan).

3.4 Comparison

Compare the information shown on the survey with that obtained from the agreement of purchase and sale, title search, municipal searches, and comments made by the client. Discrepancies can be found in lot measurements, type of buildings, accessory buildings, etc. If the client commented that additions or a pool are contemplated, look at the survey to see if utility easements or other features will prevent or impede such plans.

4. Remedies

The appropriate remedy to be followed when dealing with issues arising out of the survey will, of course, depend in large measure upon the nature of the problem, the extent of the problem, and the client's wishes. A brief review of the various remedies follows.

4.1 Variance applications

Where minor breaches of zoning by-laws are noted or where the solicitor is not satisfied that a property enjoys legal non-conforming status, an application may be made to the appropriate authority to allow these breaches to continue and, in effect, legitimize them. Obviously, a purchaser will insist that an application for a variance from the appropriate by-law be done by the vendor at no expense to the purchaser prior to closing.

4.2 Acknowledgement

Where the encroachments are minor, a simple written acknowledgement from the person enjoying the benefits from them can be sufficient.

4.3 Abatement

Many discrepancies found on the examination of a survey are extremely minor, and the clients do not want any action taken. However, where the discrepancy has nuisance value and the clients want to close, the appropriate remedy may be an abatement in the purchase price. When the problem is of a more serious nature (for example, the client cannot install a swimming pool because the backyard is too small), again, an abatement may satisfy the clients. Obtain the client's instructions as to the range of abatement sought and negotiate accordingly. Obviously a vendor may be quite hesitant to grant any abatement for such minor matters. Abatements are not rights that can be enforced, they are merely an option for a negotiated settlement.

4.4 Extend closing

While it may be possible to solve a problem arising from a review of the survey prior to closing, sometimes more time is required to reach a party to obtain a signature or to negotiate terms. In these circumstances, ask the other solicitor for an extension of the closing date. Rather than take an undertaking for something to be done after closing, mutually agree to extend the closing to a date where the problem may be resolved. Make sure that extensions are authorized by the client in writing and are to definite, fixed dates. The lender's consent must similarly be obtained to any extension of closing.

Several statutes and procedures can assist in resolving difficulties discovered from reviewing the survey. Some examples are the *Vendors and Purchasers Act*, the *Planning Act*, the *Boundaries Act*, and the *Land Titles Act*.

4.5 Line Fences Act

This statute allows fence disputes to be resolved by municipal appointees. The *Line Fences Act* does not apply in areas where municipal council has passed a by-law under the *Municipal Act, 2001*. In that case, that specific by-law will govern. The process, which is set out in the *Line Fences Act*, is an arbitration conducted by fence-viewers.

4.6 Title insurance

Title insurance has provided the real estate lawyer and his or her clients with insurance coverage for survey-related issues or where no survey exists. Where there is insufficient time to obtain an up-to-date survey or the client simply wishes to avoid the expense of a new survey, consideration can be given to the cheaper alternative, a title insurance policy. The instructions from many institutional lenders today provide for acceptance of such policies in lieu of a survey. However, the practitioner should approach this area with caution. In the first instance, make sure the client appreciates that title insurance does not solve any problems but merely provides coverage against financial loss. Further, your opinion as to title should be qualified to the extent that you cannot comment as to encroachments, zoning compliance, or anything else that would have been disclosed by a survey. In addition, it is obviously necessary to ascertain exactly what the title insurance product selected covers. Finally, written instructions from the client to accept this alternative along with an acknowledgement that it only "papers over" any problems are an absolute necessity.

Chapter 51
Requisitions

1. Introduction

After completion of the title search, return of letter enquiries, and completion of all off title searches, all in a timely manner, the purchaser's lawyer would then write a letter to the vendor's lawyer, requesting the rectification of various defects in title, as well as any other problems that the purchaser's lawyer feels need to be resolved in accordance with the terms of the agreement of purchase and sale. The language of law is unique and precise, and the letter of requisitions must be clear and unequivocal.

The requisitions must be submitted in a timely manner, as stated in the agreement of purchase and sale. If the purchaser's lawyer misses the time, the purchaser has foregone any rights to make any complaints about title. Root of title and conveyancing requisitions are exceptions to this statement.

2. Types of requisitions

There are three kinds of requisitions:

- title;
- conveyancing; and
- contract.

2.1 Title requisitions

2.1.1 Ordinary title requisitions

These are requisitions that have arisen as a result of your review of title. Any such requisition must be submitted within the time noted in the agreement of purchase and sale. In the Ontario Real Estate Association (OREA) agreement of purchase and sale form, this is located in para. 8. Unlike some previous real estate board agreement forms, this paragraph limits the submission of requisitions not only to a specific date but also to a specific time of day. If, for some reason, the date has not been noted on the agreement, the date is set to be 30 days after acceptance by s. 4(b) of the *Vendors and Purchasers Act*.

Example:

> The search of title reveals that a spousal statement was not completed on a deed registered 10 years ago on the subject property.

Example:

> A Transfer/Deed describes the Transferor as John G. Blue. When John purchased the property, the Transfer/Deed set out his name as John George Blue.

Example:

> There is a telephone easement registered against title to the subject property that was not disclosed by the Agreement of Purchase and Sale.

This category of requisition encompasses any matters that you discover on the registered title of a seller that, while not fatal to the transaction, give cause for concern.

2.1.2 Root of title requisitions

Root of title requisitions pertain to issues that, if not satisfied, result in the seller not conveying what was originally agreed upon. These requisitions may be submitted up to the completion of the transaction, and this is the exception to the rule that missing the requisition deadline foregoes the buyer's rights to make further complaints about title.

Example:

> The title search reveals a breach of the *Planning Act*.

Example:

> A corporate search reveals that a prior corporate owner on the title was at the time of its conveyance dissolved, and therefore, the property had escheated to the Crown.

In both of the foregoing examples, the seller is unable to convey title.

2.2 Conveyancing requisitions

The satisfaction of conveyancing requisitions are within the control of the seller. The buyer has a vested right to require compliance through the acts of the seller or a third party. These requisitions may be submitted up to completion of the transaction.

Example:

> There is an old mortgage registered on title that appears to have been paid in full, but no discharge has ever been registered.

Example:

> There is registered on title in the land titles office a temporary right in the nature of an easement that has expired.

In the foregoing examples, the seller is able to obtain a discharge (because the mortgage has been paid in full) in the first case and may actually register an application to delete the right in the second case.

2.3 Contract requisitions

The agreement of purchase and sale determines requisitions on the matter of the contract. Therefore, these must be submitted within the time period specified in the agreement. If there is no time set out in the agreement, then the time for submission is up to the completion of the transaction.

There are a number of different contractual requisitions.

Example:

> A reply to an inquiry regarding work orders has been received. The relevant authority advises that there are a number of outstanding work orders.

Example:

> The Agreement of Purchase and Sale provides that the property has a frontage of fifty feet (50') by a depth of one hundred and twenty feet (120'). A review of the survey reveals that the property actually has a frontage forty-three feet (43') by a depth of one hundred and ten feet (110').

The OREA agreement of purchase and sale provides for two separate time periods relating to certain searches. The first is the time to examine title. This is referred to as the "Requisition Date." The second is a period extending for 30 days beyond the Requisition Date or when all the conditions in the agreement have been fulfilled or waived and in no event later than five days prior to the date of completion. These searches include a search of work orders or deficiency notices, whether the present use may be lawfully continued, and whether the property is insurable against risk of fire.

In addition to matters that arise as a result of enquiries with third parties such as local authorities, the agreement provides for a number of issues that the buyer may insist upon from the seller. One is the entitlement to a survey. The agreement provides in para. 12 of the OREA form that the buyer is entitled to any title documents including a survey if in the possession of the seller. The paragraph goes on to state "if requested by the buyer, seller will deliver any sketch or survey ... as soon as possible and prior to the Requisition Date."

Paragraph 16 of the OREA form provides that "if requested by buyer, seller covenants" the statements contemplated by s. 50(22) of the *Planning Act* will be completed.

In order to activate these provisions of the agreement of purchase and sale, it is necessary to include the requests in a letter of requisitions. These requests should be made at the time the file is opened or when the other requisitions are submitted.

While the contract provides that the "title to the property is good and free from all registered ... charges, liens, and encumbrances" and that this obligation lies with the seller, courtesy dictates that the buyer's solicitor notify the seller or the seller's solicitor if there are any outstanding charges, liens, and encumbrances registered on the title.

3. Construction of the requisition letter

There are certain rules that a solicitor must follow in preparing a letter of requisitions. If the rules are not followed, there may be severe implications for the client that you had not anticipated or intended. It is important to realize that all the agreement forms contain an annulment clause permitting the transaction to be terminated. Therefore, when submitting requisitions, it is imperative that the lawyer allow for the possibility that he or she will change position on the matter being submitted.

A requisition letter should begin as follows:

> I act as solicitor for the buyers herein and understand that you act on behalf of the sellers. Without prejudice to my clients' rights under the terms of the Agreement of Purchase and Sale, I wish to submit the following requisitions.

This affords the opportunity to revise the lawyer's position on a matter.

The next portion of the requisition letter should refer to those matters that require the attention of the seller and his or her solicitor. It should be noted that a large number of requisition letters are of a general nature. In an attempt to blanket all the possibilities, these requisitions are structured to be vague and all encompassing. In that regard, the decision of *Stykolt v. Maynard* should be noted:

> A reading of this letter, it seems to me, makes it very clear, not only that its author was in complete ignorance of the title, but also that the letter was written without any reference to the actual agreement between the parties. *I am not able to find in it any "valid objection" to the title of the lands in question.* (emphasis added) (at 254)

One is not to structure a requisition letter so that the seller's solicitor is then required to search title. That is the buyer's solicitor's obligation.

In addition, it is mandatory that communication of any requirements must be clear and understandable. At a later date someone else may be reviewing your requisitions, namely, a court.

Each requisition commences by outlining the facts that cause the requisition to arise. These "facts" are to be sufficiently detailed so that anyone who has not investigated the title or other problem raised will be able to determine without any further enquiry exactly what the issue is. Once the lawyer has outlined the facts, the lawyer then proceeds to request specific relief.

The relief demanded should be the best possible solution to the requisition. It is not appropriate to offer alternatives unless they are equally satisfactory. The seller is entitled to choose between alternatives when they are offered.

Based on the foregoing, the requisition letter should first address those matters of title that the seller, or the seller's lawyer, is to direct their attention to. These are to include defects or clouds on the title and matters that will prevent the transaction from being completed. Examples of these are demands respecting documents that are deficient.

Example:

(1) Instrument No. 1234565 is a Transfer from Jane Smith to Joan Brown registered on the 5th day of October 2005. It contains a restrictive covenant that expires five years from the date of registration.

REQUIRED: On or before closing, registration of an application to amend the register to delete the said covenant.

Example:

(2) Instrument No. 987654 is a Lease between Company A and Company B registered July 12, 1985. The Agreement of Purchase and Sale does not call for the assumption of this lease.

REQUIRED: On or before closing, a release of the said lease from title.

At this point in the letter, it is appropriate to set out any outstanding mortgages, liens, or other encumbrances. Most standard form agreements of purchase and sale are set up to provide for acceptance of the seller's solicitor's undertaking to obtain and register the discharge for any Charge/Mortgage of an institutional nature. However, one is to accept the undertaking only if a discharge is not available. If the Charge/Mortgage is not within the discharge parameters provided for in the agreement, the buyer's solicitor must insist upon a discharge being registered by closing.

Example:

(3) Instrument No. 567980 is a Charge/Mortgage of Land from Walter Green, as mortgagor, in favour of the Bank of Ontario, as mortgagee, registered the 5th day of March 1992.

REQUIRED: On or before closing, registration of a good and valid discharge in accordance with the Agreement of Purchase and Sale.

(4) Instrument No. 567981 is a Charge/Mortgage of Land from Walter Green, as mortgagor, in favour of Jane Brown, as mortgagee, registered on the 5th day of March 1992.

REQUIRED: On or before closing, registration of a good and valid discharge. Kindly note that this is not an institutional Charge/Mortgage as set out in the Agreement of Purchase and Sale, and we must insist upon the discharge being registered on or before closing.

The next portion of the letter to the seller's solicitor should communicate requests that do not relate to title but which are required to complete the transaction.

If the manner in which title is to be taken has not been communicated, the next portion of the letter should address that question.

If more than one individual is taking title to the property, the lawyer must indicate if title will be held as joint tenants or tenants in common. The difference is the right of survivorship. In a joint tenancy, in the event of the death of one of the joint tenants, the other joint tenants take automatically by right of survivorship. In a tenancy in common, each co-owner takes title as to a specific percentage of ownership, always totalling 100%. In the event of a co-owner's death, the deceased co-owner's interest is dealt with by the rules of estate law and does not automatically transfer to the remaining title holders by right of survivorship. In the event the designation is missing, in accordance with s. 13(1) of the *Conveyancing and Law of Property Act*, the owners will be deemed to be tenants in common.

Example:

(5) Would you kindly provide a draft Transfer engrossed as follows:

GREEN, Mary — date of birth — June 3, 1966

GREEN, John — date of birth — May 1, 1963 as joint tenants

The address for service of the transferees will be the property.

For both the registry and land titles systems, rules apply as to how parties should be described. Individuals must be described in the following order:

– surname;

– first name in full, and
– another given name, if any, in full.

If there are certain forms that you wish to have executed by the seller, these should be included at this time.

Example:

(6) **REQUIRED:** the enclosed Undertaking, Declaration of Possession, Warranty respecting Urea Formaldehyde Foam Insulation, and Bill of Sale executed and delivered on closing.

Next, if there has not been any correspondence on matters to be requested, provide for those matters that the agreement requires the seller to provide upon request.

(7) **REQUIRED:** delivery of such documents of title that may be in the possession of or under the control of the sellers.

(8) **REQUIRED:** a survey of the subject property as required under the Agreement of Purchase and Sale.

(9) **REQUIRED:** pursuant to the Agreement of Purchase and Sale, a Transfer with the appropriate *Planning Act* statements completed.

(10) **REQUIRED:** a statutory declaration that the sellers are not non-residents of Canada within the meaning of s. 116 of the *Income Tax Act* pursuant to the Agreement of Purchase and Sale.

The letter of requisitions should end with the following:

> I reserve the right to make such other and further requisitions as I may deem necessary.

In so doing, if an additional matter arises that was omitted in the original letter, it may be submitted later on. In the absence of this reservation, the buyer's solicitor may be precluded from making any further requisitions.

It should be noted that there is one more opportunity to submit requisitions. This occurs when fresh or new matters have arisen after the time of requisitions has passed, but before closing.

Example:

> The local authority issues a work order after the time for searching for work orders has expired.

If this issue did not arise when the time set for the requisitions had expired, the buyer's lawyer may submit it later.

Finally, and most importantly, it should be noted that the letter of requisitions is to be in the hands of the seller or the seller's solicitor within the time set out in the agreement of purchase and sale. It is not enough to mail it out before the Requisition Date; the seller or the seller's solicitor must receive it no later than the time for submitting requisitions as stated in the agreement of purchase and sale.

There have been cases where the seller has not retained a lawyer during the deadlines set for submitting requisitions. In that situation, the buyer's lawyer should make all efforts to inquire of the real estate agent involved in order to ascertain if a lawyer has been retained. If no lawyer has been retained, in order not to miss the requisition deadline, the buyer's lawyer may want to send the requisition letter by courier to the vendor directly, as well as to his or her agent. The buyer's lawyer will indicate in the accompanying letter that as a result of the seller not retaining a lawyer within the period set for the requisition date, he or she is submitting the requisition letter to the seller directly and requesting that a lawyer be retained immediately. This will in most cases ensure that requisitions are dealt with once a lawyer is retained and not denied just because one was not available.

4. Replying to a letter of requisitions

The reply to a letter of requisitions is also very important. Once again, it is possible that a third party, possibly a court, will review the reply. In that respect, answers must be suitable and, on issues that may be contentious, offer a reasonable solution.

The seller has certain rights under the agreement of purchase and sale and may be able to terminate the transaction without any liability. Therefore, it is important to safeguard those rights.

It is suggested that a reply to a requisition letter commence as follows:

> I acknowledge your letter of requisitions dated May 1, 2010, and received in our office May 3, 2010. Without prejudice to my clients' rights under the Agreement of Purchase and Sale and without admitting the validity of your requisitions, I would reply as follows using your numbers as a reference.

Requisitions of the buyer that are of a general nature or of matters that should be investigated or can be satisfied by the buyer's solicitor are answered:

> Kindly satisfy yourself.

Requisitions that require a specific reply are ones that disclose or appear to disclose the necessity for the seller's solicitor to prepare or obtain documents beyond the standard documentation prepared in the sale transaction of the property. Requisition 1 states:

(1) Instrument No. 1234565 is a Transfer/Deed from Jane Smith to Joan Brown registered on the 5th day

of October 2005. It contains a restrictive covenant that expires five years from the date of registration.

The reply:

(1) Please find enclosed a draft application to amend the register. I shall register same on title on closing. The restrictive covenant will be deleted from title.

It is imperative that your reply to requisitions be done as expeditiously as possible. The solution you suggest as satisfactory may not be acceptable to the buyer's lawyer, who may offer another solution to the requisition. The seller and his or her solicitor must act in good faith and make every reasonable effort to satisfy a requisition. Sources of answers to requisitions can be found in a variety of places. Ask the vendor to produce old title documents, which may have been included in a reporting letter from the time of acquisition. Neighbours can be interviewed, and the title search itself may contain answers or building blocks to find a solution. Inquiries can be made to appropriate government authorities. The lawyer must be resourceful in looking for solutions.

Discharges of mortgages should be addressed as required by the agreement of purchase and sale. The OREA form makes specific provisions for attending to a discharge of a mortgage of an institutional nature. Requisition 3 states:

(3) Instrument No. 567980 is a Charge/Mortgage of Land from Walter Green, as mortgagor, in favour of the Bank of Ontario, as mortgagee, registered the 5th day of March 1992.

The reply might be as follows:

(3) I do not anticipate that a Discharge of this mortgage will be available on closing for registration. In the alternative, please find enclosed a copy of the Discharge Statement from the Bank of Ontario, together with my draft form of undertaking to obtain and register a discharge after closing. I shall direct from the proceeds on closing sufficient funds to obtain the said discharge.

Where a discharge must be available on closing, there is no choice but to make arrangements for the Discharge to be registered on closing.

The reply to the letter of requisitions should always be concluded with:

We respectfully deny your right to make any further requisitions.

4.1 Annulment clause

The annulment clause in the agreement of purchase and sale provides that if the buyer submits requisitions that the seller is "unable or unwilling to remove, remedy or satisfy or obtain insurance" against, then the agreement is over. The seller is able to terminate the transaction if there is a requisition that the seller is unable or unwilling to remove, remedy, or satisfy, and if the buyer is unwilling to waive this requisition, then the agreement is over. It should be noted that this annulment capability is in reference to the searches and problems or requisitions arising from those searches and is provided for in para. 10 of the OREA agreement of purchase and sale. The seller is not entitled to exercise the right to terminate the transaction in a capricious and arbitrary manner (*Freedman v. Mason*).

5. Solutions

As noted above, the requisition letter is to demand the best possible solution to a concern or a problem. However, in many instances, the best answer to a problem may not be available. In those circumstances, other solutions may be available that will adequately address the situation.

Please note that due to electronic registration, certain solutions, such as correcting deeds, quit claims deeds, and deposits on title, are no longer applicable. Depending on the situation, the appropriate method of resolution that will comply with the electronic registration system must be used.

5.1 Statutory declarations

On occasion, documents on title require additional support in the form of a statutory declaration to confirm their veracity. In addition, these are used to connect the owner of the property who is registered on title with the person who is purporting to convey (i.e., a person who took title in one name, later married, and transferred title in another name). A statutory declaration deposing to the circumstances of the marriage would be sufficient to connect the two.

In circumstances where there is an estate and information has to be provided to show compliance with the *Estates Administration Act*, a statutory declaration would be appropriate to set out details surrounding the right to transfer.

Where a search with the sheriff reveals judgments outstanding against the seller or debtors with identical or similar names to the seller, depending on the amount outstanding, a statutory declaration by the seller setting out the facts of the writ and the fact the seller is not one and the same person as the judgment debtor is utilized in some instances to clear the problem. If the amount exceeds the threshold set by the land titles or registry office, it will be necessary to obtain a solicitor's affidavit or a letter from the creditor stating that the debtor is not one and the same as the client.

A statutory declaration may also be used to state that the seller is not a non-resident for the purpose of s. 116 of the *Income Tax Act*. The statutory declaration should provide that the seller will not be a non-resident as of the date the declaration is signed and sworn and as of the completion of the transaction.

Thus, a statutory declaration can be utilized in a wide variety of situations to address and rectify problems that might otherwise hinder the completion of a transaction.

Reference should be made to the *Commissioners for taking Affidavits Act* for the procedure to follow. Section 9 sets out that the declaration or oath shall be taken in the presence of the commissioner, the commissioner must satisfy himself or herself as to the genuineness of the signature of the declarant or deponent, and the commissioner shall administer the oath prior to signing the jurat or declaration.

5.2 Declaration of possession

This document is one that should be obtained on every transaction where the property is registered under the *Registry Act* and for those properties that are Land Titles Conversion Qualified. The entitlement is contained in s. 5(1)1.iii of the *Land Registration Reform Act*, which obliges the transferor to execute such further assurances of the land as may be reasonably required. Since land registered under the *Registry Act* may be subject to prescriptive rights or claims of adverse possession, a buyer is entitled to know that there are no such claims.

The "declaration of possession" will set out the fact that there have not been any claims made against the registered owners during the time of their ownership. It is possible to join together successive periods of ownership from previous owners to the period of ownership of the current owners. The purpose is to arrive at a period of 10 consecutive years to obtain the protection of the *Real Property Limitations Act*.

This document has been used to clarify misdescriptions on deeds, encroachments of fences and structures, and a variety of other problems that may arise in the process of completing a transaction.

5.3 Vendors and Purchasers Act

Section 1 of the *Vendors and Purchasers Act* provides that recitals, statements, and descriptions of facts that are 20 years old or older are sufficient evidence of the truth of such facts unless there is evidence to the contrary. This has been used in a number of instances where it would not be feasible to obtain declaratory evidence.

5.4 Construction Lien Act

There are instances where a claimant has registered a construction lien on title. Unless dealt with, these will be inherited by subsequent owners of the property if the claim for lien will be or has been perfected by registration of a certificate of action. A construction lien may be discharged by the registration of a release signed by the lien claimant. A court order may be obtained by payment of moneys into court to vacate the lien and certificate of action, if registered. Finally, the *Construction Lien Act* provides that a certificate of action must be registered on the title within 90 days of substantial performance of the work or supply of materials. In the absence of registration of the certificate of action, the construction lien expires. Where no certificate of action is registered, the answer to a requisition to vacate a lien would be that there is no need to do anything further because the lien is of no effect.

5.5 Discharges of mortgages

5.5.1 Mortgages in favour of chartered banks, trust companies, insurance companies, and companies registered under the Trust and Loan Companies Act (Canada)

The OREA agreement of purchase and sale form provides for the method by which these mortgages are to be discharged. If a discharge is available on closing, then the obligation is to register it on closing. In most instances, that will not be the case, and the OREA agreement form provides that upon delivery of a mortgage discharge statement, an undertaking by the seller's lawyer to obtain and register a discharge within a reasonable time after closing is to be accepted by the buyer if a direction is provided to pay a sufficient portion of the proceeds of sale to the financial institution.

5.5.2 Other mortgages

Mortgages other than those set out in the OREA pre-printed form must be discharged on closing.

5.6 Real Property Limitations Act

There are a number of sections within the *Real Property Limitations Act* that provide remedies for defects on title. Section 25 provides that a dower interest ceases to exist after 10 years. Subsection 43(1) provides that an action on a covenant in a mortgage expires on the later of 10 years after the cause of action arose or the date upon which the person liable on the covenant transferred his or her interest.

5.7 Rules of Civil Procedure

Clause 14.05(3)(d) of the *Rules of Civil Procedure* provides for an application to court for a determination of rights that depend on the interpretation of a deed, will, contract, or other instrument.

5.8 Vendors and purchasers application

If all else fails and there is a difference of opinion between the parties' lawyers that cannot be resolved and where each lawyer believes that his or her position is correct, namely, the buyer's lawyer feels that the answer to a requisition provided by the seller's lawyer is not adequate but the seller's lawyer feels that the answer is in fact appropriate, the parties can take their dispute to a third party. An application can be made under s. 3(1) of the *Vendors and Purchasers Act* (colloquially referred to as a "V. and P. application") to have a judge make such a determination. It should be noted that while any orders obtained on such an application will bind the immediate transaction, they may not be binding upon future transactions on the same property.

5.9 Title insurance

Within the annulment clause of para. 10, there is provision for the seller to obtain insurance to correct a problem. There are instances where the conventional means are unable to rectify a problem. In those circumstances, it may be possible to obtain title insurance to facilitate completion of the transaction. One example might be that it has been determined that the setbacks of the dwelling do not comply. Time will not permit an application to the committee of adjustments for a minor variance. It may be possible to obtain title insurance against this risk in order to allow the transaction to be completed. The insurance company must make specific provision for the problem at hand and be willing to underwrite the risk. Title insurance does not fix this or any other problem. It merely insures over the risk to the purchaser and the lender, and each party must understand that distinction.

Chapter 52
The standard loan transaction

1. Introduction

Most acquisitions of real property are financed by way of a loan to the purchaser. As security for its promise to repay this loan, the borrower/chargor grants a mortgage or charge against its real property in favour of the lender/chargee. This chapter outlines the steps usually taken in such a loan transaction and examines standard clauses in a typical form of charge.

2. Terminology

Section 1 of the *Land Registration Reform Act* (*LRRA*) defines "charge" as that which secures the payment of a debt or the performance of an obligation and includes a charge under the *Land Titles Act* and a mortgage. A "chargor" and "chargee" are, respectively, the borrower and the lender. A charge can be transferred or assigned by one lender to another by a transfer of charge. A "discharge" is defined as a discharge of a charge and includes a cessation under the *Land Titles Act*. You may also encounter references to "mortgagor," "mortgagee," and "mortgage," which are the equivalent terms to "chargor," "chargee," and "charge," respectively, and which were used under the registry system.

When negotiating a loan, the chargor and the chargee will document the agreed upon business terms in a "commitment letter" or "commitment." After the commitment has been finalized, the chargee and chargor will forward a copy to their respective solicitors. An example commitment can be found in Appendix A (all appendices referred to are located at the end of this chapter).

The chargee will also provide instructions to its solicitor setting out the conditions that must be satisfied before the solicitor can advance the loan. Example instructions can be found in Appendix B. Section 2 of these instructions contains the standard provision that a charge must be registered that constitutes a valid first charge subject only to certain approved encumbrances.

3. Legal effect of a charge

The old form of mortgage in the registry system was an actual conveyance of the legal estate in the land subject to

- the mortgagor's right to remain in possession of the land; and
- the mortgagor's right to a reconveyance when the mortgagor had repaid the debt.

In other words, the mortgagor retained the equity of redemption. Subsection 6(1) of the *LRRA* reverses this system and provides that a charge "does not operate as a transfer of the legal estate in the land to the chargee." Rather, a charge is an encumbrance on the legal estate of the chargor.

However, s. 6(3) of the *LRRA* provides as follows:

> **6.—(3)** Despite subsection (1), a chargor and chargee are entitled to all the legal and equitable rights and remedies that would be available to them if the chargor had transferred the land to the chargee by way of mortgage, subject to a proviso for redemption.

The intent of ss. 6(1) and (3) of the *LRRA* is to harmonize the different concepts of the registry and land titles systems by preserving the rights of the chargor and chargee while eliminating the need for a transfer of title.

4. Form of charge

Form of Documents, R.R.O. 1990, Reg. 688, made under the *LRRA*, states that all charges in a non-electronic format must be documented on Form 2. Subsection 20(1) of the *LRRA* states that an electronic document submitted for registration shall be in an electronic format approved by the Director of Titles appointed pursuant to the *LRRA*. Currently, this means an electronic document completed using Teranet Inc.'s Teraview software, a copy of which is found at Appendix C.

Form 2 can be completed in one of three ways:

- Pursuant to s. 4(1) of the *LRRA*, a schedule may be attached as part of the form, containing the terms of the chargee's own standard form of mortgage.
- Form 2 can incorporate by reference a set of standard charge terms that have been filed pursuant to s. 8 of the *Land Titles Act*.
- The one-page form can constitute a complete charge without incorporation of any additional terms but with the implied covenants contained in s. 7 of the *LRRA* (which are set out below).

An electronic charge can also be completed by attaching an electronic schedule of mortgage terms, relying on standard charge terms filed under the *LRRA*, or relying on the implied covenants contained in the *LRRA*.

5. Review of a typical form of charge

The following is a review, on a clause-by-clause basis, of the typical electronic form of charge that can be used in a loan transaction. Generally, identical information is

required for the completion of non-electronic charges and electronic charges. For specific instructions on the completion of electronic documents, including charges, lawyers should consult the Teraview software instruction manuals and training materials.

For this review, a hypothetical fact situation and completed forms are set out below.

Hypothetical fact situation

> January 15, 2006 — Mary Smith borrows $100,000 from Acme Lending Company Limited (Appendices A–D).
>
> March 12, 2006 — The chargee, Acme, transfers the charge to William Brown (Appendix J). Brown gives notice of the transfer to the chargor, Mary Smith (Appendix K), and obtains an acknowledgment from the chargor (Appendix L).
>
> April 16, 2006 — Mary Smith sells the property to David Wood. Wood obtains an assumption statement from the chargee, William Brown (Appendix M), and signs an assumption agreement in favour of William Brown (Appendix N).
>
> June 18, 2006 — David Wood pays off the loan and gets a discharge statement and a discharge (Appendices O–P).

5.1 Electronic form

The following paragraphs comment on the most important elements of the electronic charge.

5.1.1 Properties and interest charged

As noted above, there is one standard electronic form of charge for land. The applicable PIN, legal description, address, and interest being charged must be indicated.

In most instances, the interest charged is the fee simple or freehold interest. It is also possible for a tenant to create a leasehold charge on the tenant's leasehold interest in the property. Leasehold charges should be drafted carefully since they contain a mixture of real property concepts and landlord and tenant concepts. Since the charge will only encumber real property, the issue of adequately securing fixtures and chattels is addressed in other security documentation. For example, an assignment of rents and leases would be used to secure the income generated at the charged property, and a general security agreement would be used to secure personal property located at or used in connection with the charged property.

Pursuant to s. 15(1) of the *Conveyancing and Law of Property Act*, buildings and fixtures are included in any "conveyance of land" unless there is a provision to the contrary. At common law, this included not only such items in existence at the time of the mortgage, but also anything that was later annexed to the property. Therefore, any future additions or installation of fixtures by the chargor were automatically covered by the mortgage for the benefit of the chargee. Since a charge is not a conveyance of land, it is possible for charges to make specific reference to the fact that all present and future fixtures are encumbered by the charge. Language such as the following is sometimes included:

> It is hereby mutually covenanted and agreed by and between the parties hereto that all erections and improvements fixed or otherwise now on or hereafter put upon the said premises, including but without limiting the generality of the foregoing, all fences, heating, piping, plumbing, aerials, air-conditioning, ventilating, lighting and water heating equipment, cooking and refrigeration equipment, window blinds, radiators and covers, fixed mirrors, fitted blinds, storm windows and storm doors, window screens and screen doors, shutters and awnings, floor coverings, and all apparatus and equipment appurtenant thereto, are and shall, in addition to other fixtures thereon, be and become fixtures and an accession to the freehold and a part of the realty as between the parties hereto, their heirs, executors, administrators, successors, legal representatives and assigns, and all persons claiming by, through, or under them and shall be a portion of the security for the indebtedness herein mentioned.

Depending on the transaction, the chargee may also insist on other terms of security (such as a general security agreement) in order to more fully secure its interests.

5.1.2 Fixtures and the Personal Property Security Act

Provisions of the *Personal Property Security Act* (*PPSA*) recognize certain prior rights to such later additions to the land. Section 34 of the *PPSA* provides, in part, as follows:

> **34.—(1)** A security interest in goods that attached,
>
> (a) before the goods became a fixture, has priority as to the fixture over the claim of any person who has an interest in the real property; or
>
> (b) after the goods became a fixture, has priority as to the fixture over the claim of any person who subsequently acquired an interest in the real property, but not over any person who had a registered interest in the real property at the time the security interest in the goods attached and who has not consented in writing to the security interest or disclaimed an interest in the fixture.
>
> **—(2)** A security interest mentioned in subsection (1) is subordinate to the interest of,

(a) a subsequent purchaser for value of an interest in the real property; or

(b) a creditor with a prior encumbrance of record on the real property to the extent that the creditor makes subsequent advances,

if the subsequent purchase or subsequent advance under a prior encumbrance of record is made or contracted for without knowledge of the security interest and before notice of it is registered in accordance with section 54.

The priority of the chargee's security interest in the real property will not be affected so long as the charge was properly registered.

5.1.3 PPSA regarding chattels

This form of charge does not cover chattels on the property. If the chattels on the property are also to be encumbered as security for the loan, a general security agreement should be executed. The chargee should comply with the provisions of the *PPSA* regarding perfection of security interests by registering a financing statement under the *PPSA*.

5.1.4 Chargors and charging language, etc.

The chargor is the person who owns the property and is borrowing the money and encumbering the property with the charge as security for the chargor's promise to repay the loan. All of the owners of the property must sign the charge if the chargee is to have full security.

The statement by the chargor that the chargor is at least 18 years old has replaced the old affidavit of age.

The former affidavit with respect to marital status has been replaced by a statement, which must be completed, as to the chargor's marital status. Part II of the *Family Law Act*, gives to a non-owner spouse certain possessory rights in any "matrimonial home" and the right to consent to any encumbering of it. Therefore, if the property being charged is a matrimonial home, the chargee must ensure that the spouse of the chargor joins in the charge and consents to the charge pursuant to s. 21 of the *Family Law Act*. If the spouse does not join in the charge in order to consent, the charge is no less valid but may be subject to the non-owner spouse's prior possessory rights in the property. If the property is not a matrimonial home, the chargor should so declare.

The statement to the effect that the chargor has received a true copy of the charge is inserted because of s. 4 of the *Mortgages Act*, which requires the chargee to deliver a true copy of the mortgage to the chargor.

An electronic charge is "signed" for the chargor by the person who submits it for registration. The disk and pass phrase of a person acting for the chargor essentially serves as the electronic "signature" of the chargor. Such person registering for the chargor should obtain an acknowledgement and direction (see Appendix D) signed by the chargor authorizing the person submitting the charge for registration to sign and register the charge for the chargor. The acknowledgement and direction confirms that the chargor is bound by the electronic charge as if the chargor had executed it himself or herself. A printed copy of the draft electronic charge and all schedules should be attached to the acknowledgement and direction.

If the property being charged is a matrimonial home, the consent of a non-owner spouse of the chargor is required, pursuant to s. 21 of the *Family Law Act*.

Spouses should obtain independent legal advice before giving this consent.

The solicitor for the spouse should always ensure that any consent given is limited to the particular loan transaction, so that the spouse retains a possessory right in the property for all other purposes.

5.1.5 Chargee

If there is more than one chargee, either the words "on joint account with right of survivorship" or the percentage interest of each chargee should be inserted.

5.1.6 Statements

This section is to be completed if the statutory covenants are to be amended or if relevant statements of law are required to be made.

5.1.7 Provisions

(a) Financial terms

The essential financial provisions of the charge are contained in this section, including a statement of the principal amount, the interest rate and the calculation period for interest, and the term or "balance due date" of the loan.

(b) Interest rate

With respect to interest, s. 6 of the federal *Interest Act*, provides that where repayment is by way of an amount that blends both principal and interest (and in two other rare situations), no interest whatsoever is recoverable unless the charge contains a statement showing:

- the amount of principal money; and
- the rate of interest chargeable thereon calculated either "yearly or half-yearly, not in advance."

Section 6 of the *Interest Act* was not intended to protect the chargor from a high rate of interest, but to ensure that the chargor was fully aware of the amount of interest for which the chargor was responsible. If interest is calculated other than yearly or half-yearly and if repayment is by way of blended payments, then to comply with s. 6 of the *Interest Act*, the equivalent rate of interest as if calculated yearly or half-yearly must also be stated. For example, interest at the rate of 12% per annum calculated monthly should also be stated to be 12.3% per annum calculated half-yearly.

If the interest rate is stated but the frequency of calculation of interest is omitted, the case law has implied that interest is calculated yearly not in advance.

Payments are blended if the total amount of each payment remains the same while its interest and principal components vary from month to month. The monthly blended payments are due on the same day of each month (e.g., the first day of the month). The "interest adjustment date" is the first day of the period that the first monthly blended payment relates to—in our hypothetical fact situation, February 1, 2006. The first monthly payment would be due one month after the interest adjustment date—i.e., March 1, 2006. If money is advanced before the interest adjustment date, then interest alone from the date of the advance to the interest adjustment date is payable on the interest adjustment date, after which date a fixed amount containing a blend of principal and interest is payable monthly, in arrears. In other words, a payment on September 1 covers the month of August, and so on. Whatever interest has accrued is deducted from the monthly payment, and the balance of the payment is then used to reduce the principal outstanding.

(c) Calculation of interest

The calculation of accrued interest each month can be tricky as how often interest is calculated and how often it is payable need not be the same. If interest is calculated (or compounded) at the same frequency as payments are made, the determination of that part of the monthly payment that is interest is a simple matter. Section 1 of the repayment (or amortization) schedule in Appendix G gives an example of this.

If payments are made more frequently than interest is calculated (i.e., if the chargee receives payments monthly when interest is calculated half-yearly), the determination of accrued interest in each payment may become complicated if the "deemed reinvestment principle" is either expressly applied by the parties or is deemed to apply. Basically, this principle provides that if the chargee has received any interest in advance of the time it is to be calculated, the chargee is deemed to have reinvested that interest and to have earned interest on it at the same rate as the interest rate set out in the charge. The actual interest paid by the chargor and the interest the chargee is deemed to have earned from reinvestment must total no more than the yield stated in the charge. Therefore, in this situation, an interest factor is applied and the effective interest payable under the charge is reduced accordingly. Section 2 of Appendix G contains an example of this.

In Ontario, as a general rule, this interest factor has been built into any repayment schedule where the payments are made more frequently than interest is calculated, unless the parties have stipulated to the contrary. The Ontario Court of Appeal confirmed this practice in *Re Morenish Land Developments Ltd. and Metropolitan Trust Co. et al.* It would be useful if every charge dealt directly with this issue. If a charge containing the standard blended-payment clause is silent on this point, the better view, at present, would seem to be that the "deemed reinvestment principle" would be applied.

(d) Term

The interest adjustment date is the effective commencement date of the term of the mortgage. The term of the mortgage is the period of time for which the lender agrees to lend money and the borrower agrees to borrow it. There is no limitation on how short or how long the term of a charge may be.

The term of any charge by an individual person is normally five years or less. Section 10 of the *Interest Act* and s. 18 of the *Mortgages Act* both provide that if the term of any mortgage is longer than five years, the mortgagor (unless it is a corporation) has the right, at any time after five years following the date of the mortgage, to pay it off together with three months' interest in lieu of notice.

The Supreme Court of Canada in *Royal Trust Co. v. Potash* held that a mortgagor may elect not to exercise its right under s. 10 of the *Interest Act* and s. 18 of the *Mortgages Act* and instead enter into an otherwise valid and enforceable renewal agreement that "deems" the date of the original mortgage to be the date of maturity of the existing loan. If the term of the renewal agreement does not itself exceed five years, the mortgagor cannot pay off the mortgage until the end of the five-year renewal period.

It should be noted that in the absence of a provision in the charge to the contrary, the chargor has no right to prepay the loan or shorten the term (except as noted above) without the agreement of the chargee. This is normally referred to as a "closed" mortgage. Likewise, in

the absence of a default by the chargor, the chargee has no right to shorten the term and accelerate repayment without the agreement of the chargor. A provision is often inserted permitting the chargor to prepay the loan (see the "Additional Provisions" section in Appendix C for an example). This is normally referred to as an "open" mortgage.

A loan is generally amortized over a period (usually 25 years) that is much longer than the term. In other words, using the monthly payment figure in the charge, it would take 25 years of the monthly blended payments of principal and interest for the loan to be completely repaid. Therefore, on the maturity date of a charge with a term of only 5 years but an amortization period of 25 years, a large lump sum or balloon payment will be due.

(e) Standard charge terms

Section 9 of the *LRRA* provides that a charge is deemed to include a set of standard charge terms if the charge terms are referred to in the charge by their filing number. By inserting the relevant number, the set of standard charge terms filed as that number will be incorporated into the charge. If no number is inserted, this option is inoperative. Unless Form 2 or the electronic charge expressly excludes the implied covenants set out in s. 7 of the *LRRA*, the charge will be deemed to include them.

(f) Insurance

Either a monetary amount or the words "full replacement value" or a similar provision can be inserted. If the chargee requires extra provisions concerning the obligation of the chargor to keep insurance in place and pay premiums, these should be inserted in a schedule to the charge.

Insurance is a key financial provision, since the insurance proceeds are the replacement for the security if the building that has been charged is destroyed. Accordingly, on closing, solicitors for chargees should require evidence that the insurance is in place, usually by way of insurance certificates showing the chargee as an additional named insured and showing proceeds as payable to the chargee.

5.1.8 Additional provisions

This section can be completed if there are any important terms of the charge that need to be documented (e.g. a pre-payment privilege).

5.1.9 File Number

Your office file number can be inserted in this section.

5.2 Implied covenants

Section 7 of the *LRRA* provides as follows:

> **7.—(1)** A charge in the prescribed form shall be deemed to include the following covenants by the chargor, for the chargor and the chargor's successors, with the chargee and the chargee's successors and assigns:
>
> 1. In a charge of freehold or leasehold land by the beneficial owner:
>
> i. That the chargor or the chargor's successors will pay, in the manner provided by the charge, the money and interest it secures, and will pay the taxes assessed against the land.
>
> ii. That the chargor has the right to give the charge.
>
> iii. That the chargor has not done, omitted or permitted anything whereby the land is or may be encumbered, except as the records of the land registry office disclose.
>
> iv. That the chargor or the chargor's successors will insure the buildings on the land as specified in the charge.
>
> v. That the chargee on default of payment for the number of days specified in the charge or in the *Mortgages Act*, whichever is longer, may on giving the notice specified in the charge or required by that *Act*, whichever is longer, enter on and take possession of, receive the rents and profits of, lease or sell the land.
>
> vi. That where the chargee enters on and takes possession of the land on default as described in subparagraph v, the chargee shall have quiet enjoyment of the land.
>
> vii. That the chargor or the chargor's successors will, on default, execute such assurances of the land and do such other acts, at the chargee's expense, as may be reasonably required.
>
> viii. That the chargee may distrain for arrears of interest.
>
> ix. That on default of payment of the interest secured by the charge, the principal money shall, at the option of the chargee, become payable.
>
> 2. In a charge of freehold land by the beneficial owner, that the chargor has a good title in fee simple to the land, except as the records of the land registry office disclose.
>
> 3. In a charge of leasehold land by the beneficial owner:
>
> i. That, despite anything done, omitted or permitted by the chargor, the lease or grant creating the term or estate for which the land is held is, at the time the charge is given, a valid lease or grant of the land charged, in full force, unforfeited and unsurrendered, and

that there is no subsisting default in the payment of the rents reserved by or in the performance of the covenants, conditions and agreements contained in the lease or grant at the time the charge is given.

ii. That the chargor or the chargor's successors will, while the moneys secured by the charge remain unpaid, pay, observe and perform all the rents reserved by and all the covenants, conditions and agreements contained in the lease or grant and will indemnify the chargee against all costs and damages incurred by reason of any non-payment of rent or non-observance or non-performance of the covenants, conditions and agreements.

—(2) Where a charge to which subsection (1) applies is given by or to more than one person, the covenants deemed to be included by that subsection are made,

(a) by the chargors jointly and severally, unless the charge specifies otherwise; and

(b) with the chargees jointly, unless the money secured is expressly secured to them in several shares or distinct sums.

—(3) A covenant deemed to be included in a charge by subsection (1) may, in a schedule to the charge, or in a set of standard charge terms filed under subsection 8(1) and referred to in the charge by its filing number, be expressly excluded or be varied by setting out the covenant, appropriately amended.

—(4) A covenant deemed to be included in a charge by subsection (1) may be enforced by a successor or assignee of the chargee.

—(5) A charge in the prescribed form shall be deemed to include the prescribed standard charge terms, unless a set of standard charge terms filed under subsection 8(1) is referred to in the charge by its filing number.

—(6) A prescribed standard charge term deemed to be included in a charge by subsection (5) may, in a schedule to the charge, be expressly excluded or be varied by setting out the term, appropriately varied.

Section 28 of the *LRRA* states that s. 7 of the *LRRA* also applies to charges registered in an electronic format.

The deemed covenants in the *LRRA* replaced covenants contained in two other statutes. Before April 1, 1985, ss. 7–8 of the *Mortgages Act* set out extensive implied covenants. However, s. 9 of the *Mortgages Act* provides that ss. 7–8 do not apply to any mortgage or charge that is executed after the *LRRA* has come into effect.

As stated in s. 7 of the *LRRA*, the use of Form 2 or an electronic charge, absent any limiting language, will deem certain covenants on the part of the chargor. These cover all of the matters of critical concern to the chargee, i.e., that the chargor will repay the loan, pay taxes, insure the building, and so on. However, the deemed covenants contained in the *LRRA* are limited in scope, especially compared to those contained in the *Short Forms of Mortgages Act*. A practice has developed to exclude the *LRRA* deemed covenants (as permitted by s. 7 of the *LRRA*) and replace them with a more detailed set of covenants such as those from the Dye & Durham standard charge terms reviewed below.

Apart from the *LRRA*, there are other statutes that imply terms in a charge in certain circumstances.

Section 24 of the *Mortgages Act* provides that three months after default in payment, the mortgagee will have the following powers as if they were included in the mortgage:

- the power to sell; and
- the power to insure.

Subsection 88(1) of the *Condominium Act, 1998* provides that all mortgages of a condominium unit are deemed to contain certain provisions including the following:

- The mortgagee may collect the unit owner's common expenses from him or her and remit them to the condominium corporation.
- The owner's default in payment of common expense is a default under the mortgage.
- If the mortgagee makes payments of common expenses that are not reimbursed by the owner, these can be added to the mortgage debt, and the mortgagee can accelerate the mortgage if these amounts are not reimbursed forthwith.

The reasoning for these deemed inclusions is that s. 86(1) of the *Condominium Act, 1998* makes arrears of common expenses a lien having priority to the charge in certain circumstances.

Note should also be made of the *Unconscionable Transactions Relief Act*, which may relieve a chargor, in certain circumstances, from the onerous provisions of a loan. If the cost of the loan is excessive, the court may revise the contract if it finds the effective rate of interest to be criminal.

5.3 Standard charge terms

As noted above, Form 2 and an electronic charge may contain a statement that the parties to the charge are bound by the provisions of certain standard charge terms identified by a filing number.

Incorporating standard charge terms by reference to those on file, rather than setting the terms out in full in the charge, greatly simplifies the charge.

Section 8 of the *LRRA* grants authority to file standard charge terms, and s. 9(1) provides that a charge will be deemed to include a set of standard charge terms if the

set is referred to in the charge by its filing number. Section 9 of the *LRRA* states:

> **9.—(1)** A charge shall be deemed to include a set of standard charge terms filed under subsection 8(1) if the set is referred to in the charge by its filing number.
>
> **—(2)** A term deemed to be included in a charge by subsection (1) may, in a schedule to the charge, be expressly excluded or may be varied by setting out the term, appropriately amended.
>
> **—(3)** Where a charge refers to more than one set of standard charge terms by their filing numbers, the charge shall be deemed to include only the set that was filed last.
>
> **—(4)** Where there is a conflict between an express term in a charge and a term deemed to be included in the charge by subsection (1), the express term prevails.

Any set of standard charge terms that has been filed can be used by any parties entering into a charge simply by completing the "charge provisions" section of an electronic charge with the filing number of that set. For purposes of this chapter, the set of standard charge terms filed by Dye & Durham will be examined, a copy of which is in Appendix E.

The following comments on this set of standard charge terms are premised on the assumption that they are being reviewed for the first time and the comments are, therefore, very basic. Each clause has been extracted from the set and then examined. The numbering of each clause corresponds to the numbering on the Dye & Durham form.

5.3.1 Exclusion of statutory covenants

The wording follows standard practice, which has developed and excludes the implied covenants contained in the *LRRA*. The excluded covenants are effectively replaced by the standard charge terms.

5.3.2 Right to charge the land

The wording is similar to but expands on the implied covenant in s. 7(1)1.ii of the *LRRA*, which states that "the chargor has the right to give the charge."

5.3.3 No act to encumber

Again, the wording expands upon the implied covenant in s. 7(1)1.iii of the *LRRA*. It should be noted that excluded from this statement are any matters that are registered against the title to the property. Therefore, the responsibility for ensuring there are no prior encumbrances on the property lies with the solicitor giving the title opinion to the chargee.

5.3.4 Good title in fee simple

The wording replaces the implied covenant in s. 7(1)2 of the *LRRA* and does not contain the qualification as to matters registered on title, with the only exception being those items contained in the original grant from the Crown.

If the chargor's title is not totally free of all encumbrances or limitations, this clause must be amended accordingly.

5.3.5 Promise to pay and perform

The wording replaces the implied covenant in s. 7(1)1.i of the *LRRA* and sets out the obligation of the chargor to repay the loan, etc. This obligation is not terminated by any sale of the property by the chargor, who remains liable on this covenant until

- the loan is repaid; or
- the chargee releases the chargor, either by specific deed or by the chargee's actions.

Section 20 of the *Mortgages Act* provides that, in certain circumstances in an action to recover money, the mortgagee can sue either the current owner or the original mortgagor.

5.3.6 Interest after default

This clause provides that unpaid interest in default becomes capitalized at certain intervals, after which interest is also charged on this unpaid capitalized interest. Unless this clause is inserted in the charge, the chargee can only charge interest on the principal outstanding. At common law, if the charge did not provide that interest at the rate set in the charge was payable after the maturity date, it was only chargeable until the maturity date.

5.3.7 No obligation to advance

This clause provides that the chargee is not compelled to advance all the money secured by the charge and is significant in connection with construction loans where the face amount of the charge is not advanced in full at the time of registration of the charge. The case of *Reid v. Garnet B. Hallowell Ltd. et al.* confirmed the validity of this type of provision while stating that there may be certain extraordinary circumstances in which the chargee may be liable for failing to advance the full amount of the loan.

If the loan is advanced in stages, consider s. 93(4) of the *Land Titles Act*:

> **93—(4)** A registered charge is, as against the chargor, the heirs, executors, administrators, estate trustees and assigns of the chargor and every other person claiming by, through or under the chargor, a security upon the land thereby charged to the extent of the money or money's worth actually advanced or supplied under the charge, not exceeding the amount for which the charge is expressed to be a security, although the money or money's worth, or some part thereof, was advanced or supplied after the registration of a transfer, charge or other instrument affecting the land charged, executed by the chargor, or the heirs, executors, administrators or estate trustees of the chargor and registered subsequently to the first-mentioned charge, unless, before advancing or supplying the money or money's worth, the registered owner of the first-mentioned charge had actual notice of the execution and registration of such transfer, charge or other instrument, and the registration of such transfer, charge or other instrument after the registration of the first-mentioned charge does not constitute actual notice.

Section 73 of the *Registry Act* contains a similar provision. Thus, on all subsequent advances, the solicitor for the chargee must conduct appropriate subsearches to ensure priority.

In addition, s. 78 of the *Construction Lien Act*, which applies to lands in both the registry and land titles systems, contains numerous provisions with respect to the priorities between construction liens and charges. It is important that this section be considered when an advance on the loan is being made to ensure its priority.

5.3.8 Costs added to principal

Certain payments outside of the charge may, if not paid, create liens on the land in priority to any charge (e.g., realty taxes) or may put the chargee's security at risk (e.g., insurance premiums). Therefore, it is in the chargee's interest to ensure that they are paid. This clause allows the chargee to make certain payments with respect to the property and to add these to the debt. If the chargor does not reimburse the chargee "forthwith" with respect to all such items, the chargee has the right to accelerate the loan.

5.3.9 Power of sale

This clause contains the chargee's remedy of sale under a power of sale and replaces the implied covenant contained in the s. 7(1)1.v of the *LRRA*. It is also subject to Part III of the *Mortgages Act*.

5.3.10 Quiet possession

Pursuant to the charge, the chargor is entitled to remain in possession until the chargor defaults. After that point, the chargee is entitled to quiet possession. The wording used in this clause is taken from the expanded wording contained in the *Short Forms of Mortgages Act*. Quiet possession essentially means that the chargee can obtain and maintain its possession of the property free from interference by the chargor or those claiming through the chargor. This wording replaces the implied covenant in s. 7(1)1.vi of the *LRRA*.

5.3.11 Right to distrain

This clause gives to the chargee the right of distress, i.e., the right to seize chattels of the chargor if the charge is in default. (See ss. 14–16 of the *Mortgages Act*.)

The wording replaces the implied covenant contained in s. 7(1)1.viii of the *LRRA*, which allows the chargee to distrain for arrears of interest. The above clause further provides that the chargee may distrain for arrears of principal.

5.3.12 Further assurances

The wording replaces the implied covenant in s. 7(1)1.vii of the *LRRA* and provides that the chargor, after default, will do whatever is necessary to convey the property absolutely to the chargee.

5.3.13 Acceleration of principal and interest

The wording replaces the implied covenant contained in s. 7(1)1.ix of the *LRRA*, which provides that upon default of any payment of principal or interest, the entire balance may become immediately due at the option of the chargee. This does not cover a breach of any other covenant. See below for the chargee's right to accelerate for a breach of covenant.

Section 22 of the *Mortgages Act* provides some relief against this acceleration by providing that, notwithstanding any agreement to the contrary, where there has been default and acceleration, the chargor may pay all arrears and expenses and put the charge into good standing at any time

- before the sale of property pursuant to the power of sale contained in the charge; or
- before any action has been commenced;

whereupon the chargor is relieved from the consequences of the acceleration clauses. The amount the chargor must pay does not include any accelerated amounts. After a "sale" has taken place, no relief against acceleration is available.

Once an action has been commenced, s. 22 of the *Mortgages Act* no longer provides any relief against acceleration. However, the chargor can resort to s. 23 of

the *Mortgages Act*, which provides that notwithstanding any agreement to the contrary, if an action by the mortgagee has been commenced for enforcement of its rights and the charge has been accelerated, the chargor can apply to the court to put the charge into good standing by paying the arrears and certain costs.

Moreover, s. 17 of the *Mortgages Act* provides that notwithstanding any agreement to the contrary, the chargor may put the mortgage into good standing at any time by paying

- the amount of principal in arrears; and
- a bonus of three months interest on the principal in arrears or giving three months' notice of his or her intention to put the mortgage into good standing.

This provision protects the chargor by permitting payment of arrears without penalty. The chargor is not required to make further payments of interest except to the date of payment. Such interest would merely constitute payment for the use of the principal during the three-month notice period. This provision also protects the chargee by giving a three-month period during which to arrange for reinvestment of the chargee's principal or compensation for lack of that notice. The option is that of the chargor.

However, s. 17 of the *Mortgages Act* does not give the chargor the right to also pre-pay the balance of principal that was not in arrears without paying the interest that is payable on this balance of principal to the maturity date, unless the chargee has taken steps to compel payment. Case law also holds that this provision does not apply if the chargee is exercising its remedies to recover the money on default and asking for this bonus as well. Subsection 17(3) further provides that s. 17(1) does not limit the right of the mortgagee to pursue any of the mortgagee's remedies with respect to the amount in default.

5.3.14 Unapproved sale

This is the "due upon sale" provision, which provides that the amount secured under the charge shall, at the option of the chargee, become immediately due and payable if the chargor disposes of its interest in the property. Accordingly, a chargor should first obtain the chargee's consent before selling the property if the purchaser is to assume the charge.

5.3.15 Partial releases

This clause provides that the chargee may, at any time, release part of the property from the charge. If released, the remainder of the property remains as security for the repayment of the full amount owing under the charge.

If the chargor contemplates subdividing the lands, the chargor should ensure that a provision is inserted in the charge that

- obligates the chargee to give partial discharges; and
- apportions the principal over the property *pro rata*.

5.3.16 Obligation to insure

The wording replaces the implied covenant in s. 7(1)1.iv of the *LRRA* and contains a covenant by the chargor to carry insurance for the full insurable value of the buildings that are located on the lands at any time during the term of the charge. It also provides that any recovery pursuant to such insurance shall be paid directly to the chargee as the chargee's interest may appear.

Section 6 of the *Mortgages Act* gives the chargee the choice of requiring that the insurance moneys be used either for repair or for paying off the moneys due under the mortgage. Therefore, the chargor cannot insist on using the insurance proceeds to rebuild, unless the chargee has consented.

The chargee is not entitled to make a windfall profit in this regard. If the premises are not repaired, the first chargee has first entitlement to that part of the insurance proceeds equal to the amount then due to that first chargee pursuant to the charge. It appears this chargee can then hold an amount sufficient to cover the remainder of all amounts owing under the charge that, in effect, replaces the buildings as security. Any second chargee then becomes entitled to similar rights and so on, with any balance going to the chargor.

The requirement that the standard form of mortgage clause be attached to all insurance policies is important, since this creates a more direct relationship between the insurer and the chargee. This clause, an example of which is contained in Appendix H, provides, among other things, that the insurance proceeds are payable to the chargee, that the policy will not be cancelled by the insurer without notice to the chargee, that the policy is valid vis-à-vis the chargee regardless of any act of the insured chargor, and that subject to the insured's liability, the rights of the insurer shall be subrogated to those of the chargee. Section 147 of the *Insurance Act* also contains similar notice provisions.

5.3.17 Obligation to repair

This provision contains the chargor's covenant to keep the property in a state of good condition and repair. If the chargor does not do so or if the chargor commits waste or defaults in any of the covenants contained in the charge, the chargee has the right to accelerate the charge and to employ all the usual remedies on default. This is because

failure to repair or the commission of waste reduces the value of the chargee's security. Technically, any demolition or alteration to the buildings on the property constitutes waste. If such demolition or alterations are contemplated, this provision should be amended accordingly.

This provision also provides that any default in any prior charge automatically constitutes an act of default under the charge, entitling the chargee to all of its remedies, including acceleration.

5.3.18 Building charge

The first part of this provision states that where any portion of the principal amount advanced by the chargee is used to finance construction, the chargor must provide the chargee with details concerning the proposed improvements. The second portion deals with the provisions of the *Construction Lien Act* that require certain holdbacks of funds during construction.

5.3.19 Extensions not to prejudice

This clause provides that no dealings between the chargee and the chargor or the owner of the property shall prejudice the rights of the chargee against the chargor or such other person.

This should be read in light of s. 20(3) of the *Mortgages Act*, which states that where a mortgagee obtains a judgment against the current owner of the property satisfying the mortgagee's claim, the mortgagee ceases to have a right to claim against the guarantor or mortgagor, as the case may be. In addition, the case law suggests that if the chargee alters the original contract in any material manner without the consent of the chargor, the chargor may be relieved from the chargor's continuing personal liability.

While normally the chargor is not released from the chargor's personal covenant even when the chargor sells the property, the chargor and the chargee can agree, in a "limited recourse" or "non-recourse" provision, that the recourse of the chargee will be limited to the property and the chargor will have no personal obligation to repay the debt if the property is worth less than the amount outstanding on the loan.

This provision permits (but does not obligate) the chargee to renew the charge and alter the interest rate without losing priority over subsequent encumbrances, notwithstanding the provisions of the *Registry Act* dealing with priority of registration.

Note should also be made of the comments set out above with respect to box 9 of Form 2 regarding renewals and the right of a chargor who is an individual person to repay the loan after five years.

5.3.20 No merger of covenants

This clause provides that if the chargee obtains judgment against the chargor with respect to any covenant, such covenant does not merge in the judgment, and the chargee is still entitled to be paid according to the terms of the charge. Also, interest shall run on the amount of the judgment at the same rate as is contained in the charge.

5.3.21 Change in status

This provision imposes an obligation on the chargor to advise the chargee regarding any sale of the property, which allows the chargee to keep its records up to date since future payments will be made by the new owner. It also provides the chargee with necessary information regarding the name, spousal status, and address of the current owner for any power of sale proceedings by the chargee.

5.3.22 Condominium provisions

This provision states that the chargor must comply with the provisions of the *Condominium Act, 1998* relating to the chargor's unit. The chargor must provide the chargee with all notices, assessments, by-laws, etc., that the chargor receives from the condominium corporation. The chargor must abide by all terms of the condominium agreements to which it is a party. Moreover, the chargor must also maintain insurance above and beyond that of the condominium corporation. Finally, the chargor irrevocably authorizes the chargee to exercise the chargor's rights under the *Condominium Act, 1998* to vote, consent, and dissent to any changes to the particular condominium corporation's by-laws.

5.3.23 Discharge

The clause provides that any required discharge of the charge is to be prepared by the chargee at the expense of the chargor.

5.3.24 Guarantee

This clause provides that in the event a third party provides a guarantee of the obligations of the chargor under the charge, the guarantor may be treated as a principal covenantor under the charge and therefore may be considered as primarily liable for all the obligations under the charge.

5.3.25 Severability

This clause provides that if any term of the charge is found to be unenforceable or inconsistent with the

provisions of any applicable statute or regulation or if the effect of any such applicable statute or regulation would prevent the chargee from being able to collect the amount of any loss sustained by it as a result of making the loan secured by the charge, then such provision shall be deemed to not apply to the extent that it is so illegal, invalid, or inconsistent.

5.3.26 Interpretation

This clause provides that the terms of the charge are binding on and exercisable by all successors to the parties to the charge. The clause also provides that if there is more than one chargor at any time, all covenants are joint and several.

5.3.27 Paragraph headings

This clause explains that the paragraph headings are for reference only and are not part of the charge and are not to be used in its interpretation.

5.3.28 Date of charge

This clause deems that the date of the charge is the date of delivery for registration, unless otherwise provided.

5.3.29 Effect of delivery of charge

This clause is required in connection with the electronic registration of the charge and provides that the electronic form is to have the same effect for all purposes as if the charge were in written form, signed by the parties, and delivered to the chargee.

5.4 Acknowledgment

Appendix F contains a form of acknowledgment that addresses s. 11 of the *LRRA*, which provides that the chargee is guilty of an offence unless the chargor has been provided with a copy of the standard charge terms before taking the charge.

6. Special additional provisions

6.1 Charge of condominium

A charge of a condominium unit should contain the following additional provisions:

- a covenant by the chargor to comply with the *Condominium Act, 1998*;
- a covenant by the chargor to pay common expenses, with failure to do so constituting an event of default.
- an assignment to the chargee of the right to vote;
- a covenant to give the chargee notices regarding meetings, demands for payment, etc.; and
- an amendment of the usual insurance provisions.

Sample provisions are contained in Appendix I.

7. Transfers by chargee and chargor

7.1 Transfer by chargee

The chargee may sell to a third party the chargee's right to repayment of the loan by the chargor. In this event, the chargee causes the electronic transfer of charge (an example of which is located at Appendix J) to be registered on its behalf. A transfer of charge replaces the old assignment of mortgage in the registry system, which included both an assignment of the debt and a conveyance of the property.

Note that s. 53(1) of the *Conveyancing and Law of Property Act* provides as follows:

> **53.—(1)** Any absolute assignment made on or after the 31st day of December, 1897, by writing under the hand of the assignor, not purporting to be by way of charge only, of any debt or other legal chose in action of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to receive or claim such debt or chose in action is effectual in law, subject to all equities that would have been entitled to priority over the right of the assignee if this section had not been enacted, to pass and transfer the legal right to such debt or chose in action from the date of such notice, and all legal and other remedies for the same, and the power to give a good discharge for the same without the concurrence of the assignor.

Therefore, the assignee should always give the chargor "express notice in writing" of the transfer of the charge in order to take advantage of the provisions of s. 53(1) and to preclude any further payments by the chargor to the original chargee. In *Hopman et al. v. Carleton Credit Ltd.*, the Ontario High Court confirmed that such notice by either the assignor or the assignee was acceptable. An example of a notice is contained in Appendix K.

Subsection 101(4) of the *Land Titles Act* provides that every transfer of a charge is subject to the state of account upon the charge between the chargor and the chargee. As the transferee of the charge takes it subject to the state of accounts between the chargor and the original chargee at the time notice of the transfer of charge is given to the chargor, the transferee should always obtain an acknowledgment from the chargor as to the amount outstanding on the charge at the time of the transfer. The chargor is then stopped from later claiming that the chargor had prepaid certain amounts under the charge or had a right of set-off against the amount owing to the original chargee. This acknowledgment should also contain a covenant by the chargor to make all future charge payments to the transferee. An example of such an acknowledgment is contained in Appendix L.

Section 13 of the *Mortgages Act* provides as follows:

> **13.—** The purchaser in good faith of a mortgage may, to the extent of the mortgage, and except as against the mortgagor, set up the defence of purchase for value without notice in the same manner as a purchaser of the mortgaged property might do.

Note should also be taken of s. 7 of the *Conveyancing and Law of Property Act*, which provides as follows:

> **7.—** A statement of consideration money or other consideration in the body of a conveyance or endorsed thereon is, in favour of a subsequent purchaser not having notice that the money or other consideration was not in fact paid or given wholly or in part, sufficient evidence of the payment or giving of the whole amount thereof.

As mentioned above, Form 2 or the corresponding position of an electronic charge may constitute an acknowledgment by the chargor of receipt of the entire loan amount (whether or not it has, in fact, been advanced at that point). It may be that the transferee of the charge is entitled to rely on this unless the transferee has knowledge to the contrary.

7.2 Transfer by chargor

The owner/chargor may sell the chargor's freehold interest in the property subject to an existing charge. Upon the sale, the purchaser would assume the outstanding loan and pay the owner/chargor on closing the balance of the purchase moneys less the amount owing on the outstanding charge.

The purchaser inherits the true state of accounts between the original chargor and the chargee. Therefore, the purchaser should obtain from the chargee an assumption statement setting out the state of accounts between the chargor and the chargee as of the closing date. Once again, this statement is received to prevent the chargee from later claiming that a greater amount was owing under the charge. The purchaser should ensure that the assumption statement is not marked "E. & O.E." ("Errors and Omissions Excepted"), which may give the chargee the right, at some later date, to claim a greater amount because of an error or omission in the statement by the chargee. The assumption statement may be made subject to certain payments by the original chargor being honoured by the bank. The purchaser should ensure that this has taken place by closing or should withhold funds from the balance due on closing. An example of an assumption statement is contained in Appendix M.

As noted above, a transfer of the property by the original chargor does not automatically relieve the chargor of possible liability if the charge later falls into default. Section 20 of the *Mortgages Act* provides as follows:

> **20.—(1)** In this section, "original mortgagor" means any person who by virtue of privity of contract with the mortgagee is personally liable to the mortgagee to pay the whole or any part of the money secured by the mortgage.
>
> **—(2)** Despite any stipulation to the contrary in a mortgage, where a mortgagor has conveyed and transferred the equity of redemption to a grantee under such circumstances that the grantee is by express covenant or otherwise obligated to indemnify the mortgagor with respect to the mortgage, the mortgagee has the right to recover from the grantee the amount of the mortgage debt in respect of which the grantee is obligated to indemnify the mortgagor; provided that the right of the mortgagee to recover the amount of the mortgage debt under this section from the grantee of the equity of redemption shall as against such grantee terminate on the registration of a grant or transfer of the equity of redemption by such grantee to another person unless prior to such registration an action has been commenced to enforce the right of the mortgagee.
>
> **—(3)** Where a mortgagee has the right to recover the whole or any part of money secured by a mortgage from an original mortgagor and also has a right by virtue of this section to recover from a grantee of the equity of redemption from a mortgagor, if the mortgagee recovers judgment for the amount of the mortgage debt against the original mortgagor, the mortgagee thereupon forever ceases to have a right to recover under this section from a grantee, and if the mortgagee recovers judgment under this section against a grantee the mortgagee thereupon forever ceases to have a right to recover from the original mortgagor; provided that where there is more than one original mortgagor this section does not affect the right of a mortgagee after the recovery of judgment against one original mortgagor to recover judgment against the other original mortgagor or mortgagors.

The original chargor can only escape later responsibility in the following circumstances:

- by obtaining from the chargee a specific release of the chargor from the chargor's personal covenant; or
- by the actions of the chargee (i.e., obtaining judgment against a subsequent owner or, possibly, agreeing with a subsequent owner to materially alter the charge without the consent of the chargor).

Subsection 20(2) of the *Mortgages Act* provides that the chargee has the right to recover the amount outstanding on the mortgage from either the original covenantor or the owner at the time of the default if that subsequent owner has become "by express covenant or otherwise obligated to indemnify the mortgagor with respect to the mortgage." Once the chargee obtains a judgment against one, his or her rights against the other cease. Clearly, it is to the benefit of the original chargor to ensure that the subsequent owner is so obligated.

The prudent solicitor for the transferor in this situation should require that the transfer contain a covenant by the

transferee to indemnify the transferor with respect to the debt being assumed. Ideally, the transfer should be executed by the transferee as well as the transferor.

At common law, the transfer of property subject to a charge did not impose upon the transferee any personal responsibility to the chargee to pay the mortgage loan, since there was no privity of contract between the chargee and such subsequent owner. Section 20 of the *Mortgages Act* provides further rights to the chargee in this regard so long as the subsequent owner is the owner of the property. Once the subsequent owner sells the property, the subsequent owner's liability to the chargee ceases. However, if the subsequent owner had entered into an assumption agreement such as the one contained in Appendix N, his or her personal contractual liability to the chargee will remain in effect even after the completion of the transfer.

The chargee cannot prohibit the chargor from selling the property. However, as noted above, many printed forms of charges now contain a clause permitting the chargee to accelerate full payment of the loan if the chargee does not approve of any new purchaser (the so-called "due-on-sale" clause). Obviously, in this case, the consent of the chargee must be obtained to any transfer of the property. The chargee may require that the new purchaser enter into an assumption agreement, such as the one attached as Appendix N, as a condition to giving such consent.

8. Extinguishment of charges

8.1 Reconveyance

A mortgage entered into prior to the enactment of the *LRRA* can be extinguished by the chargee reconveying the property to the chargor by way of an ordinary grant or quit claim deed.

8.2 Statutory discharge

The usual manner of extinguishing a charge is by a discharge. A copy of the current electronic form of discharge is contained in Appendix O.

Prior to forwarding funds to the chargee and requesting a discharge, the chargor should obtain a discharge statement from the chargee setting out the exact amount owing on the charge as of the projected payment date. An example of a discharge statement is contained in Appendix P. It should be noted that many discharge statements are marked "E. & O.E.," indicating they may not be binding on the chargees who issued them. If this is the case, care should be taken by any solicitor who undertakes to obtain a discharge that is to be registered subsequent to closing. Any caveats in the discharge statement as to cheques being honoured by the bank should be followed up carefully.

8.3 Court order

Section 12 of the *Mortgages Act* provides that in certain circumstances, an application can be made to the court for an order discharging a mortgage. This can be of use where the chargee cannot be found or where the amount due is in dispute. Subsection 12(9) of the *Mortgages Act* states that once the order discharging the mortgage is registered on title, it has the same effect as the registration of a certificate of discharge signed by the chargee.

8.4 Assignment

On rare occasions, the chargor may require the chargee to assign the charge pursuant to the provisions of s. 2 of the *Mortgages Act*.

9. Mortgage insurance

9.1 Statutory restriction on mortgage lending by banks

Section 418 of the federal *Bank Act* provides as follows:

> **418.—(1)** A bank shall not make a loan in Canada on the security of residential property in Canada for the purpose of purchasing, renovating or improving that property, or refinance such a loan, if the amount of the loan, together with the amount then outstanding of any mortgage having an equal or prior claim against the property, would exceed 80 per cent of the value of the property at the time of the loan.
>
> **—(2)** Subsection (1) does not apply in respect of (a) a loan made or guaranteed under the *National Housing Act* or any other Act of Parliament by or pursuant to which a different limit on the value of property on the security of which the bank may make a loan is established ....

Banks are therefore prohibited from giving residential mortgage loans that exceed 80% of the value of the home unless the loan is guaranteed under the federal *National Housing Act*. There are similar prohibitions in effect for trust companies and other financial intermediaries under provincial legislation (e.g., see s. 191 of the *Credit Unions and Caisses Populaires Act, 1994*).

9.2 National Housing Act

A crown corporation called Canada Mortgage and Housing Corporation (often called CMHC and called the Corporation in the *National Housing Act*) administers and provides funding for the *National Housing Act*. The purpose of the *National Housing Act* is contained in s. 3:

> **3.—** The purpose of this Act, in relation to financing for housing, is to promote housing affordability and choice, to facilitate access to, and competition and

> efficiency in the provision of, housing finance, to protect the availability of adequate funding for housing at low cost, and generally to contribute to the well-being of the housing sector in the national economy.

Section 8 of the *National Housing Act* provides as follows:

> **8.—(1)** The Corporation may provide insurance against risks relating to housing loans.
>
> **—(2)** For lenders, the purpose of insuring housing loans is to indemnify lenders in the event of default by borrowers. The obligations of borrowers or other persons are not released or discharged by that insurance or indemnification.

9.3 A typical insured residential mortgage transaction

Because of s. 418(1) of the *Bank Act*, potential home buyers require a minimum cash down payment of 20% of the purchase price of the home. This provision minimizes the risk of a bank losing money on a first mortgage loan if the borrower should default and increases the safety of the banking system. However, many potential home buyers will not have the required 20% cash down payment and will therefore not qualify for a first mortgage from a chartered bank.

To resolve this problem, s. 8 of the *National Housing Act* authorizes CMHC to insure mortgage loans, and s. 418(2) allows banks to lend more than 80% of the purchase price if the mortgage is insured by CMHC.

A home buyer who requires an insured mortgage will typically apply to CMHC, Genworth Financial Canada, or others for the insurance at the time the buyer applies to a bank for a first mortgage.

If the borrower qualifies and the insurance application is granted, the borrower will be required to pay an insurance premium to CMHC. The premium is paid once only, at the inception of the insured loan. Usually, the bank remits the premium on the borrower's behalf out of the mortgage proceeds. CMHC sets insurance premiums from time to time.

The mortgage insurance insures the bank or other lender against a loss on its mortgage account if the borrower should default under the mortgage. Despite the fact that the borrower pays the insurance premium, mortgage insurance insures the lender, not the borrower. Thus, if a borrower defaults under a mortgage and the lender sustains a loss, CMHC will reimburse the lender for its loss, but the borrower will remain liable, under the mortgage covenants, for payment of the loss. Usually the lender will sue the borrower for the loss, obtain judgment, and assign its judgment to CMHC, which will then try to enforce the judgment against the borrower. The insurance remains in effect until the insured mortgage is discharged.

Appendix A

Loan Commitment

APPROVAL OF MORTGAGE LOAN	MORTGAGE CORPORATION ONTARIO REGIONAL OFFICE	Mortgage No. 80025
N.H.A. ☐ **CONVENTIONAL** ☒ **CONV. INSURED** ☐	Application made through: 01812 - Yonge and Finch, Toronto Transit No. Branch: Ontario	Insurer: C.M.H.C. Insurer's No. 31-675
MORTGAGOR	TO: Mary Smith	

Your application for a loan to be secured by a first mortgage on the property hereinafter referred to has been approved on the following basis, provided your title proves satisfactory. This commitment is not transferable and the benefit thereof may not be assigned. The provisions of the National Housing Act, R.S.C. 1985, C.N-11 and the regulations thereunder are in all respects to be observed if an N.H.A. loan.

LOAN	Amount Basic Ins. $100,000 Fee (%) NIL RTotal $100,000	Term of Mortgage 5 yrs.	Amortization Period 25 yrs.	Interest Rate (calc. half-yearly not in advance) 12%	Monthly Instalment Payment (for Principal & Interest) $1,031.90
DUE DATES	Interest Adjustment Date: Feb. 1, 2006 First Regular Monthly Payment: Mar. 1, 2006 Final Regular Monthly Payment: Jan. 1, 2011 Maturity Date: Feb. 1, 2011				
PROPERTY	Civic Address: 360 Yonge Street Toronto, Ontario Brief Legal Description: Part of Park Lot 9 Concession 1, Township of York, City of Toronto Lot Size: 16.459 m x 60.121 m Leasehold:		Brief Description of Building (if other than single detached dwelling)		
ADDITIONAL COVENANTORS					
CANCELLATION	We reserve the right to cancel this commitment if your acceptance has not been received within fourteen days from this date, or if, for any reason whatsoever, there have not been any mortgage moneys advanced by February 1, 2006				
HOLDBACKS	Completion of required repairs and improvements Approved Sale Loan may be closed at amount advanced if final disbursement is not made by				$ NIL $ NIL February 1, 2006

TAXES AND INTEREST ON ADVANCES	Under the terms of the mortgage an amount for taxes will be payable monthly in addition to the amortization payment applied to principal and interest. You are to pay or provide for all taxes due or to become due up to the disbursement date and you may be required to create a tax credit equivalent to the fraction of the next levy, or estimated levy, that will accrue to that date. The monthly payment required on account of taxes is $ NIL Tax credit required is – $ Holdback not requested Any change in the Interest Adjustment Date may change these amounts. The required tax credit, plus accrued interest on advances to interest adjustment date, if not otherwise paid, shall be retained out of the proceeds of the loan.
SOLICITOR OR NOTARY	The legal work on our behalf will be done by the undernoted solicitor or notary and you or your solicitor or notary should deliver your title deeds to him at once, and the survey and insurance policy as soon as possible. These documents are required before advances may be made. Name: Paul J. Morassutti, c/o Osler, Hoskin & Harcourt LLP Address: P.O. Box 50, First Canadian Place Toronto, Ontario M5X 1B8
LEGAL AND APPRAISAL COSTS	You are to pay all legal fees, appraisal fees and expenses incurred with respect to the loan and incurred in complying with the provisions stated herein, whether or not the loan is completed.
SURVEY REQUIREMENTS	You are to provide an up-to-date survey, by a surveyor showing the size of lot and location of the buildings on the land, or title insurance.
FIRE HAZARD INSURANCE	Coverage for not less than the amount of the loan, or a lesser amount if the insurer certifies in writing such lesser amount is the full insurable value, with loss payable to us and with our special form of mortgage clause attached must be exhibited to our solicitor or notary before advances will be made.
ADVANCES	In order that our solicitor will be in a position to release funds as required it is necessary that you or your solicitor arrange beforehand with our solicitor a mutually satisfactory date for disbursement.
PAYMENTS	Payments may be made at any branch of Canadian Imperial Bank of Commerce. Arrangements for payment by convenient pre-authorized cheques, free of service charges, are available.
OTHER CONDITIONS	On any payment date, this mortgage can be prepaid in full or any multiple of $500.00 without notice or bonus.
Office Use Only Taxes 595 Mun. Code June Due Date	Date: Jan. 10/06 "J. Jones" (Signature of Approver)

The accepted form should be returned to the above branch	I accept the within terms "Mary Smith" Signature of Mortgagor	Date Jan. 10/06

Appendix B

Instructions to Lender's Solicitor

Dear Sirs:

MORTGAGE REFERENCE No.

MORTGAGOR:

Please obtain first mortgage in favour of in accordance with the attached copy of the commitment letter and the following instructions:

(1) (A) N.H.A. LOANS: Delete those sections in the mortgage applicable to graduated payment loans.

(B) CONVENTIONAL LOANS: *change due dates for payment and gale dates from the last day to the first day.*

(2) REPORT ON TITLE: *Your report on Form MTG.126 must be received by us before we can disburse the loan.* If an existing loan is to be discharged from the proceeds of this new loan, please forward the report in interim form indicating that prior encumbrances will be discharged from the proceeds of the loan. In due course, please let us have a final report indicating the mortgage/deed of loan is a first/charge/hypothec against the said lands. Your report should not be delayed pending receipt of the surveyor's certificate from the Mortgagor.

PLEASE SHOW ON FORM MTG.126 PRELIMINARY REPORT, THE DATE FUNDS ARE REQUIRED. THIS FORM SHOULD BE RECEIVED BY US AT LEAST 5 DAYS BEFORE FUNDS ARE REQUIRED BY YOU. IF YOU ARE UNABLE TO DISBURSE FUNDS WITHIN 4 DAYS OF RECEIPT PLEASE REFUND TO US PROMPTLY. ANY INQUIRIES CALL: (416) 927-5772. PLEASE SEND PRELIMINARY REPORT TO THE ABOVE ADDRESS.

(3) TAXES: Check and ensure municipal and school taxes are paid up to date and advise us of address of tax office.

(4) SURVEY : Up-to-date survey to be obtained from the Mortgagor and prepared by a qualified surveyor confirming that the property conforms to all governing regulations.

(5) ADVANCES: Will be sent to you for release to the Mortgagor. Make advances after you have:

— ensured no liens are registered.

— taken necessary precautions with regard to provincial law as it relates to liens.

— ensured that the property conforms to all governing regulations as disclosed by the survey sketch or certificate.

Advance will be the *BASIC loan amount. NOTHING* to be deducted unless specified on Commitment. Pre IAD INT. to be collected by servicing branch prior to first payment date.

(6) FIRE INSURANCE: Have the Mortgagor furnish a policy of satisfactory coverage for full insurable value with loss payable to and branch indicated above. The policy is to contain an extended coverage clause and either the Mortgage clause Form MTG.42, the Standard Mortgage Clause No. I.B.C. 3000 or a mortgage clause indicating "Approved by THE INSURANCE BUREAU OF CANADA." The mortgage clause (if other than those indicated) and insurance company are to be acceptable to us and we suggest you consult us in this regard.

(7) OTHER INFORMATION: DRAFT MORTGAGE IS NOT REQUIRED AS STANDARD FORMS ARE PROVIDED.

WATER AND SEWAGE CERTIFICATES: Before requesting advance of funds, please obtain from the local health unit an appropriately signed certificate to confirm that

(A) The well water system is adequate and potable.

(B) The septic tank system appears to be adequate and that no known defects exist.

IDENTIFICATION VERIFICATION

Prior to disbursing funds, we require that you verify the identity of each Mortgagor, Guarantor, Attorney, and signing officer(s) of Corporate Mortgagor(s) in accordance with the Bank's Instructions.

Upon completion of this transaction please forward your Final Report on Title, the duplicate registered mortgage, survey, insurance certificate, and other documents to this office. Should you become aware of anything that is not in good order, please refer the matter to us.

Appendix C

Charge

LRO # 80 Charge/Mortgage

In preparation on at

This document has not been submitted and may be incomplete yyyy mm dd Page 1 of 1

Properties

PIN	21103 – 0073 LT	Interest/Estate	Fee Simple
Description	PT PARKLT 9 CON 1 FTB TWP OF YORK AS IN EP138577; CITY OF TORONTO		
Address	360 Yonge ST TORONTO		

Chargor(s)

The chargor(s) hereby charges the land to the chargee(s). The chargor(s) acknowledges the receipt of the charge and the standard charge terms, if any.

Name	SMITH, MARY IRENE Acting as an individual
Address for Service	360 Yonge Street Toronto, Ontario

I am at least 18 years of age

SMITH, JOHN JEREMY is my spouse and has consented to this transaction.

This document is not authorized under Power of Attorney by this party.

Chargee(s)		*Capacity*	*Share*
Name	ACME LENDING COMPANY LIMITED Acting as a company		
Address for Service	100 Bay Street Toronto, Ontario		

Statements

Schedule:

Provisions

Principal	$ 100,000.00	*Currency*	CDN
Calculation Period	Half-yearly, not in advance		
Balance Due Date	2011/02/01		
Interest Rate	12.0%		
Payments	$ 1,031.90		
Interest Adjustment Date	2006 02 01		
Payment Date	1st monthly		
First Payment Date	2006 03 01		
Last Payment Date	2011 02 01		
Standard Charge Terms	200033		
Insurance Amount	full insurable value		
Guarantor	n/a		

Additional Provisions

PROVIDED THAT the Chargor shall have the privilege of paying all or any part of the Principal hereby secured at any time or times without notice or bonus, provided that any partial repayment is in the amount of $500.00 or a multiple thereof.

File Number

Chargor Client File Number : 1128235 – P. MORASSUTTI

Appendix D

Acknowledgement and Direction

TO: All Lawyers within the firm of Osler, Hoskin & Harcourt LLP

AND TO: Any and all designees of the above

RE: Charge/Mortgage in favour of Acme Lending Company Limited from Mary Irene Smith of 360 Yonge Street, Toronto, Ontario, being legally described as Part of Park Lot 9, Concession 1, FTB, Township of York, City of Toronto - PIN: 21103-0073 (the "**Property**")

This will confirm that:

- The undersigned have reviewed the information set out in the draft document attached and that this information is accurate;
- You are authorized and directed to sign and register electronically on behalf of the undersigned the following document:

  1. Charge/Mortgage of the Property in favour of Acme Lending Company Limited from Mary Irene Smith

  as well as any other document(s) required to complete the transaction described above;
- You are authorized to amend the attached document provided the amendments are minor in nature and necessary to effect registration of the attached document;
- The effect of the electronic document described in this Acknowledgement and Direction has been fully explained to the undersigned, and the undersigned understand that the undersigned are parties to and bound by the terms and provisions of this electronic document to the same extent as if the undersigned had signed the document; and
- The undersigned are in fact parties named in the electronic document described in this Acknowledgement and Direction, and the undersigned have not misrepresented the identity of the undersigned to you.
- I, John Jeremy Smith, am the spouse of Mary Irene Smith within the meaning of the *Family Law Act* and hereby consent to the attached Charge/Mortgage of the Property.

Dated at Toronto, Ontario, this 15th day of January, 2006.

Witness: (as to all signatures, if applicable)

_____	_____ Mary Irene Smith
_____	_____ John Jeremy Smith

Appendix E

Land Registration Reform Act
Set of Standard Charge Terms

Filed by
Dye & Durham Co. Inc.

Filing Date: November 3, 2000
Filing number: 200033

The following Set of Standard Charge Terms shall be applicable to documents registered in electronic format under Part III of the Land Registration Reform Act, R.S.O. 1990, c. L.4 as amended (the "Land Registration Reform Act") and shall be deemed to be included in every electronically registered charge in which this Set of Standard Charge Terms is referred to by its filing number, as provided in Section 9 of the Land Registration Reform Act, except to the extent that the provisions of this Set of Standard Charge Terms are modified by additions, amendments or deletions in the schedule. Any charge in an electronic format of which this Set of Standard Charge Terms forms a part by reference to the above-noted filing number in such charge shall hereinafter be referred to as the "Charge".

Exclusion of Statutory Covenants

1. The implied covenants deemed to be included in a charge under subsection 7(1) of the *Land Registration Reform Act* as amended or re-enacted are excluded from the Charge.

Right to Charge the Land

2. The Chargor now has good right, full power and lawful and absolute authority to charge the land and to give the Charge to the Chargee upon the covenants contained in the Charge.

No Act to Encumber

3. The Chargor has not done, committed, executed or willfully or knowingly suffered any act, deed, matter or thing whatsoever whereby or by means whereof the land, or any part or parcel thereof, is or shall or may be in any way impeached, charged, affected or encumbered in title, estate or otherwise, except as the records of the land registry office disclose.

Good Title in Fee Simple

4. The Chargor, at the time of the delivery for registration of the Charge, is, and stands solely, rightfully and lawfully seized of a good, sure, perfect, absolute and indefeasible estate of inheritance, in fee simple, of and in the land and the premises described in the Charge and in every part and parcel thereof without any manner of trusts, reservations, limitations, provisos, conditions or any other matter or thing to alter, charge, change, encumber or defeat the same, except those contained in the original grant thereof from the Crown.

Promise to Pay and Perform

5. The Chargor will pay or cause to be paid to the Chargee the full principal amount and interest secured by the Charge in the manner of payment provided by the Charge, without any deduction or abatement, and shall do, observe, perform, fulfill and keep all the provisions, covenants, agreements and stipulations contained in the Charge and shall pay as they fall due all taxes, rates, levies, charges, assessments, utility and heating charges, municipal, local, parliamentary and otherwise which now are or may hereafter be imposed, charged or levied upon the land and when required shall produce for the Chargee receipts evidencing payment of the same.

Interest After Default

6. In case default shall be made in payment of any sum to become due for interest at the time provided for payment in the Charge, compound interest shall be payable and the sum in arrears for interest from time to time, as well after as before maturity, and both before and after default and judgment, shall bear interest at the rate provided for in the Charge. In case the interest and compound interest are not paid within the interest calculation period provided in the Charge from the time of default a rest shall be made, and compound interest at the rate provided for in the Charge shall be payable on the aggregate amount then due, as well after as before maturity, and so on from time to time, and all such interest and compound interest shall be a charge upon the land.

No Obligation to Advance

7. Neither the preparation, execution or registration of the Charge shall bind the Chargee to advance the principal amount secured, nor shall the advance of a part of the principal amount secured bind the Chargee to advance any unadvanced portion thereof, but nevertheless the security in the land shall take effect forthwith upon delivery for registration of the Charge by the Chargor. The expenses of the examination of the title and of the Charge and valuation are to be secured by the Charge in the event of the whole or any balance of the principal amount not being advanced, the same to be charged hereby upon the land, and shall be, without demand therefor, payable forthwith with interest at the rate provided for in the Charge, and in default the Chargee's power of sale hereby given, and all other remedies hereunder, shall be exercisable.

Costs Added to Principal

8. The Chargee may pay all premiums of insurance and all taxes, rates, levies, charges, assessments, utility and heating charges which shall from time to time fall due and be unpaid in respect of the land, and that such payments, together with all costs, charges, legal fees (as between solicitor and client) and expenses which may be incurred in taking, recovering and keeping possession of the land and of negotiating the Charge, investigating title, and registering the Charge and other necessary deeds, and generally in any other proceedings taken in connection with or to realize upon the security given in the Charge (including legal fees and real estate commissions and other costs incurred in leasing or selling the land or in exercising the power of entering, lease and sale contained in the Charge) shall be, with interest at the rate provided for in the Charge, a charge upon the land in favour of the Chargee pursuant to the terms of the Charge and the Chargee may pay or satisfy any lien, charge or encumbrance now existing or hereafter created or claimed upon the land, which payments with interest at the rate provided for in the Charge shall likewise be a charge upon the land in favour of the Chargee. Provided, and it is hereby further agreed, that all amounts paid by the Chargee as aforesaid shall be added to the principal amount secured by the Charge and shall be payable forthwith with interest at the rate provided for in the Charge, and on default all sums secured by the Charge shall immediately become due and payable at the option of the Chargee, and all powers in the Charge conferred shall become exercisable.

Power of Sale

9. The Chargee on default of payment for at least fifteen (15) days may, on at least thirty-five (35) days' notice in writing given to the Chargor, enter on and lease the land or sell the land. Such notice shall be given to such persons and in such manner and form and within such time as provided in the *Mortgages Act.* In the event that the giving of such notice shall not be required by law or to the extent that such requirements shall not be applicable, it is agreed that notice may be effectually given by leaving it with a grown-up person on the land, if occupied, or by placing it on the land if unoccupied, or at the option of the Chargee, by mailing it in a registered letter addressed to the Chargor at his last known address, or by publishing it once in a newspaper published in the county or district in which the land is situate; and such notice shall be sufficient although not addressed to any person or persons by name or designation; and notwithstanding that any person to be affected thereby may be unknown, unascertained or under disability. Provided further, that in case default be made in the payment of the principal amount or interest or any part thereof and such default continues for two months after any payment of either falls due then the Chargee may exercise the foregoing powers of entering, leasing or selling or any of them without any notice, it being understood and agreed, however, that if the giving of notice by the Chargee shall be required by law then notice shall be given to such persons and in such manner and form and within such time as so required by law. It is hereby further agreed that the whole or any part or parts of the land may be sold by public auction or private contract, or partly one or partly the other; and that the proceeds of any sale hereunder may be applied first in payment of any costs, charges and expenses incurred in taking, recovering or keeping possession of the land or by reason of non-payment or procuring payment of monies, secured by the Charge or otherwise, and secondly in payment of all amounts of principal and interest owing under the Charge; and if any surplus shall remain after fully satisfying the claims of the Chargee as aforesaid same shall be paid as required by law. The Chargee may sell any of the land on such terms as to credit and otherwise as shall appear to him most advantageous and for such prices as can reasonably be obtained therefor and may make any stipulations as to title or evidence or commencement of title or otherwise which he shall deem proper, and may buy in or rescind or vary any contract for the sale of the whole or any part of the land and resell without being answerable for loss occasioned thereby, and in the case of a sale on credit the Chargee shall be bound to pay the Chargor only such monies as have been actually received from purchasers after the satisfaction of the claims of the Chargee and for any of said purposes may make and execute all agreements and assurances as he shall think fit. Any purchaser or lessee shall not be bound to see to the propriety or regularity of any sale or lease or be affected by express notice that any sale or lease is improper and no want of notice or publication when required hereby shall invalidate any sale or lease hereunder.

Quiet Possession

10. Upon default in payment of principal and interest under the Charge or in performance of any of the terms or conditions hereof, the Chargee may enter into and take possession of the land hereby charged and where the Chargee so enters on and takes possession or enters on and takes possession of the land on default as described in paragraph 9 herein the Chargee shall enter into, have, hold, use, occupy, possess and enjoy the land without the let, suit, hindrance, interruption or denial of the Chargor or any other person or persons whomsoever.

Right to Distrain

11. If the Chargor shall make default in payment of any part of the interest payable under the Charge at any of the dates or times fixed for the payment thereof, it shall be lawful for the Chargee to distrain therefor upon the land or any part thereof, and by distress warrant, to recover by way of rent reserved, as in the case of a demise of the land, so much of such interest as shall, from time to time, be or remain in arrears and unpaid, together with all costs, charges and expenses attending such levy or distress, as in like cases of distress for rent. Provided that the Chargee may distrain for arrears of principal in the same manner as if the same were arrears of interest.

Further Assurances

12. From and after default in the payment of the principal amount secured by the Charge or the interest thereon or any part of such principal or interest or in the doing, observing, performing, fulfilling or keeping of some one or more of the covenants set forth in the Charge then and in every such case the Chargor and all and every other person whosoever having, or lawfully claiming, or who shall have or lawfully claim any estate, right, title, interest or trust of, in, to or out of the land shall, from time to time, and at all times thereafter, at the proper costs and charges of the Chargor make, do, suffer, execute, deliver, authorize and register, or cause or procure to be made, done, suffered, executed, delivered, authorized and registered, all and every such further and other reasonable act or acts, deed or deeds, devises, conveyances and assurances in the law for the further, better and more perfectly and absolutely conveying and assuring the land unto the Chargee as by the Chargee or his solicitor shall or may be lawfully and reasonably devised, advised or required.

Acceleration of Principal and Interest

13. In default of the payment of the interest secured by the Charge the principal amount secured by the Charge shall, at the option of the Chargee, immediately become payable, and upon default of payment of instalments of principal promptly as the same mature, the balance of the principal and interest secured by the Charge shall, at the option of the Chargee, immediately become due and payable. The Chargee may in writing at any time or times after default waive such default and any such waiver shall apply only to the particular default waived and shall not operate as a waiver of any other or future default.

Unapproved Sale

14. If the Chargor sells, transfers, disposes of, leases or otherwise deals with the land, the principal amount secured by the Charge shall, at the option of the Chargee, immediately become due and payable.

Partial Releases

15. The Chargee may at his discretion at all times release any part or parts of the land or any other security or any surety for the money secured under the Charge either with or without any sufficient consideration therefor, without responsibility therefor, and without thereby releasing any other part of the land or any person from the Charge or from any of the covenants contained in the Charge and without being accountable to the Chargor for the value thereof, or for any monies except those actually received by the Chargee. It is agreed that every part or lot into which the land is or may hereafter be divided does and shall stand charged with the whole money secured under the Charge and no person shall have the right to require the mortgage monies to be apportioned.

Obligation to Insure

16. The Chargor will immediately insure, unless already insured, and during the continuance of the Charge keep insured against loss or damage by fire, in such proportions upon each building as may be required by the Chargee, the buildings on the land to the amount of not less than their full insurable value on a replacement cost basis in dollars of lawful money of Canada. Such insurance shall be placed with a company approved by the Chargee. Buildings shall include all buildings whether now or hereafter erected on the land, and such insurance shall include not only insurance against loss or damage by fire but also insurance against loss or damage by explosion, tempest, tornado, cyclone, lightning and all other extended perils customarily provided in insurance policies including “all risks” insurance. The covenant to insure shall also include where appropriate or if required by the Chargee, boiler, plate glass, rental and public liability insurance in amounts and on terms satisfactory to the Chargee. Evidence of continuation of all such insurance having been effected shall be produced to the Chargee at least fifteen (15) days before the expiration thereof; otherwise the Chargee may provide therefor and charge the premium paid and interest thereon at the rate provided for in the Charge to the Chargor and the same shall be payable forthwith and shall also be a charge upon the land. It is further agreed that the Chargee may at any time require any insurance of the buildings to be cancelled and new insurance effected in a company to be named by the Chargee and also of his own accord may effect or maintain any insurance herein provided for, and any amount paid by the Chargee therefor shall be payable forthwith by the Chargor with interest at the rate provided for in the Charge and shall also be a charge upon the land. Policies of insurance herein required shall provide that loss, if any, shall be payable to the Chargee as his interest may appear, subject to the standard form of mortgage clause approved by the Insurance Bureau of Canada which shall be attached to the policy of insurance.

Obligation to Repair

17. The Chargor will keep the land and the buildings, erections and improvements thereon, in good condition and repair according to the nature and description thereof respectively, and the Chargee may, whenever he deems necessary, by his agent enter upon and inspect the land and make such repairs as he deems necessary, and the reasonable cost of such inspection and repairs with interest at the rate provided for in the Charge shall be added to the principal amount and be payable forthwith and be a charge upon the land prior to all claims thereon subsequent to the Charge. If the Chargor shall neglect to keep the buildings, erections and improvements in good condition and repair, or commits or permits any act of waste on the land (as to which the Chargee shall be sole judge) or makes default as to any of the covenants, provisos, agreements or conditions contained in the Charge or in any charge to which this Charge is subject, all monies secured by the Charge shall, at the option of the Chargee, forthwith become due and payable, and in default of payment of same with interest as in the case of payment before maturity the powers of entering upon and leasing or selling hereby given and all other remedies herein contained may be exercised forthwith.

Building Charge

18. If any of the principal amount to be advanced under the Charge is to be used to finance an improvement on the land, the Chargor must so inform the Chargee in writing immediately and before any advances are made under the Charge. The Chargor must also provide the Chargee immediately with copies of all contracts and subcontracts relating to the improvement and any amendments to them. The Chargor agrees that any improvement shall be made only according to contracts, plans and specifications approved in writing by the Chargee. The Chargor shall complete all such improvements as quickly as possible and provide the Chargee with proof of payment of all contracts from time to time as the Chargee requires. The Chargee shall make advances (part payments of the principal amount) to the Chargor based on the progress of the improvement, until either completion and occupation or sale of the land. The Chargee shall determine whether or not any advances will be made and when they will be made. Whatever the purpose of the Charge may be, the Chargee may at its option hold back funds from advances until the Chargee is satisfied that the Chargor has complied with the holdback provisions of the *Construction Lien Act* as amended or re-enacted. The Chargor authorizes the Chargee to provide information about the Charge to any person claiming a construction lien on the land.

Extensions not to prejudice

19. No extension of time given by the Chargee to the Chargor or anyone claiming under him, or any other dealing by the Chargee with the owner of the land or of any part thereof, shall in any way affect or prejudice the rights of the Chargee against the Chargor or any other person liable for the payment of the money secured by the Charge, and the Charge may be renewed by an agreement in writing at maturity for any term with or without an increased rate of interest notwithstanding that there may be subsequent encumbrances. It shall not be necessary to deliver for registration any such agreement in order to retain priority for the Charge so altered over any instrument delivered for registration subsequent to the Charge. Provided that nothing contained in this paragraph shall confer any right of renewal upon the Chargor.

No Merger of Covenants

20. The taking of a judgment or judgments on any of the covenants herein shall not operate as a merger of the covenants or affect the Chargee's right to interest at the rate and times provided for in the Charge; and further that any judgment shall provide that interest thereon shall be computed at the same rate and in the same manner as provided in the Charge until the judgment shall have been fully paid and satisfied.

Change In Status

21. Immediately after any change or happening affecting any of the following, namely: *(a)* the spousal status of the Chargor, *(b)* the qualification of the land as a family residence within the meaning of Part II of the *Family Law Act,* and *(c)* the legal title or beneficial ownership of the land, the Chargor will advise the Chargee accordingly and furnish the Chargee with full particulars thereof, the intention being that the Chargee shall be kept fully informed of the names and addresses of the owner or owners for the time being of the land and of any spouse who is not an owner but who has a right of possession in the land by virtue of Section 19 of the *Family Law Act.* In furtherance of such intention, the Chargor covenants and agrees to furnish the Chargee with such evidence in connection with any of *(a), (b)* and *(c)* above as the Chargee may from time to time request.

Condominium Provisions

22. If the Charge is of land within a condominium registered pursuant to the *Condominium Act* (the "Act") the following provisions shall apply. The Chargor will comply with the Act, and with the declaration, by-laws and rules of the condominium corporation (the "corporation") relating to the Chargor's unit (the "unit") and provide the Chargee with proof of compliance from time to time as the Chargee may request. The Chargor will pay the common expenses for the unit to the corporation on the due dates. If the Chargee decides to collect the Chargor's contribution towards the common expenses from the Chargor, the Chargor will pay the same to the Chargee upon being so notified. The Chargee is authorized to accept a statement which appears to be issued by the corporation as conclusive evidence for the purpose of establishing the amounts of the common expenses and the dates those amounts are due. The Chargor, upon notice from the Chargee, will forward to the Chargee any notices, assessments, by-laws, rules and financial statements of the corporation that the Chargor receives or is entitled to receive from the corporation. The Chargor will maintain all improvements made to the unit and repair them after damage. In addition to the insurance which the corporation must obtain, the Chargor shall insure the unit against destruction or damage by fire and other perils usually covered in fire insurance policies and against such other perils as the Chargee requires for its full replacement cost (the maximum amount for which it can be insured). The insurance company and the terms of the policy shall be reasonably satisfactory to the Chargee. This provision supersedes the provisions of paragraph 16 herein. The Chargor irrevocably authorizes the Chargee to exercise the Chargor's rights under the Act to vote, consent and dissent.

Discharge

23. The Chargee shall have a reasonable time after payment in full of the amounts secured by the Charge to deliver for registration a discharge or if so requested and if required by law to do so, an assignment of the Charge and all legal and other expenses for preparation, execution and registration, as applicable to such discharge or assignment shall be paid by the Chargor.

Guarantee

24. Each party named in the Charge as a Guarantor hereby agrees with the Chargee as follows:

(a) In consideration of the Chargee advancing all or part of the Principal Amount to the Chargor, and in consideration of the sum of TWO DOLLARS ($2.00) of lawful money of Canada now paid by the Chargee to the Guarantor (the receipt and sufficiency whereof are hereby acknowledged), the Guarantor does hereby absolutely and unconditionally guarantee to the Chargee, and its successors, the due and punctual payment of all principal monies, interest and other monies owing on the security of the Charge and observance and performance of the covenants, agreements, terms and conditions herein contained by the Chargor, and the Guarantor, for himself and his successors, covenants with the Chargee that, if the Chargor shall at any time make default in the due and punctual payment of any monies payable hereunder, the Guarantor will pay all such monies to the Chargee without any demand being required to be made.

(b) Although as between the Guarantor and the Chargor, the Guarantor is only surety for the payment by the Chargor of the monies hereby guaranteed, as between the Guarantor and the Chargee, the Guarantor shall be considered as primarily liable therefor and it is hereby further expressly declared that no release or releases of any portion or portions of the land; no indulgence shown by the Chargee in respect of any default by the Chargor or any successor thereof which may arise under the Charge; no extension or extensions granted by the Chargee to the Chargor or any successor thereof for payment of the monies hereby secured or for the doing, observing or performing of any covenant, agreement, term or condition herein contained to be done, observed or performed by the Chargor or any successor thereof; no variation in or departure from the provisions of the Charge; no release of the Chargor or any other thing whatsoever whereby the Guarantor as surety only would or might have been released shall in any way modify, alter, vary or in any way prejudice the Chargee or affect the liability of the Guarantor in any way under this covenant, which shall continue and be binding on the Guarantor, and as well after as before maturity of the Charge and both before and after default and judgment, until the said monies are fully paid and satisfied.

(c) Any payment by the Guarantor of any monies under this guarantee shall not in any event be taken to affect the liability of the Chargor for payment thereof but such liability shall remain unimpaired and enforceable by the Guarantor against the Chargor and the Guarantor shall, to the extent of any such payments made by him, in addition to all other remedies, be subrogated as against the Chargor to all the rights, privileges and powers to which the Chargee was entitled prior to payment by the Guarantor; provided, nevertheless, that the Guarantor shall not be entitled in any event to rank for payment against the lands in competition with the Chargee and shall not, unless and until the whole of the principal, interest and other monies owing on the security of the Charge shall have been paid, be entitled to any rights or remedies whatsoever in subrogation to the Chargee.

(d) All covenants, liabilities and obligations entered into or imposed hereunder upon the Guarantor shall be equally binding upon his successors. Where more than one party is named as a Guarantor all such covenants, liabilities and obligations shall be joint and several.

(e) The Chargee may vary any agreement or arrangement with or release the Guarantor, or any one or more of the Guarantors if more than one party is named as Guarantor, and grant extensions of time or otherwise deal with the Guarantor and his successors without any consent on the part of the Chargor or any other Guarantor or any successor thereof.

Severability

25. It is agreed that in the event that at any time any provision of the Charge is illegal or invalid under or inconsistent with provisions of any applicable statute, regulation thereunder or other applicable law or would by reason of the provisions of any such statute, regulation or other applicable law render the Chargee unable to collect the amount of any loss sustained by it as a result of making the loan secured by the Charge which it would otherwise be able to collect under such statute, regulation or other applicable law then, such provision shall not apply and shall be construed so as not to apply to the extent that it is so illegal, invalid or inconsistent or would so render the Chargee unable to collect the amount of any such loss.

Interpretation

26. In construing these covenants the words “Charge”, “Chargee”, “Chargor”, “land” and “successor” shall have the meanings assigned to them in Section 1 of the *Land Registration Reform Act* and the words “Chargor” and “Chargee” and the personal pronouns “he” and “his” relating thereto and used therewith, shall be read and construed as “Chargor” or “Chargors”, “Chargee” or “Chargees”, and “he”, “she”, “they” or “it”, “his”, “her”, “their” or “its”, respectively, as the number and gender of the parties referred to in each case require, and the number of the verb agreeing therewith shall be construed as agreeing with the said word or pronoun so substituted. And that all rights, advantages, privileges, immunities, powers and things hereby secured to the Chargor or Chargors, Chargee or Chargees, shall be equally secured to and exercisable by his, her, their or its heirs, executors, administrators and assigns, or successors and assigns, as the case may be. The word “successor” shall also include successors and assigns of corporations including amalgamated and continuing corporations. And that all covenants, liabilities and obligations entered into or imposed hereunder upon the Chargor or Chargors, Chargee or Chargees, shall be equally binding upon his, her, their or its heirs, executors, administrators and assigns, or successors and assigns, as the case may be, and that all such covenants and liabilities and obligations shall be joint and several.

Paragraph headings

27. The paragraph headings in these standard charge terms are inserted for convenience of reference only and are deemed not to form part of the Charge and are not to be considered in the construction or interpretation of the Charge or any part thereof.

Date of Charge

28. The Charge, unless otherwise specifically provided, shall be deemed to be dated as of the date of delivery for registration of the Charge.

Effect of Delivery of Charge

29. The delivery of the Charge for registration by direct electronic transfer shall have the same effect for all purposes as if such Charge were in written form, signed by the parties thereto and delivered to the Chargee. Each of the Chargor and, if applicable, the spouse of the Chargor and other party to the Charge agrees not to raise in any proceeding by the Chargee to enforce the Charge any want or lack of authority on the part of the person delivering the Charge for registration to do so.

DATED this day of ,
(year)

Appendix F

Acknowledgement

This Set of Standard Charge Terms filed as No. 200033 is included in a Charge dated the 15th day of January, 2006, made by Mary Irene Smith, as Chargor, to Acme Lending Company Limited, as Chargee (the "Charge"), and the Chargor and John Jeremy Smith, as Consenting Spouse, hereby acknowledge receipt of a copy of this Set of Standard Charge Terms before signing the Charge.

DATED at Toronto, this 15th day of January, 2006.

Mary Irene Smith

DATED at Toronto, this 15th day of January, 2006.

John Jeremy Smith

Appendix G

Repayment Schedule

Each monthly payment is $1,031.90.

(1) Where interest is payable at the same rate as interest is calculated

- no deemed reinvestment
- simple interest calculation

$$\text{monthly interest} = \text{principal outstanding} \times \text{interest payment} \left(\text{i.e. } \frac{\text{annual interest rate}}{12} \right)$$

$$\text{i.e. interest payment of first payment} = \$100{,}000 \times 0.010000 \left(\text{i.e. } \frac{12\%}{12} \right) = \$1000.00$$

Therefore, the balance ($1,031.90 - $1,000.00 = $31.90) of $31.90 of the first payment is applied against principal.

$$\text{interest payment of second payment} = \$99{,}968.10 \times 0.010000 = \$999.68$$

Therefore, the balance ($1,031.90 - $999.68 = $32.22) of $32.22 of the second payment is applied against principal.

(2) Where interest is payable more frequently than interest is calculated

- deemed reinvestment principle applies

$$\text{monthly interest} = \text{principal outstanding this month} \times \text{interest payment factor} \left(\text{i.e. } \frac{\text{annual interest rate less a figure reflecting early receipt of interest by the lender}}{12} \right)$$

The effective annual rate of interest = 0.00975894 x 12 = 11.7%

i.e., interest portion of first payment = $100,000.00 x 0.00975894 = $975.88

interest portion of second payment = $99,943.98 x 0.00975894 = $975.33

Appendix H

Standard Mortgage Clause in Insurance Policy

MORTGAGE CLAUSE

(officially approved by The Insurance Board of Canada)

Special endorsement granted to Canadian Imperial Bank of Commerce, hereinafter called the "Mortgagee."

IT IS HEREBY PROVIDED AND AGREED THAT:

Breach of conditions by mortgagor, owner, or occupant

1. This insurance and every documented renewal thereof — AS TO THE INTEREST OF THE MORTGAGEE ONLY THEREIN — is and shall be in force notwithstanding any act, neglect, omission or misrepresentation attributable to the mortgagor, owner or occupant of the property insured, nor by transfer of interest, nor by any vacancy or non-occupation, nor by the occupation of the property for purposes more hazardous than specified in the description of the risk;

   PROVIDED ALWAYS that the Mortgagee shall notify forthwith the Insurer (if known) of any non-occupancy or vacancy extending beyond thirty (30) consecutive days, or of any transfer of interest or increased hazard THAT SHALL COME TO HIS KNOWLEDGE, and that every increase of hazard (not permitted by the policy) shall be paid for by the Mortgagee — on reasonable demand — from the date such hazard existed, according to the established scale of rates for the acceptance of such increased hazard, during the continuance of this insurance.

Right of subrogation

2. Whenever the Insurer pays the Mortgagee any loss award under this policy and claims that — as to the mortgagor or owner — no liability therefor existed, it shall be legally subrogated to all rights of the Mortgagee against the Insured; but any subrogation shall be limited to the amount of such loss payment and shall be subordinate and subject to the basic right of the Mortgagee to recover the full amount of its mortgage equity in priority to the Insurer; or the Insurer may at its option pay the Mortgagee all amounts due or to become due under the mortgage or on the security thereof, and shall thereupon receive a full assignment and transfer of the mortgage together with all securities held as collateral to the mortgage debt.

Other insurance

3. If there be other valid and collectible insurance upon the property with loss payable to the Mortgagee — at law or in equity — then any amount payable thereunder shall be taken into account in determining the amount payable to the Mortgagee.

Who may give proof of loss

4. In the absence of the Insured, or the inability, refusal or neglect of the Insured to give notice of loss or deliver the required Proof of Loss under the policy, then the Mortgagee may give the notice upon becoming aware of the loss and shall deliver as soon as practicable the Proof of Loss.

Termination

5. The term of this mortgage clause coincides with the term of the policy;

   PROVIDED ALWAYS that the Insurer reserves the right to cancel the policy as provided by Statutory provision but agrees that the Insurer will neither terminate nor alter the policy to the prejudice of the Mortgagee without the notice stipulated in such Statutory provision.

Foreclosure

6. Should title or ownership to said property become vested in the Mortgagee and/or assigns as owner or purchaser under foreclosure or otherwise, this insurance shall continue until expiry or cancellation for the benefit of the said Mortgagee and/or assigns.

SUBJECT TO THE TERMS OF THIS MORTGAGE CLAUSE (and these shall supersede any policy provisions in conflict therewith BUT ONLY AS TO THE INTEREST OF THE MORTGAGEE), loss under this policy is made payable to the Mortgagee.

Attached to and forming part of policy number ..... of the .....

Dated at ..... this ..... day of ..... , ...

Signed .....

Agent for the Insurer

Appendix I

Special Clauses for Charge of Condominium

1. Compliance with Condominium Act, 1998, etc.

The Chargor covenants and agrees with the Chargee to comply with and observe all the covenants, provisions, terms, conditions, stipulations, specifications, rules, and regulations of the *Condominium Act, 1998* and of the Declaration and of the By-law and of any future By-laws of the condominium corporation and of any of the rules and regulations of the owners of the units.

2. Covenant to pay common expenses, etc.

The Chargor covenants and agrees that he will pay promptly when due any contributions to common expenses and any other moneys required of him as an owner of the parcel, and in the event of his default in doing so the Chargee, at its option, may pay the same and exercise all or any of its rights under this charge whether or not any payment in default has priority to this or any part of the moneys secured hereby.

3. Assignment of right to vote

The Chargor hereby agrees to and by these presents does irrevocably nominate, appoint, and authorize the Chargee to exercise from time to time and at any time the right of the Chargor, to vote at all times and for all purposes, wherever and whenever the Chargor would have such right to vote, at any meeting of the members of the condominium corporation.

The Chargor hereby further agrees to and by these presents does hereby irrevocably authorize the Chargee to exercise from time to time and at any time the right of the Chargor, in the name of the Chargor and on behalf of the Chargor, to consent at any time or times and for all purposes, wherever and whenever the Chargor would have such right of consent, to any matter relevant to the management or sale of or any dealings with the property of the condominium corporation or its assets or the termination of the application of the *Condominium Act, 1998* to the condominium corporation.

The Chargee may from time to time waive its right to vote or consent by giving notice of its intention to do so to the condominium corporation, and such waiver may be for an indeterminate period of time until withdrawn or for a limited period of time or for a specific meeting or matter, and while such waiver is in effect the Chargor may exercise the right to vote or to consent.

The parties hereto hereby acknowledge that notwithstanding the exercise by the Chargee of the right of the Chargor to either vote or consent, such exercise shall not render the Chargee a mortgagee in possession.

The parties further acknowledge that the right to vote assigned herein to the Chargee does not entail any representation, express or implied, that the Chargee shall be in any way responsible to protect the interest of the Chargor, and the Chargee shall not be responsible for any exercise of the right to vote or any failure to exercise the right to vote.

4. Notice re notices, etc.

The Chargor covenants and agrees with the Chargee to deliver by mailing to the Chargee by prepaid registered mail a copy of each and every

(a) claim or demand for payment by the Chargor to the condominium corporation or to any person, firm, or corporation duly authorized to receive moneys otherwise payable to the condominium corporation at least five clear days prior to the date upon which such claim or demand becomes due and payable as provided by the terms of such claim or demand;

(b) notice of any breach of any of the provisions of the *Condominium Act, 1998* or of the Declaration or of any By-law or By-laws of the condominium corporation, copies of which are or are hereafter duly registered in the Office of Land Titles or of any rule or regulation of the owners of the units and made pursuant to the provisions of Section II of the *Condominium Act, 1998* within five days of the date upon which such notice is received by the Chargor; and

(c) request or demand for the consent of the Chargor to any matter affecting the unit herein or the common elements of the condominium corporation (as to which the Chargee shall be the sole judge) within five days of the date upon which such request or demand is received by or made of the Chargor.

Appendix J

Transfer of Charge by Chargee

LRO # 80 Transfer of Charge

In preparation on at

This document has not been submitted and may be incomplete yyyy mm dd Page 1 of 1

Properties

PIN 12121 - 0322 LT ☑ Redescription

Description LOT 10, PLAN 100, CITY OF TORONTO

Address 360 YONGE STREET
TORONTO

Source Instruments

Registration No.	*Date*	*Type of Instrument*
AT556322	2003 09 29	Charge/Mortgage

Transferor(s)

Name ACME LENDING COMPANY LIMITED
Acting as a company

Address for Service 100 Bay Street
Toronto, Ontario

I, TOM LOANS, President, have the authority to bind the corporation

This document is not authorized under Power of Attorney by this party.

Transferee(s)

Name BROWN, WILLIAM
Acting as an individual

Address for Service 254 Wright Avenue
Toronto, Ontario

Statements

The chargee transfers the selected charge for NINETY-NINE THOUSAND, NINE HUNDRED & FORTY-THREE DOLLARS NINETY-EIGHT CENTS (99,943.98)

File Number

Transferor Client File Number : 83510 P. MORASUTTI

Appendix K

Notice to Chargor of Transfer of Charge by Chargee

NOTICE AND DIRECTION

TO: MARY IRENE SMITH

RE: Charge Lot 10, Plan 100, Toronto, Ontario
by Mary Irene Smith to Acme Lending Company Limited
Lot 10, Plan 100, Toronto, Ontario

THIS WILL SERVE AS NOTICE to you of the transfer of the above-mentioned charge number 88265 from Acme Lending Company Limited to William Brown.

THIS WILL THEREFORE AUTHORIZE AND DIRECT you to make all future payments commencing with that due April 1, 2006, to William Brown at 254 Wright Avenue, Toronto, Ontario.

DATED at Toronto, this 12th day of March, 2006.

ACME LENDING COMPANY LIMITED

PER: _____
A.S.O. c/s

PER: _____
A.S.O.

We have authority to bind the corporation.

Appendix L

Acknowledgement by Chargor to Assignee

ACKNOWLEDGEMENT

TO: WILLIAM BROWN

AND TO: His Solicitors, Osler, Hoskin & Harcourt LLP

RE: Acme Lending Company Limited transfer to William Brown of Charge No. 88265
from Mary Irene Smith to Acme Lending Company Limited
covering Lot 10, Plan 100, City of Toronto.

This is to confirm that, in connection with my charge in favour of Acme Lending Company Limited, covering the above-mentioned property, there is now outstanding on the charge the sum of $99,943.98. The interest rate chargeable under the charge is 12% per annum. The maturity date is February 1, 2011. I have paid all loan payments up to and including the payment on March 1, 2006. I have not prepaid any amounts under the charge. The charge has not been amended.

I have no right of set-off against Acme Lending Company Limited, the Chargee.

I hereby covenant to pay all future payments beginning with the payment on April 1, 2006, to William Brown at 254 Wright Avenue, Toronto, Ontario.

DATED at Toronto, this 13th day of March, 2006.

_____

Mary Irene Smith

Appendix M

Assumption Statement

STATEMENT OF MORTGAGE ACCOUNT FOR ASSUMPTION PURPOSES ONLY

	NAME OF MORTGAGOR Mary Irene Smith	
	PROPERTY ADDRESS 360 Yonge Street, Toronto, Ontario	
	MORTGAGE NO.	DATE PREPARED April 3, 2005
	MATURITY DATE February 1, 2011	INTEREST RATE 12%

BALANCE PARTICULARS	MONTHLY PAYMENT DETAILS
PRINCIPAL BALANCE OUTSTANDING April 16, 2006 $ 99,887.41	PRINCIPAL & INTEREST $1,031.90
INTEREST FROM Apr. 1/06 TO Apr. 16/06 $ 492.60	TAX PORTION (SUBJECT TO ANNUAL ADJUSTMENT) $ NIL
CREDIT (~~DEBIT~~) BALANCE IN TAX ACCOUNT $ NIL	TOTAL (DUE 1ST DAY OF EACH MONTH) $1,031.90
OTHER CHARGES $	
$ NIL	[X] PAYMENT OF REALTY TAXES IS THE RESPONSIBILITY OF THE MORTGAGOR
E. & O.E. TOTAL * $100,380.01	

DAILY RATE **$ 32.84**

* THE FOLLOWING MUST BE PAID AND DEDUCTED FROM THE ABOVE TOTAL

1. ARREARS OUTSTANDING $ nil
2. MONTHLY PAYMENTS DUE $ 1,031.90

TOTAL $ 1,031.90

CONDITIONS AND REMARKS

1. BALANCE PARTICULARS ASSUME THAT ALL INSTALMENTS ARE PAID AND HONOURED AND THAT THERE ARE NO FURTHER CHARGES. PAYMENTS SUBSEQUENTLY DISHONOURED WILL BECOME THE RESPONSIBILITY OF THE PERSON ASSUMING THE MORTGAGE WHETHER THE PAYMENT IS DISHONOURED PRIOR TO OR AFTER THE PROPOSED SALE CLOSING DATE.
2. UNTIL SUCH TIME AS THIS OFFICE RECEIVES CONFIRMATION OF THE SALE PARTICULARS ON THE TEAR-OFF PORTION OF THIS STATEMENT. MONTHLY INSTALMENTS WILL CONTINUE TO BE PROCESSED IN THE NAME OF THE ABOVE MENTIONED MORTGAGOR.
3. THIS STATEMENT MAY NOT BE USED FOR DISCHARGE PURPOSES.
4. This statement is based on all payments up to and including April 1, 2006, payment $1,031.90 being honoured by the bank.
5. Purchaser will be responsible for May 1, 2006 payment.

PREPARED BY	APPROVED BY

FORM

REPRODUCED WITHOUT PERMISSION

Appendix N

Assumption Agreement

THIS ASSUMPTION AGREEMENT made the 16th day of April, 2006

B E T W E E N:

DAVID WOOD, of the City of Toronto, in the Municipality of Metropolitan Toronto,

(the "Purchaser")

– and –

WILLIAM BROWN, of the City of Toronto, in the Municipality of Metropolitan Toronto,

(the "Lender")

WHEREAS by Charge registered on January 16, 2006, in the Land Registry Office for the Land Titles Division of Toronto as No. 88265 (the "Charge") Mary Irene Smith charged Lot 10, Registered Plan 100 in the City of Toronto in the Municipality of Metropolitan Toronto (the "Lands") to Acme Lending Company Limited;

AND WHEREAS by Transfer of Charge registered on March 12, 2006, in the Land Registry Office for the Land Titles Division of Toronto as No. 653218 Acme Lending Company Limited transferred the Charge to William Brown;

AND WHEREAS the Purchaser has purchased the lands from Mary Irene Smith and has assumed payment of the moneys secured by the Charge and performance of the covenants, provisos, and conditions therein contained;

NOW THEREFORE THIS AGREEMENT WITNESSETH that in consideration of $10.00 now paid by the Lender to the Purchaser, the Purchaser covenants, promises, and agrees to and with the Lender to pay to him, his successors, or assigns, the moneys due upon the Charge amounting to $99,893.01 with interest at 12% per annum from April 16, 2006, on the days and times therein provided for payment and to observe and perform all the covenants, provisos, and conditions therein contained.

Nothing herein shall release or affect any party to the Charge or any security held by the Lender against whom and which all remedies are reserved.

IN WITNESS WHEREOF the Purchaser has hereunto set his hand and seal.

SIGNED, SEALED AND DELIVERED	)	
IN THE PRESENCE OF	)	
	)	
	)	
	)	
_____	)	_____
		DAVID WOOD

Appendix O

Discharge

LRO # 80 Discharge of Charge

In preparation on at

This document has not been submitted and may be incomplete yyyy mm dd Page 1 of 1

Properties

PIN	12121 - 0322 LT	☑ Redescription
Description	LOT 10, PLAN 100, CITY OF TORONTO	
Address	360 YONGE STREET TORONTO	

Source Instruments

Registration No.	*Date*	*Type of Instrument*
AT556322	2003 09 29	Charge/Mortgage

Transferor(s)

This discharge complies with the Planning Act. This discharge discharges the charge.

Name	BROWN, WILLIAM Acting as an individual
Address for Service	254 Wright Avenue Toronto, Ontario

This document is not authorized under Power of Attorney by this party.

The party giving the discharge is not the original chargee or is the original chargee and has changed its name but is the party entitled to give an effective discharge.

File Number

Discharging Party Client File Number : 83510 P. MORASSUTTI

Appendix P

Discharge Statement

STATEMENT

FOR MORTGAGE PAYMENT IN FULL ONLY

DATE: June 2, 2006

MAIL TO: NAME AND ADDRESS OF MORTGAGORS

DAVID WOOD

BRANCH 111 Yonge Street, Toronto

BANK REFERENCE NO.

CIVIC ADDRESS OF SECURITY	NUMBER STREET CITY OR TOWN PROVINCE 360 Yonge Street			
TYPE OF MORTGAGE	FIXED INTEREST RATE VARIABLE INTEREST RATE	X CONVENTIONAL	HIGH RATIO NHA	ROYFARM
BALANCE PARTICULARS COMPLETE WORKSHEET ON REVERSE	DATE OF PROPOSED PAYMENT JUNE 18, 2006 BALANCES ARE ESTIMATED ON THE ASSUMPTION THAT ALL REGULAR MONTHLY PAYMENTS INCLUDING LIFE INSURANCE PREMIUMS IF ANY TO DATE OF PROPOSED PAYMENT ARE MADE. BALANCES OF VARIABLE RATE RESIDENTIAL MORTGAGES ARE BASED ON CURRENT RESIDENTIAL LOAN BASE RATE AND ARE APPROXIMATE			

MORTGAGE ACCOUNT		$99,772.66
INCLUDING INTEREST 12%	TO DATE OF PROPOSED PAYMENT	590.40
BONUS INTEREST IF ANY		$ NIL
TAX ACCOUNT See note below	Credit / Debit	$ NIL
DISCHARGE FEE IF ANY	To be paid by client Direct to Solicitor	$ NIL
	Amount	$ 100,363.06

PLEASE NOTE: If funds are not received on date of proposed payment a per diem rate of $ 32.80 is to be added to amount due for each additional day until June 30, 2006

If payment is not received by the bank on or before the latter date a new mortgage statement should be obtained. In particular please note that there may be bonus interest or additional bonus interest should payment not be received on or before the latter date.

Taxes: Tax notices received from this date to the date of receipt of funds will be forwarded direct to mortgagor for payment.

CHECKED BY

BRANCH ADMINISTRATION OFFICER

MANAGER

Chapter 53

Enforcement of mortgage security

1. Potential remedies

When a mortgagor has defaulted under a mortgage, the mortgagee has a number of remedies to choose from.

The mortgagee may either

- sell the mortgaged property
  - under the private power of sale provisions contained in the mortgage; or
  - pursuant to a court order made in a judicial sale action;
- obtain title to the mortgaged property by means of
  - a foreclosure action; or
  - acceptance of a quit claim deed to the mortgaged property;
- take possession of the mortgaged property privately, by court order, or by a receiver; or
- obtain a judgment against
  - the mortgagor and/or any guarantor; or
  - the current owner of the mortgaged property, if there has been a change of ownership for payment of the debt secured by the mortgage either
    - before sale under power of sale; or
    - after sale under power of sale for the amount then due on the mortgage debt (after application of the net proceeds of sale).

2. Information to be obtained

A full understanding of the relevant facts is necessary before properly advising a mortgagee as to which remedy to pursue. Information that should be obtained from the mortgagee prior to invoking a remedy includes

- a copy of the mortgage, any appraisals obtained by the mortgagee at the time of making the loan, a survey of the mortgaged property, and a solicitor's report on the closing of the mortgage loan;
- the address and a brief legal description of the mortgaged property;
- information as to whether the mortgaged property is vacant or occupied and, if occupied, the names and status of the occupant as owner or tenant;
- confirmation that fire insurance coverage is in place;
- a copy of any notices of any lien or interest in the mortgaged property received by the mortgagee;
- the name and address of the present owner and other known addresses of the mortgagor and any guarantors; and the name of the spouse of the owner if the property could potentially be a matrimonial home;
- credit reports, if any, on the original mortgagor, any guarantors, and the current owner;
- the date of default under the mortgage;
- a copy of any demand made on subsequent encumbrancers or guarantors and details of any payments made in response to such demands;
- the amount owing on the mortgage for principal and interest, the amount of disbursements made by the mortgagee for realty taxes, insurance premiums, and any other items; and
- details of any assignment of the mortgage to the current holder of the mortgage, where applicable, and a copy of any notice to the mortgagor of such assignment.

3. Selecting the appropriate remedy: power of sale, judicial sale, or foreclosure

When a mortgagee exercises the power of sale, which is generally contained in a mortgage, the mortgagee conveys the mortgaged property to a purchaser free and clear of the interest of the mortgagor and any other person having an interest in the mortgaged property subsequent in priority to the mortgagee. A judicial sale has essentially the same result. Alternately, by exercising a foreclosure action, the mortgagee will become the owner of the mortgaged property, and those interests subsequent to the mortgagee in priority will lose their interest in the mortgaged property.

3.1 Advantages of power of sale

There are several advantages to the exercise of power of sale as compared to a judicial sale or foreclosure:

- **Time:** The mortgagor is generally required to pay the money due under the mortgage within 35–45 days after the issuance of a notice of sale as compared to 60 days after the taking of accounts in a judicial sale or foreclosure action (with the possibility of further extensions of the redemption period and other delays caused by motions and other court proceedings).
- **Cost:** The power of sale procedure is fairly standard and is conducted from a solicitor's office. In a judicial sale or foreclosure action, there may be several attendances and motions before the courts.

- **Service:** A notice of sale may be served by registered mail, whereas a judicial sale or foreclosure action is commenced by a statement of claim which must be personally served upon the defendants.
- **Deficiency after sale:** If the mortgage debt has not been fully repaid by selling the mortgaged property under the power of sale, the mortgagee is entitled to sue the mortgagor and others to recover the shortfall. The same right exists in favour of the mortgagee after a judicial sale (*Rules of Civil Procedure*, r. 64.04(14)). By obtaining a final order of foreclosure, the mortgagee is deemed to have accepted the property in satisfaction of the debt and is precluded from proceeding with an action against the mortgagor for any deficiency.
- **Land transfer tax:** Land transfer tax is not payable by the mortgagee in exercising a power of sale or when selling in a judicial sale but is payable by a mortgagee when registering a final order of foreclosure in the mortgagee's favour.
- **Flexibility:** A mortgagee is generally entitled to abandon a power of sale proceeding at any time, subject only to s. 42 of the *Mortgages Act*. Once a mortgagee has commenced a foreclosure action or judicial sale action, the mortgagee is not at liberty to abandon the action and then commence power of sale proceedings without the leave of the court being granted, which will likely be denied.

3.2 Advantages of judicial sale or foreclosure

The major advantages of a judicial sale or a foreclosure action as compared to the exercise of power of sale are

- **Propriety of sale:** Judicial sale or foreclosure proceedings are court supervised, and the mortgagee does not have to account to the mortgagor or to subsequent encumbrancers for any surplus realized on a subsequent sale of the mortgaged property after the granting of a final order of foreclosure. By contrast, under a power of sale, the mortgagee has the responsibility to conduct the sale properly, sell the property for a fair value, and account to the mortgagor and to subsequent encumbrancers for any surplus.
- **Resolution of problems:** In a judicial sale or foreclosure action, the court is an available forum for the disposition of complex issues. This forum is not available in a power of sale procedure.
- **Combined action:** Claims for possession and recovery of the mortgage debt may be combined with judicial sale or foreclosure proceedings, whereas a separate action must be commenced for possession and/or payment of the mortgage debt in power of sale proceedings.
- **Ownership:** Foreclosure may appeal to a mortgagee in a depressed market where a sale of the property in the short term will not generate sufficient proceeds to repay the mortgage debt. In the long term, real estate values may improve to such an extent that, after foreclosure, the mortgagee may be able to sell the property for an amount in excess of the mortgage debt without having to account to the mortgagor for any surplus. This is especially important in circumstances where the mortgagee intends to expend considerable moneys in improving the property for resale.

4. Demand letters

Before commencing enforcement proceedings, it is generally prudent for a solicitor to send a demand letter to the mortgagor. In order to do so, a solicitor will need to ascertain the name and address of the mortgagor and, if possible, any known names or addresses of subsequent mortgagees. The letter should specify

- the amount required to bring the mortgage account into good standing, including monthly payments, late interest payments, disbursements, and legal fees;
- a deadline for payment;
- the method of payment; and
- that if the mortgage account is not brought into good standing, legal proceedings will be commenced a certain number of days after the date of the letter.

Section 42 of the *Mortgages Act* precludes the mortgagee from commencing further enforcement proceedings during the demand period specified for payment. The mortgagee should retain a copy of the demand letter for his or her file.

Contacting subsequent encumbrancers at this preliminary stage is advisable, since this will increase the possibility of payment. This may be done in conjunction with the sending of the demand letter to the mortgagor. Furthermore, a subsequent encumbrancer will be less likely to attack the amount due and the legal costs incurred in the enforcement of the mortgage if he or she has been given adequate notice at an early stage of the proceedings. In some instances, the second mortgagee will pay the arrears on the first mortgage to protect the second mortgagee's position. Conversely, when acting for the second mortgagee, if the second mortgage is in default, the lawyer should obtain information from the first mortgagee to ascertain if that mortgage is in good standing. Consideration should be given to keeping the first mortgage in good standing to prevent the first mortgagee from exercising a power of sale, which will ultimately extinguish the second mortgagee's interest in the mortgaged property.

5. Sale by a mortgagee under power of sale

After considering the relative merits of power of sale, judicial sale, and foreclosure, mortgagees most often select the private power of sale procedure as the appropriate realization remedy.

5.1 When may the power of sale be exercised?

In each case, the power of sale provisions contained in the mortgage should be studied. Section 32 of the *Mortgages Act* provides that notice of the exercise of the power of sale shall not be given until the default has continued for at least 15 days and the sale shall not be made for at least 35 days after the notice has been given. If the default in question is not a default of payment of principal and/or interest, but rather the mortgagor has failed to pay taxes or insurance premiums or has breached other mortgage covenants, the mortgage should be carefully reviewed to determine if the default or breach is a proper basis for commencing power of sale proceedings. A mortgagee is required to give the mortgagor notice of any breach of covenant that constitutes a default (other than default in payment of principal or interest) together with a reasonable time for the mortgagor to remedy the breach prior to issuing a notice of sale.

Section 244 of the *Bankruptcy and Insolvency Act* (*BIA*) requires a secured creditor that intends to enforce its security on all or substantially all of the inventory, accounts receivable, or other property of an insolvent person to send notice of intention to enforce security to that person if the assets being enforced upon have been acquired for, or used in relation to, a business carried on by that insolvent person. Subject to certain exceptions, s. 244(2) of the *BIA* provides that enforcement of that security shall not proceed until 10 days after the notice of intention to enforce security has been sent, unless the insolvent person consents to an earlier enforcement of the security.

Section 21 of the federal *Farm Debt Mediation Act* requires a mortgagee to give 15 business days' written notice of intent to realize on security that constitutes the property of a farmer. The notice should advise the farmer of his or her right to apply to an administrator for relief pursuant to s. 5 of that *Act*, which may result in a 30-day stay of proceedings, as outlined in s. 7(1)(b) of that *Act*.

5.2 Statutory power of sale

If the mortgage does not contain power of sale provisions, the mortgagee may look to the statutory power of sale provisions set out in Part II of the *Mortgages Act*. Some of the time periods in Part II differ from those set forth in usual standard form power of sale provisions. For example, s. 24 states that a sale cannot take place until after at least a three-month default in payment of moneys due under the mortgage or after omission to pay any premium of insurance that by the terms of the mortgage ought to have been paid by the mortgagor. Additionally, no sale under the power conferred by s. 24 may be made until after 45 days' notice in writing in the form under the *Act* has been given to the persons and in the manner provided by Part III of the *Mortgages Act* (see s. 26(1)). The power of sale provisions of Part II do not apply in the case of a mortgage that contains a power of sale.

5.3 Procedure in issuing the notice of sale

A subsearch of title to the mortgaged premises should be conducted prior to issuing a notice of sale to determine the names of all persons having an interest in the mortgaged property subsequent in priority to the mortgagee. After the subsearch has been reviewed, a draft notice of sale should be prepared.

All of the addresses of the recipients of the notice should be set out in a schedule to the notice of sale. These addresses should be obtained from the subsearch of title and from the mortgagee.

A registration receipt form from the post office should be prepared. All addresses to which the notice of sale is to be sent should be set out in the registration receipt. Additionally, envelopes marked "registered mail" should be prepared and addressed to each recipient.

The subsearch of title should be updated as of 5:00 p.m. on the day prior to issuance of the notice of sale. Additionally, the mortgagee's solicitor should, on the day the notice is being issued, verify that no other instruments were registered against title to the mortgaged property prior to 5:00 p.m. the previous day and also recheck executions. If there are any additional parties entitled to receive the notice of sale, these should be added to the schedule to the notice, and the registration receipt and a new envelope should be prepared.

The notice of sale should be completed after confirming all amounts with the mortgagee. After the notice of sale has been finalized, each copy of the notice should be signed by the solicitor for the mortgagee and then placed in a separate envelope and taken to the post office where the registration receipt will be stamped. A copy of the notice should be sent to the mortgagee together with a warning that the mortgagee should take no further proceedings to enforce the mortgage until the expiration of the time for payment in the notice, since such proceedings would be a contravention of s. 42 of the *Mortgages Act*.

On the day of mailing the notice of sale, a statutory declaration as to service of the notice of sale should be prepared and sworn.

5.4 Recipients of the notice of sale

Part III of the *Mortgages Act* requires that a statutory form of notice be given in accordance with the *Act* and stipulates the persons upon whom the notice must be served, as set out below, and the manner of service.

Prior encumbrancers need not be served with a copy of the notice of sale, since a power of sale does not extinguish the rights of prior encumbrancers in the mortgaged property.

5.4.1 The original mortgagor

If the mortgaged property has been sold, the original mortgagor is not a necessary party to whom the notice of sale must be forwarded, but if the mortgagee intends to proceed against the original mortgagor on the covenant to pay or otherwise, a notice of sale should be served on the mortgagor to provide the original mortgagor with an opportunity to "redeem" the mortgaged property. Service of the notice of sale on the original mortgagor is essential if the mortgagee intends to later sue the original mortgagor on the covenant for payment, since failure to do so may relieve the original mortgagor from any liability for any deficiency.

5.4.2 The owner

The current owner of the equity of redemption is entitled to notice.

5.4.3 Spouses

The mortgagor's spouse is given statutory rights of possession and redemption paralleling those of the title-holding mortgagor under ss. 19(1) and 22(1)–(2) of the *Family Law Act*.

5.4.4 Subsequent mortgagees

The notice should be served on all subsequent mortgagees.

5.4.5 Assignees of subsequent mortgagees

If a subsequent mortgage has been assigned, service of the notice of sale upon the assignee is sufficient for the purposes of the *Mortgages Act*.

5.4.6 Execution creditors

Execution creditors of the mortgagor or, where applicable, of the owner of the equity of redemption whose writs of search and seizure are subsequent to the mortgage but in the hands of the sheriff at the time of giving the notice of sale (or if the property is in the land titles system, filed in the land titles office at the time of giving the notice of sale) are entitled to receive a copy of the notice of sale pursuant to ss. 31(1)1 and (2) of the *Mortgages Act*.

Subsection 33(2) of the *Mortgages Act* provides special rules for service of a notice of sale on an execution creditor.

5.4.7 Construction liens

Subsection 33(3) of the *Mortgages Act* provides that where a mortgagee is claiming priority over a construction lien claimant, notice of the exercise of the power of sale may be given by addressing the notice to the solicitor who filed the claim for lien.

A solicitor for a purchaser should be reluctant to accept title from a mortgagee who sells under a power of sale if there has been a claim for priority made by one or more lien claimants.

If the mortgagee wishes to realize on the security but is not able to provide clear title to the purchaser because of claims made by construction lien claimants, a mortgagee may rely upon s. 44 of the *Construction Lien Act* and pay the amount of the lien claim and costs into court or post security for the lien claim, pursuant to an order under s. 44(1)(a) or (2), whereby the liens cease to attach to the mortgaged premises and the holdbacks and become instead a charge upon the amounts paid into court. The liens are vacated from title to the property, and the mortgagee is able to sell the property free of the liens. Subsequently, if the court finds the liens do not attach to the mortgaged premises, the court may order the amount paid into court be returned to the mortgagee pursuant to ss. 45(2)–(3).

5.4.8 Guarantors

Strictly speaking, a guarantor of a mortgage who has not paid any part of the mortgage debt has no charge on the mortgaged property and is therefore not entitled to receive a notice of sale. Nevertheless, it is good practice when reviewing the mortgage security documentation to make a note of the guarantors and to serve the guarantors with a copy of any notice of sale.

5.4.9 Tenants

When preparing a notice of sale, consideration should be given to serving any tenants of the mortgaged property subsequent in interest to the mortgage, especially in light of *Goodyear Canada Inc. v. Burnhamthorpe Square Inc.* Before issuing the notice of sale, the mortgagee should consider whether the tenancy in question is disadvantageous and, if so, whether the mortgagee wishes to force the tenant to vacate the mortgaged

property. The mortgagee may then take possession and re-let the mortgaged premises on more advantageous terms. The first question to be determined in making the decision of whether to force a tenant to vacate is whether the lease agreement came into existence prior or subsequent to the mortgage.

- **Prior lease:** Where a lease is executed and registered prior to the execution and registration of a mortgage and where the mortgagee took his or her security with actual notice of the lease, or where the tenant has actual possession of his or her premises and the term of the lease is such as to not require registration pursuant to the provisions of the *Registry Act* or the *Land Titles Act*, the tenant will have priority over the mortgagee. Therefore, it is not necessary for the mortgagee to serve the tenant with notice of the exercise of his or her power of sale because the tenant has priority over the mortgagee. In these cases, all the owner-mortgagor has at the time he or she mortgages the property is a reversionary interest in the property, which is then charged by the mortgage. In such a scenario, neither the mortgagee nor the tenant will be able to terminate the tenancy following default by the mortgagor under the mortgage. After default, the mortgagee may still elect to serve a notice of attornment on the tenant requiring the tenant to pay all future rent to the mortgagee. The mortgagee is thus able to enforce the tenant's obligation to pay rent and to perform his or her other obligations under the lease, but conversely, the tenant is entitled to performance by the mortgagee of the landlord's covenant under the lease. The notice of the attornment is effective upon receipt by the tenant. Prior to receipt of this notice, the tenant is free to continue to pay his or her rent to the landlord or, indeed, to a subsequent encumbrancer who has previously elected to collect rent. In any disputes between a prior and subsequent mortgagee with respect to the rents of the tenant, the mortgagee having a prior right to possession is entitled to the rents in question from and after the delivery of its notice to the tenant.
- **Subsequent lease:** Where a lease is entered into by a mortgagor without the mortgagee's consent and the tenant lacks priority over the mortgagee, the tenant has only a leasehold interest in the equity of redemption. As a consequence, the mortgagee's right to possession of the mortgaged property is paramount to that of the tenant. Such a tenant still has a right to redeem the mortgage and therefore should be served with a copy of the notice of sale. If the mortgagee has in some way consented to the mortgagor's granting of the lease subsequent to the mortgaging of the mortgaged property, the mortgagee may be bound by the terms of the lease and may be in the same position as a mortgagee holding a mortgage subsequent to the lease of the mortgaged property.
- **Non-disturbance, postponement, and subordination agreements:** It is common for mortgagees to enter into a "non-disturbance" agreement with tenants whereby the mortgagee agrees that after default by the mortgagor, the mortgagee will not disturb the tenant's possession of the mortgaged property so long as the tenant is in good standing under the lease. By virtue of this agreement, a mortgagee may be precluded from dispossessing the tenant if the mortgagor defaults under the mortgage. In certain circumstances, if key tenants do not have non-disturbance agreements, a mortgagee who wishes to recognize the priority of a tenant may agree to postpone his or her mortgage to the tenant's lease so as not to extinguish the interest of the tenant in the mortgaged property as a result of the power of sale. On the other hand, some tenants initially having priority over a mortgagee are obliged by the terms of their leases to agree to subordinate their interests in the property to facilitate mortgage financing. A notice of sale should be sent to these tenants.
- **New relationship:** As an alternative to evicting the tenant, the mortgagee may attempt to create a new tenancy arrangement with a subsequent tenant who does not have the benefit of a non-disturbance agreement. This new relationship may be created by an express agreement between the parties or may be implied by the court from the conduct of the parties. The new relationship will not be established by simply giving notice requiring the tenants thereafter to pay all rent due under a lease to the mortgagee. The fact that the tenant remains in possession of the mortgaged property after the notice to quit has been given is not necessarily evidence of an agreement to create a new tenancy. In the absence of any clear agreement of the parties establishing the terms of the new relationship and where the tenant does agree to pay rent to the mortgagee pursuant to a notice from the mortgagee, a new tenancy from year-to-year has been held to be created in some cases. The mortgagee who has accepted rent from the tenant in accordance with the terms of the original lease may, however, be precluded from forcing new terms on the tenant.
- **Assignments of rents and leases:** A mortgagee becomes a "mortgagee in possession" of the premises when he or she deprives the mortgagor of the control and management of the mortgaged property. Sometimes a mortgagee may hold an assignment of leases or assignment of rents as collateral security to the mortgage. The simple receipt of rents under an assignment of rents is not sufficient to constitute possession by the mortgagee. When the mortgagee takes an absolute assignment of the lease prior to or upon default of the mortgagor, the mortgagee is bound by the terms of such lease. Therefore, if the mortgagee wishes to alter the terms of an existing lease entered into subsequent to the mortgage, the mortgagee should not execute a non-disturbance agreement nor

should he or she take an absolute assignment of the lease from the mortgagor, but rather he or she should request an assignment of rents exercisable at the option of the mortgagee only after default by the mortgagor.

- **Service of notice of sale:** If the mortgagee has notice of the interest of the tenant, the tenant should be served with a copy of the notice of sale in accordance with s. 33(1) of the *Mortgages Act*, presumably at the premises of the tenant or any other address constituting the last known place of address of the tenant. The notice of sale should also be sent to the address for service of notices set out in the lease and to the address for service in any notice of lease registered on the title to the mortgaged property.

5.4.10 Secured parties under the Personal Property Security Act

When acting for a mortgagee, a notice of sale should be served upon the secured party at the address set out in the notice of security interest registered on title and any other address constituting the most recent address of the debtor known to the secured party (*Personal Property Security Act*, s. 68(1)(b)).

When acting for a purchaser buying land in the registry system from a mortgagee exercising a power of sale, it would be prudent to requisition a discharge of any notice of a security interest, since priority of registration by the mortgagee does not necessarily determine the respective priorities. In the alternative, the purchaser's solicitor may adopt the procedures set out in the *Ontario Land Titles Procedural Guide*.

5.4.11 The bankrupt mortgagor

When the mortgagee has notice of the bankruptcy of the debtor, the trustee-in-bankruptcy is a proper person to be served with a notice of sale in the following manner, for example: "XYZ Limited, the trustee of the estate of ABC Corporation, a bankrupt."

5.4.12 Court-appointed receivers

The notice should be addressed to the receiver as, for example: "XYZ Limited, receiver of ABC Corporation."

5.4.13 Incompetents, persons under a disability, estates, and trustees

Subsections 33(4)–(5) of the *Mortgages Act* provide special rules with respect to service of a notice of sale on incompetents, persons under a disability, estates and trustees, and deceased persons.

5.4.14 Statutory liens

Subsection 31(1) of the *Mortgages Act* also provides that where there is a statutory lien against the mortgaged property in favour of the Crown or any other public authority and the mortgagee exercising a power of sale has written notice of the lien, the notice of sale should be sent to the Crown or other public authority claiming the lien, provided, however, that the mortgage has priority over the lien.

5.4.15 Other interests

Subsection 31(1) of the *Mortgages Act* also refers to liens or claims when a mortgagee has received written notice of a lien or claim or actual notice in writing of other interests in the mortgaged property. In these cases, a copy of the notice of sale should be given to such parties.

5.5 Manner of service

Subsection 33(1) of the *Mortgages Act* provides that, subject to specific provisions to the contrary contained in the mortgage, there are a number of alternative methods of giving the notice of sale:

- by registered mail addressed to the person to whom it is to be given
  - at his or her usual or last known place of address (where the last known place of address is that shown on the registered instrument under which he or she acquired his or her interest, to such address); or
  - where the mortgage provides for a specific address, to that specific address;
- by leaving at such places of address; or
- where the mortgage provides for personal service only, by personal service.

If in doubt as to the correct address for a recipient, the notice of sale should be sent to all readily available addresses for the recipient. Documents submitted for electronic registration pursuant to the *Land Titles Act* must contain an address for service for the person claiming or obtaining an interest under the document or for the person's solicitor. Documents submitted for registration in a non-electronic format must be in the forms prescribed by the *Land Registration Reform Act*, which contain spaces in which addresses for service are to be listed. If there is no address provided in the document for service but the document does contain a notice provision, the notice of sale should be sent to the address in the notice provision. Otherwise, the notice of sale should be sent to the address on the document under which the party acquired his or her interest.

Inquiries should always be made by the mortgagee to determine what is "the usual or last known place of address" of the mortgagor or any subsequent encumbrancers (see s. 33(1) of the *Mortgages Act*).

Section 34 of the *Mortgages Act* provides that a notice exercising a power of sale shall, if given by registered mail, be mailed in Ontario and such a notice shall be deemed to have been given on the day on which it was mailed. There are special rules under the *Family Law Act* as to where the notice should be served.

5.6 Form of the notice of sale

Subsection 31(1) of the *Mortgages Act* provides that "[a] mortgagee shall not exercise a power of sale unless a notice of exercising the power of sale in the Form to this *Act* has been given ...."

The following matters should be considered in preparing the notice of sale:

- The notice of sale should be entitled "Notice of Sale Under Mortgage" at the top of the first page of the document.

  Generally speaking, the notice is addressed to the recipient of the notice in the following manner:

  "TO: [Name and address of the mortgagor]

  AND TO: the parties shown on Schedule 'A' attached hereto."

  If there is more than one mortgagor, select the first mortgagor named in the mortgage to be the party appearing on the first page and all other mortgagors and other parties should be shown on Schedule A. Postal addresses and postal codes should be included. It is good practice for the notice to be addressed to the person served, but the fact that it is not so addressed is not fatal if it was in fact served on such person.
- After the phrase "Take notice that default has been made in payment of the moneys due under a certain mortgage," the exact details of the mortgage should be carefully reviewed and repeated, since the next portion of the notice of sale is virtually a recital. Regardless of whether the mortgage is in fact a mortgage registered in the registry system, a charge registered under the *Land Titles Act*, or a debenture, the mortgage document could be defined as the "Mortgage" since all of these documents are "mortgages" for the purposes of the *Mortgages Act*. The date of the mortgage and the parties thereto should be described exactly as they appear on the mortgage. Further, if guarantors, additional covenantors, or spouses have joined in the mortgage, they should also be recited in this reference to the mortgage.
- Next, after the words "on the security of," the legal description of the mortgaged property should be set out exactly as in the mortgage.
- Following the legal description, the details of registration of the mortgage should be recorded.
- If the mortgagee named at the end of the notice of sale is not an original party to the mortgage, details of the manner in which the mortgagee acquired his or her interest should be specified in the notice of sale, including details of registration of any assignment of mortgage, change of name, or amalgamation.
- The next paragraph of the notice of sale includes the amounts due on the mortgage. This information should be obtained in writing from the mortgagee, if possible. The notice should set out separately the amounts claimed for principal, interest, and costs, and if the notice fails to do this, it is a nullity.
- The full accelerated principal amount should be set out together with interest as of the date of the issuance of the notice, so long as the mortgagee is entitled to claim the full accelerated principal amount following default.
- If municipal taxes or insurance premiums have been paid by the mortgagee, these items may be included in the claim set forth in the notice; the mortgagee is not, however, entitled to claim for outstanding taxes or insurance premiums it has not yet paid.
- Common area expense payments made by the mortgagee to a condominium corporation must be set out separately in the notice.
- A separate item for solicitor-client fees already paid by the mortgagee in connection with enforcement of the mortgage may be included.
- The costs of the power of sale proceedings should then be listed separately in the notice. Subsections 43(2) and (4) of the *Mortgages Act* permit the mortgagor to have assessed the mortgagee's solicitor's costs by an assessment officer.
- Note that minor, insignificant errors in the amounts set out in the notice of sale will not invalidate the notice.
- Solicitors generally add after the words "and unless the said sums," the following phrase, "together with interest thereon at the rate of ____% per annum calculated half-yearly, not in advance," as the case may be, followed by "and any further costs and disbursements incurred in these proceedings" so as to take into consideration the daily accrual of interest and other costs after the date of the notice of sale.
- A notice of sale must specify a date for payment more than the statutory minimum of 35 days after the notice is given. This means 35 clear days, exclusive of the first and last day. It would therefore be prudent to give at least 37 days' notice in the notice of sale.
- If the mortgage does not contain power of sale provisions and therefore the mortgaged property would not be sold "under the provisions contained in the ... mortgage," these words should be deleted and reference should instead be made to "under Part II of the *Mortgages Act*." In some forms, these two phrases are both set forth in the alternative, and the mortgagee's solicitor should be careful to delete

the inapplicable provision so as to avoid any confusion as to which procedure the mortgagee intends to follow.

- The notice should be dated and signed, and in all cases, the full name of the mortgagee must appear on the notice of sale identified as the "mortgagee." The notice may be signed by the mortgagee, or as is more usual, a mortgagee's solicitor may sign the notice of sale with the mortgagees' express authority. If a mortgagee's solicitor signs the notice of sale, he or she should be properly identified in the notice as the solicitor for the mortgagee. The notice must be signed by either the mortgagee or the mortgagee's solicitor, and the mere typewritten name of the solicitor's firm without the signature of the solicitor lacks the necessary "personal authentication" of a valid notice. The proper way of executing the notice of sale would be, for example, "Big Bank by its solicitors and authorized agents, Messrs. Red & Blue LLP, Barristers & Solicitors, Box 50, First Canadian Place, Toronto, Ontario, M5X 1B8 per: I.M. Blue."

5.7 Section 42

Section 42 of the *Mortgages Act* prevents a mortgagee from taking proceedings to enforce the mortgage during the currency of a demand for payment or the time specified for payment in a notice of sale without first obtaining an order from a judge of the Superior Court of Justice. There are two basic concerns that this provision seeks to address. First, the legislature wished to prevent the mortgagee from incurring unnecessary costs that would be passed on to the mortgagor, and second, it wanted to ensure that the mortgagor would have the benefit of the notice period without being subjected to a multiplicity of other actions or proceedings. The result of a contravention of s. 42 is that the notice or demand will remain valid, but further proceedings commenced during the currency of the notice or demand will be set aside as invalid. Once a notice exercising power of sale has been given, it cannot be abandoned in order to circumvent s. 42.

Section 42 does not preclude informal discussions with a real estate agent about selling the property in general terms where no listing is promised and does not interfere with the mortgagor's right to redeem. Also, a mortgagee who continues to collect rents after giving notice of intention to exercise power of sale would not contravene s. 42.

Subsection 42(3) creates exceptions for proceedings to stay waste or other injury to the mortgaged property. The problems raised by s. 42 of the *Mortgages Act* may be readily dealt with by an application for a court order pursuant to s. 42(2) of the *Mortgages Act*. Alternatively, the notice period may be by-passed altogether with an application under s. 39 of the *Mortgages Act* to a judge or master of the Superior Court of Justice.

5.7.1 The rights of the mortgagor or subsequent encumbrancer upon receiving a notice of sale

Although a mortgage is a legal document, equity has always played a large role in mortgage transactions. The fundamental term that equity has incorporated into a mortgage is the right in favour of the mortgagor to "redeem" or to pay off the mortgage debt in exchange for the return of the security after there has been a legal or technical forfeiture under the mortgage. In addition, there are certain statutory and other rights that may be exercised by the mortgagor in the event of legal or technical default.

(a) Statutory rights

The term "mortgagor" is defined in s. 1 of the *Mortgages Act* as including "any person deriving title under the original mortgagor or entitled to redeem a mortgage, according to the person's estate, interest or right in the mortgaged property." Thus, a "mortgagor" includes the original mortgagor, a purchaser of the mortgaged property, a second mortgagee, and any other person to whom the notice of sale has or should have been addressed, since those persons are subsequent in interest to the mortgagee. The comments that follow with respect to the statutory rights of the mortgagor are also rights in favour of the other parties receiving the notice of sale, such as the second mortgagee:

- **Section 42:** The mortgagor should first consider whether a notice or demand was given by the mortgagee and whether such notice had expired at the time the notice of sale was issued. If the time has not expired, s. 42 of the *Mortgages Act* may be of some assistance to permit the mortgagor to apply for a declaration that the notice of sale, being a "further proceeding," is a nullity.
- **Subsection 22(1):** If the mortgagee under a notice of sale accelerates all of the principal due under the mortgage, the provisions of s. 22(1) of the *Mortgages Act* will "negate" the "acceleration clause," and the mortgagor may pay the amount due under the mortgage (exclusive of the accelerated sum) and any expenses incurred by the mortgagee, and thereupon, the mortgagor is relieved from the consequences of the default. Section 22(1) does not confer any discretion upon the court. The right to relief before sale is unqualified. As a result, after receipt of payment in accordance with the section, the mortgagee's right to sell the mortgaged property under the notice of sale would be at an end until further default, at which time a fresh notice must be issued prior to sale.

There are two conditions to relief under s. 22(1). The payment must be made before "sale under the mortgage" has taken place and before "the commencement of an action for the enforcement of the rights of the mortgagee." In *Re Mission Construction Ltd. and Seel Investments Ltd.*, the court held that the acceptance of an offer to purchase by the mortgagee is effective to terminate the rights of the mortgagor under s. 22 (previously s. 21) of the *Mortgages Act*, even though the agreement of purchase and sale was specifically made subject to the right of the mortgagor to redeem.

The court has also held that where the agreement of purchase and sale entered into by the mortgagee was conditional upon the mortgage not being redeemed by any parties having an interest in the property up to the date of closing, the owner's right to redeem under s. 22 (previously s. 21) of the *Mortgages Act* was not terminated by the execution and delivery of the agreement, since the agreement clearly intended that the mortgagor would have the right to redeem the mortgage up until the closing of the transaction.

- **Subsection 23(1):** If an action has been commenced to enforce the mortgage, s. 23(1) of the *Mortgages Act* is applicable. Upon payment into court of the sum of $100 to the credit of the action as security for costs, the mortgagor may apply to the court for relief conditional upon payment of the money due under the mortgage, exclusive of the acceleration clause. If judgment has not been recovered, the action will be dismissed, and if judgment has been recovered, the proceedings in the action will be stayed, provided in each case that "no sale or recovery of possession of the land or final foreclosure of the equity of redemption has taken place." The right of redemption under this section is terminated when the mortgagee or his or her agent, a receiver appointed pursuant to the terms of the mortgage, takes possession of the mortgaged property. The mere giving of a notice to attorn would not be recovery of possession within the meaning of the section, but notice to attorn after judgment for possession constitutes possession for the purposes of the section. The mortgagor must strictly comply with provisions of s. 23(1) of the *Mortgages Act* to be entitled to relief.
- **Subsection 22(2):** To enable the mortgagor to pay up the arrears only in accordance with s. 22(1) or 23(1), he or she may need further information, such as the unaccelerated amount due under the mortgage. Subsection 22(2) of the *Mortgages Act* specifies that the mortgagor may require the mortgagee to provide a statement in writing of the amount of the principal or interest with respect to which the mortgage is in default and the amount of the expenses necessarily incurred by the mortgagee. Under s. 22(3), the mortgagee is required to answer such a request within 15 days after receipt of the request, and if, without reasonable excuse, the mortgagee fails to do so or if the answer is incomplete or incorrect, any rights that he or she may have to enforce the mortgage shall be suspended until he or she has complied with s. 22(2).
- **Subsection 12(3):** Subsection 12(3) of the *Mortgages Act* provides that when a mortgagor or any person entitled to pay off a mortgage desires to do so and the mortgagee cannot be found or where from any other cause a proper discharge cannot be obtained, the court has discretion to permit payment into court of the amount due on the mortgage and may make an order discharging the mortgage. In circumstances where the mortgagee has taken steps to enforce the mortgage, thus opening up the right to redeem in favour of the mortgagor, the mortgagor may use s. 12(3) as a means of paying off a high interest rate mortgage. Taking possession, suing for the accelerated principal sum, or issuing a notice of sale will all trigger the mortgagor's equitable right to redeem, which will permit the mortgagor to utilize the provisions of s. 12(3) of the *Mortgages Act*.

  A subsequent encumbrancer, as a successor in title to the mortgagor, is entitled to enforce a partial discharge provision and to bring an application under s. 12(3). Subsection 12(3) has also been used in conjunction with s. 8(1) of the *Interest Act* for an application to determine if the interest alleged to be due pursuant to the provisions of the mortgage was in contravention of the *Interest Act*.
- **Section 43**: The mortgagor may pay the moneys claimed under the notice of sale and thereby prevent a sale. Payment may be made by the mortgagor or a subsequent encumbrancer after the time set forth in the notice of sale. The right to redeem continues up to the time the sale is actually made, and the time set out in the notice of sale is to comply with the provisions of the mortgage and the *Mortgages Act* prohibiting a sale prior to that time.

  In a case that went before the courts, the first mortgagee had commenced power of sale proceedings under the mortgage, and the second mortgagee tendered the full amount required to discharge the first mortgage after the expiration of the notice period, whereupon the first mortgagee returned the tendered cheque on the grounds that the redemption period had expired. In dismissing the application of the second mortgagee, the court held that there is no obligation on the mortgagee to accept payment once the date set out in the notice of sale under the mortgage had passed. The second mortgagee was then confined to its rights under s. 22(1) of the *Mortgages Act*.
- **Section 2:** Pursuant to s. 2(1), where a mortgagor is entitled to redeem, he or she may require the mortgagee, instead of giving a discharge of mortgage, to assign the mortgage debt and convey the mortgaged property to any third person as the mortgagor directs. Subsection 2(2) of the

Mortgages Act goes on to state that the right of the mortgagor to require an assignment belongs to and is capable of being enforced by each encumbrancer or the mortgagor, notwithstanding any intermediate encumbrance. A requisition of an encumbrancer, prevails over that of the mortgagor, and as between encumbrancers, a requisition of a prior encumbrancer prevails over that of a subsequent encumbrancer. Section 2 does not apply if the mortgagee is or has been in possession. Accordingly, assuming the mortgagee has not taken possession of the mortgaged property, in certain circumstances, a second mortgagee may decide to require an assignment of the first mortgage so as to keep the first mortgagee from exercising his or her power of sale.

(b) Technical attacks

In addition to statutory rights, the mortgagor may raise several technical grounds to invalidate a notice of sale. The courts will be receptive to technical arguments, perhaps at the penalty of costs, especially if there is good evidence to the effect that the parties receiving the notice of sale could have been confused or misled by the technical defect. When acting for a mortgagor who has received a notice of sale, the notice should be reviewed carefully to determine whether the notice has been properly prepared and executed. If technical grounds are to be raised, they should be raised as soon as possible, for if the mortgagee is permitted to close a transaction under power of sale, then pursuant to s. 36, so long as the notice was given in "professed compliance" with the *Mortgages Act*, the purchaser will obtain good title to the mortgaged property, leaving the mortgagor with a remedy solely against the person exercising the power of sale.

(c) Injunction

A mortgagee acting in good faith and without fraud will not be restrained from a proper exercise of his or her power of sale, except upon tender by the mortgagor of the principal moneys due, interests, and costs. An application by a mortgagor for the postponement of a sale on a mortgagor's vague and indefinite hope of finding new financial backing would be an unwarranted interference with the contractual rights of the mortgagee, even if the mortgaged property is ample security for the loan.

Where a triable issue is raised by the mortgagor, the court will grant an injunction restraining the mortgagee from selling the mortgaged property on the condition that the mortgagor keep the mortgage in good standing until trial or other final disposition of the action.

A caution under s. 71 of the *Land Titles Act* may be approved by the Director of Titles if a claim is made by the registered owner that the power of sale proceedings are improper because the owner has redeemed the charge prior to the sale of the mortgaged property (see Land Registration Bulletin No. 2000-2, July 21, 2000).

(d) Costs

Form 1 of the *Mortgages Act* requires a mortgagee to set out his or her costs being claimed in the power of sale proceedings. The costs recoverable by a mortgagee are those on a substantial indemnity basis if the mortgage so provides, as long as the costs are not unreasonable. If there is a dispute as to costs payable by the person who is tendering the moneys due, such costs may be assessed by an assessment officer pursuant to s. 43(2) of the *Mortgages Act*. Pursuant to s. 43(4), the costs of and incidental to the exercise of a power of sale may be taxed by a taxing officer of the Superior Court of Justice or a local master having jurisdiction at the instance of any interested person. The costs of the assessment are at the discretion of the taxing officer.

(e) Renegotiating the mortgage

A mortgagor may attempt to enter into negotiations with a mortgagee to adjust the repayment schedule or make some other agreement that will permit the mortgagor to have further time to pay the mortgage debt. Any such agreement, if complied with by the mortgagor, will be enforced by the courts, thus precluding the mortgagee from relying upon the notice of sale that prompted the renegotiation.

(f) Partial payments

If the mortgagee merely accepts a partial payment and applies the payment to outstanding arrears, the mortgagee is not precluded from relying on the notice of sale so long as the partial payment does not put the mortgage into good standing. A mortgagee can best protect himself or herself when receiving a partial payment by ensuring that the mortgagor is made aware at the time the payment is accepted that strict compliance with the notice of sale is still insisted upon, notwithstanding the acceptance of the partial payment, and the mortgagee should confirm that no agreement nor any accommodation has been made with the mortgagor.

5.8 The standard of care

The broad enforcement rights in favour of a mortgagee contained in the standard form of mortgage used by most lenders must be considered in view of the obligations of the mortgagee set out in the case law.

The following summarizes the obligations of the mortgagee when selling under private power of sale:

- A mortgagee is not a trustee of a power of sale for the mortgagor; his or her right is to look after himself or herself first, but the mortgagee is not at liberty to look after his or her own interests alone nor to sacrifice the property of the mortgagor.
- The mortgagee, in exercising a power of sale, must act *bona fide* and take reasonable precautions to obtain a proper price. A price just sufficient to cover the outstanding mortgagee may be seen as disregarding the mortgagor's interests.
- The mortgagee need not delay the sale in the hope of an improvement in market conditions.
- It is the duty of a mortgagee to behave as a reasonable person would behave in the realization of his or her own property.
- Consideration should be given to the best means of publicizing the sale of the property, whether it be through newspapers, trade journals, or multiple listing services.
- A "for sale" sign should be put on the property.
- After having obtained appraisals, the mortgagee must keep the market value set forth in the appraisals in mind as a benchmark and should not accept an offer well below the appraised value.
- If the sale yields a surplus over the amount owed under the mortgage, the mortgagee must hold the surplus in trust for the mortgagor or subsequent encumbrancers.

A solicitor should indicate to the mortgagee that although the mortgagee is not a trustee, the mortgagee has obligations imposed upon him approaching those of a fiduciary, and what may appear to be an advantageous sale to the mortgagee may not stand up to court scrutiny at a later date.

5.9 Appraisals

Appraisals are very useful in establishing the market value of the mortgaged property. If the price at which the property is sold is contested, the mortgagee's position can be defended on the basis of the appraisals.

When retained, the appraiser should be fully informed as to the nature of the mortgaged property, including the legal description, available financing, zoning, particulars of rents, easements, and legal restrictions.

The appraisal obtained should include a reference to the uses to which a property may be put in order to determine its highest and best use.

It is also useful to have the appraiser comment on the appearance of the property and the approximate costs of putting the property into a marketable condition, where appropriate.

In the case of *Bank of Nova Scotia v. Barnard*, the court held that a mortgagee must take reasonable precautions to obtain the "true market value," and in the case where the appraisal was made on the assumption that a sale would take place as a fast sale, the appraisal was held not to be appropriate. The term "fast sale" meant a sale occurring within 60 to 90 days. The mortgagee could not rely on the appraisal as a defence in the circumstances, since the mortgagee was liable for the actions of the mortgagee's agent in making a deficient appraisal.

In general, two appraisals would be satisfactory, as long as they both independently come to approximately the same market value. After the appraisals have been received, it may be prudent to advise the mortgagor and subsequent encumbrancers of the market value set forth in the valuations and indicate the mortgagee's intention to proceed to list the mortgaged property through a multiple listing service asking a price of approximately five to ten percent in excess of the higher or the average of the two valuations obtained.

5.10 Separate parcels

Most standard form power of sale provisions permit the mortgagee to sell the mortgaged property or any part thereof "in whole or in part." If it is more advantageous to sell the mortgaged property as separate parcels rather than together in one transaction, provided sale as separate parcels is otherwise permitted at law, the mortgagee may be liable for the difference between the amount realized in the sale *en bloc* and what could have been realized if the lots had been sold as separate parcels. There is an obligation on the mortgagee to make inquiries as to the most beneficial way of disposing of the property. The foregoing principles are qualified by the provisions of s. 50(18) of the *Planning Act*, which states:

> No ... exercise of a power of sale in a mortgage or charge shall have any effect in law without the approval of the Minister ... unless all of the land subject to such mortgage or charge is included in the ... exercise of the power of sale ....

There are, of course, exceptions for the sale of the whole of lots on plans of subdivision or parcels that do not abut other lands forming part of the mortgage security. A mortgagee selling one lot under power of sale and holding a separate mortgage given by a different mortgagor on an abutting lot does not require consent under the *Planning Act* to complete a sale of the first lot.

5.11 Listing agreements and offers

Unless specifically permitted to do so in the mortgage, the mortgagee should not list the property for sale with an affiliate.

Solicitors should advise mortgagees to specify to the listing real estate brokers that, wherever possible, all offers should provide for a reasonable period of acceptance by the mortgagee. The listing should make reference to the property being sold under a power of

sale. The agreement of purchase and sale should include an acknowledgment by the purchaser that the mortgagee is selling the property pursuant to a mortgage registered in its favour.

Pursuant to s. 32 of the *Mortgages Act*, the mortgagee is not entitled to enter into an agreement of purchase and sale for at least 35 days after the notice has been given.

The purchase agreement should not include the usual phrase "the vendor agrees to discharge any existing mortgages, liens, or other encumbrances now registered against the property on or before the closing date at his own expense." The clause should be confined to prior encumbrances only, if not assumed by the purchaser as a part of the transaction. As subsequent encumbrances are extinguished by operation of law, the inclusion of the foregoing clause would create a positive obligation to discharge subsequent encumbrances. Furthermore, the mortgage under which the property is being sold is not discharged.

Special thought should be given to adjustments for arrears such as realty taxes, condominium expenses, utilities, and arrears under prior mortgages. From the mortgagee's point of view, it would be preferable not to advance any further funds and to have these items adjusted on closing or, alternatively, paid out of the proceeds due on closing.

If prior opinions are available, they should be reviewed carefully so as to include in the purchase agreement as permitted encumbrances those items such as prior mortgages, restrictive covenants, and easements that the mortgagee is unable to extinguish as a result of power of sale.

Unless the mortgagee has additional security charging the chattels or the mortgaged property, the usual chattels clause and any references to chattels should be deleted from the purchase agreement.

If the mortgagee has possession of the property, he or she will be in a position to promise vacant possession on closing. If not, since the purchaser will generally require vacant possession prior to closing, the agreement should contain provisions in favour of the mortgagee for appropriate extensions of the closing date if the mortgagee is unable to obtain possession of the mortgaged property by the closing date.

If the property is being sold at a price less than the amount owed on the mortgage, it would be advantageous for the mortgagee to leave open the right of the mortgagor to redeem until the closing.

5.12 Closing the sale transaction

The purchaser's solicitor should ascertain whether s. 35 of the *Mortgages Act* has been complied with, since it is pursuant to that section that the purchaser obtains good title to the mortgaged property. In the registry system, the practice has developed whereby three declarations are delivered and deposited on title to the property at the time of closing:

- a statutory declaration proving service of the notice of sale, usually by registered mail;
- a statutory declaration of the mortgagee or his or her solicitors or agents as to default under the mortgage; and
- a statutory declaration of the mortgagee or his or her solicitors or agent that the sale complies with Part III and, if applicable, Part II of the *Mortgages Act*.

Section 99 of the *Land Titles Act* provides that the registered owner of a registered charge containing a power of sale, upon registering the "evidence specified by the Director of Titles," may sell and transfer the interest in the land subject to the charge in accordance with the terms of the power of sale in the same manner as if the registered owner of the registered charge were the registered owner of the land. The specified evidence, once registered, is conclusive evidence of compliance with Part III of the *Mortgages Act* and, where applicable, with Part II of the *Mortgages Act* and, upon registration of a transfer under s. 99(1) of the *Land Titles Act*, is sufficient to give a good title to the purchaser of the land.

Outside the electronic registration system, the required evidentiary declarations take the same basic format as in the registry system but are referred to as the "sale papers" and are attached to the transfer at closing rather than being deposited on title as is done in the registry system. The sale papers should be approved by the land registrar prior to closing.

A transfer under power of sale submitted for electronic registration under the land titles system must do all of the following:

- Either
  - comply with the *Land Titles Act* by ensuring that the usual paper affidavit evidence is filed separately from the electronically registered document (if no compliance with law statements are included);

  or

  - include all of the following compliance with law statements in the document that is electronically registered:
    - The sale is authorized under both the charge and the *Mortgages Act*.
    - The charge was in default at the time notice of sale was given and continues to be in default, and moneys have been advanced under the charge.

- The sale proceedings and transfer comply with the charge, the *Mortgages Act*, and where applicable, the *BIA*, the *Condominium Act, 1998*, the *Construction Lien Act*, and the *Farm Debt Mediation Act*.

- Identify the following:
  - instruments subsequent to the charge, by instrument number and date of registration; and
  - writs of execution subsequent to the charge, by name and writ number.
- Provide the spousal status under the *Family Law Act* for each person whose spouse was not served with a notice under the *Mortgages Act* and whose interest may be deleted upon registration for the transfer.

In the registry system deeds, the recitals should include reference to the mortgage and its registration, the power of sale and the length of notice required under the mortgage, specifics of the notice given to those required, and the continued default by the mortgagor.

The Transfer/Deed of Land for both the registry and land titles systems is prescribed by Form 1 to the *Land Registration Reform Act*.

A solicitor acting for the purchaser should do all of the following:

- Review the draft sale documentation to confirm that the mortgage contains a power of sale provision and that the relevant time periods have expired.
- Verify the dates and details of registration of the mortgage and see if they are accurately set forth in the notice of sale.
- Check if there are any specific addresses for service and the places where the mortgagor and subsequent encumbrancers were served.
- Review the notice of sale for any typographical errors in the legal description, statement of accounts, or names of the parties.
- Confirm that the notice of sale properly identifies the mortgagee, the notice has been signed, and the proper number of days have passed with respect to redemption.
- Check the post office receipts to see if they correspond with the affidavit of service.
- Subsearch for executions, construction liens, notices of security interests, notices of condominium arrears, or notices of corporations tax arrears registered subsequent to the mortgage.

Sections 35–36 of the *Mortgages Act* will protect the title of a purchaser who buys from a mortgagee under power of sale so long as the notice of sale was given in "professed compliance" with the *Mortgages Act*. The purchaser must, however, be *bona fide* without notice of any invalidity or non-compliance of the notice or related sale proceeding. The Ontario Court of Appeal has interpreted the phrase "professed compliance," as meaning a notice "must be such as to enable the parties to whom the notice is required to be given to protect their interests. It must, in other words, identify the mortgage, stipulate the amount due thereon for principal, interest and costs and state that unless the sum is paid by the specified date the property will be sold."

5.13 Sale proceeds

The sale does not affect the interest of any prior encumbrancers. Accordingly, if any prior mortgagees are in existence, their mortgages should be assumed by the purchaser (if assumable) or discharged out of the sale proceeds.

Since the sale of the mortgaged property extinguishes the interest of the mortgagor or subsequent encumbrancers in the property, such persons may look only to the proceeds of the sale to satisfy claims on the property. The mortgagee is the trustee for any surplus of the sale proceeds beyond that required to satisfy the mortgagee's mortgage and the costs of the sale.

If there is a question as to priority of subsequent encumbrances or other uncertainties, the mortgagee may obtain an order for payment of the surplus proceeds into court under the provisions of s. 36 of the *Trustee Act*.

5.14 The results of a power of sale

After the mortgagee has completed the exercise of a power of sale, the mortgagee no longer has any further interest in the mortgaged property. He or she may, however, sue the mortgagor or any guarantors of the mortgage debt for any deficiency between the net sale proceeds and the amount owed on the mortgage.

Any prior encumbrancers are not affected by the power of sale.

The new owner of the purchased property who bought the property under the power of sale acquires good title to the property subject only to prior encumbrances so long as the mortgage sale was completed "in professed compliance" with the *Mortgages Act* and all proper parties were served with the notice of sale.

The mortgagor and all subsequent encumbrancers lose their interest in the mortgaged property as a result of the exercise of the power of sale. Their only claim is against the mortgagee for an improper or improvident sale of the mortgaged property and an accounting for any surplus sale proceeds.

Chapter 54

Preparation for closing, closing and post-closing

1. Introduction

Lawyers can begin preparing for the completion of a transaction, or "closing," as soon as the agreement of purchase and sale is signed.

The solicitor for the purchaser should conduct a title search, make the required off-title inquiries regarding the property, and submit requisitions in a timely fashion. As solicitor for the vendor, you can retrieve the vendor's report from the purchase of the property to assist you in answering the purchaser's requisitions and in preparing the necessary sale documentation.

The introduction of electronic registration (e-reg™), an all electronic, paperless system where documents are created, submitted, and maintained in electronic form, has significantly altered closing procedures. As a result of a statutory amendment to the *Land Registration Reform Act*, electronic documents do not have to be produced or printed on paper to have legal effect. Electronic documents are created and modified online on behalf of the vendor and purchaser, and registration occurs electronically, which eliminates the need for personal attendance at a land registry office.

E-reg is only available for properties that are registered under the *Land Titles Act*. All land in Ontario that is not already in a land titles jurisdiction will eventually be converted to land titles.

In order to gain access to Teranet, the electronic searching and registration system, you must have a licence. There are a number of different licences available.

First there is the licence to use the Teranet software. This licence will permit access through a number of selected desktop computers in your office. Teranet will assign an account name to your office, and all transactions will be billed to that account.

The second level of access is through a personal licence granted by Teranet to individual users of e-reg. These users may be staff members in lawyers' offices or other members of the public who require access to electronic registration.

A third level of access is granted exclusively to lawyers who have obtained a Teraview® licence. Only lawyers are entitled to make statements of law in a document.

Each user is allocated a "user name" and selects a personal pass phrase. This information is stored on a disk that the user inserts in a licensed computer each time access is required. Disks and pass phrases must be kept confidential by the licensee and not shared with or disclosed to others.

The lawyer will have the ability to designate persons in his or her office who are to have "blanket authority" to access all of the documents. This includes documents created by third parties and sent to the lawyer's office. A person can be granted access to a particular document instead of granting them "blanket authority" by using the message function in Teraview. The lawyer will also have the ability to "message" a document to another person, granting release authority only. In this latter case, the person will not have the ability to revise the document.

2. Timeline and closing agenda

The first step in processing a file for closing, whether acting for a vendor or a purchaser, is to review the agreement of purchase and sale. While reviewing the agreement, it is a good idea to make a list of critical dates, including the dates by which any conditions are to be waived or satisfied, any deliveries that are to be made, the requisition date, the closing date, etc. Prepare a closing agenda or checklist for the transaction, which is a list of the various matters that must be attended to by your vendor or purchaser client, the documentation that must be prepared and delivered, the documents to be received, the documents to be registered on closing, the payment or receipt of the balance due on closing, and any matters to be attended to after closing. Any issues revealed by the title search, off-title enquiries, or other due diligence can be noted on the closing agenda, which can act as a checklist for completing the transaction.

3. Teraview

If e-reg is available for the property, then as part of processing the file, open a Teraview docket for the transaction. The gateway software designed by Teranet to access and use the e-reg system is called Teraview.

At this stage, it is a good idea to conduct a subsearch of title. Obtain and print a parcel register for the subject lands and abutting lands if acting for the purchaser. Performing the abutting owners searches while this

parcel is open will reduce the cost of obtaining the abutting parcel register.

While the docket is still open, start preparing the transfer and search executions against the vendors using the "writ search" feature in the transfer itself. If there are executions against the vendor or a person with a similar name, the particulars will attach to the document and be available to the vendor's solicitor to satisfy without the need to do a separate execution search. Executions against the purchaser need not be searched while the Transfer is open.

Identify the Transfer adequately with the name of both vendor and purchaser and the solicitor for the "party to." Also identify "party to" as the person responsible for payment of the fees. Immediately advise the vendor's lawyer that the Transfer is being drafted and request the exact name of the person in his or her office to whom access should be granted in e-reg. When the vendor's solicitor responds, send the message in e-reg granting access to the Transfer.

When acting for a purchaser, complete the full title search in e-reg by imaging the documents to view from the parcel register and obtaining plans and documents that are not available in this manner by fax or directly from the land registry office.

4. Requisitions

As lawyer for a purchaser, prepare and submit a requisition letter. The requisition letter will contain a list of all title defects that you require the vendor's counsel to address and all contractual matters that require satisfaction on closing. The contents of the requisition letter may require some modification if the parties intend to close the transaction electronically. For example, the purchaser's solicitor may want to indicate in the requisition letter the intention to rely on a specific escrow closing protocol, which in most cases will be evidenced by a document registration agreement (DRA). The requisition letter should ask for the vendor's solicitor's confirmation that he or she will participate in this manner.

If any executions were revealed in the relevant searches, advise vendor's counsel of these executions in the requisition letter and ask for them to be dealt with appropriately. If the lawyer does not do the initial search of executions "in the transfer," it will be necessary for a later search to be done "in the transfer," so that the proper statements may be made, removing the executions from the parcel register without a separate application.

Request that the vendor review the documents in the draft electronic file and ask that the vendor carry out any modification and amendments that may be required. The purchaser's solicitor may also want to confirm that access to the draft electronic file has been provided to the correct party acting for the vendor.

From the vendor's solicitor's perspective, part of the process of dealing with the purchaser's solicitor's requisitions will be approving the electronic Transfer for completeness and registration.

Whether or not the purchaser's solicitor will have signed the electronic Transfer for completeness and registration at this early stage will depend on the level of completeness of the document itself. If additional information, compliance with law statements, or modifications are required to be entered into the document by the vendor's solicitor, any prior electronic signatures will be invalidated, thereby necessitating the re-signing of the document. In addition, if the land transfer tax statement has not been completed, the document will not accept a completeness signature from either party.

A solicitor should take extra precaution when dealing with entities or persons governed by legislation. For instance, when dealing with a religious organization, a solicitor should review the *Religious Organizations' Lands Act* to determine the steps required to complete the transaction and to make any special requisitions that may be necessary as a result of the legislation. In addition, when dealing with persons that have capacity issues, the solicitor should review the *Substitute Decisions Act*, 2002.

It is wise to deal with matters that require the assistance of third parties as soon as possible. Do not count on third parties to respond to last-minute requests. The usual request made of a third party is in connection with obtaining advice regarding a mortgage assumption or a mortgage discharge. If the purchaser is assuming a mortgage, the purchaser's solicitor will write to the mortgage company to obtain a mortgage statement for assumption purposes. The purchaser's solicitor will be interested in confirming the basic terms of the mortgage, i.e., the principal amount outstanding on closing, the interest rate, the term, whether there are any prepayment privileges, whether there are any outstanding defaults, and whether the mortgagee has the right to consent to the purchaser's assumption of the mortgage.

Many mortgages provide that, at the mortgagee's option, a mortgage will become due if the property is sold. This would prevent a purchaser from assuming a mortgage without the mortgagee's consent. If the purchaser

intends to assume a mortgage with such a clause in it, it is important to obtain the mortgagee's consent to the purchaser's assumption of the mortgage very early in the transaction.

The mortgage assumption statement should set out the principal amount outstanding as of the closing date, the interest rate, the term of the mortgage, and whether the mortgagee has approved the new purchaser to assume the mortgage. If the mortgagee pays the taxes for the mortgagor, the mortgage statement should also show the status of the tax account so that it can be properly adjusted for in the statement of adjustments. The mortgage statement will also show what date the mortgage has been paid up to. It will be the purchaser's responsibility prior to closing to ensure that the vendor has made all of its payments under the mortgage due on or before the date of closing.

If there is a mortgage registered on title that is not being assumed by the purchaser on closing, it must be discharged. Typically, the vendor's solicitor will write to the mortgage company for a mortgage statement for discharge purposes so that the vendor's solicitor knows how much has to be paid on closing to obtain a discharge of the mortgage. When acting for a vendor, take care to ensure that the discharge statement properly takes into account any available prepayment privileges. If the agreement of purchase and sale requires that the vendor produce a registrable discharge for closing, the vendor's solicitor must immediately determine from the mortgage company whether it will provide the discharge for the closing. If the mortgage company is agreeable to doing so, the vendor's solicitor will typically undertake to the mortgage company not to release the signed discharge until he or she has received sufficient funds to pay out the outstanding balance of the mortgage and to deliver these funds, with interest, to the mortgage company immediately after closing. Institutional lenders rarely provide a discharge until they have first received the discharge payment in full and booked it through their head office. The discharge normally follows in 30 to 60 days.

If it becomes apparent that there is not going to be a discharge for closing, determine if the agreement of purchase and sale permits delivery of the lawyer's undertaking on closing that he or she will obtain and register a discharge after the closing date rather than having a discharge for closing. If the agreement does not provide for a solicitor's undertaking to be delivered instead of a discharge, ask the purchaser's solicitor to obtain his or her client's instructions to accept such an undertaking instead of the discharge for closing. If the purchaser insists upon a discharge for closing, a mortgage company may be convinced to provide a discharge for closing rather than having a transaction abort. Confirm with the financial institution whether it intends to register the discharge or it will provide the discharge to register.

If the lender is a private individual or a company, obtain a discharge for closing and do not proceed with the "undertaking" route.

If acting for the vendor, obtain the title report from the time the vendor purchased the property. This report will be very helpful in determining whether there are any title difficulties or other problems with the property that will have to be dealt with in some fashion. The vendor should also supply a copy of their existing Transfer/Deed of Land for the property, since it will be useful in the preparation of the Transfer/Deed of Land required for closing. Ask the vendor for the survey for the property, as well as the tax bill, utility accounts, and copies of any mortgages that are going to be assumed by the purchaser or discharged on closing. The survey of the property is useful in confirming the property's boundaries. If a boundary dispute arises, the solicitor should review the *Line Fences Act* in conjunction with the survey.

Remember to advise the vendor of the vendor's obligation to have utility meters read on closing and to advise the utility departments where final bills should be sent.

If acting for the purchaser, ensure that answers to your requisitions and inquiries are satisfactory. If not, take immediate action to ensure that these matters are resolved prior to closing. If there are arrears in payment of taxes or utilities, advise the vendor's solicitor of this so that the arrears can be paid or adjusted for and paid out of the closing proceeds.

As the purchaser's solicitor, you should find out from the purchaser how the client wishes to take title. Ascertain the legal name and birth date of the purchaser, and if there is more than one purchaser, whether they wish to take title as "joint tenants" or as "tenants in common." If they take title as joint tenants, then if one party should die, the property will automatically devolve to the survivor. If they take title as tenants in common, then on the death of one party, the property becomes part of his or her estate and does not pass by survivorship to the other tenant in common. This information must be communicated to the vendor's solicitor so that he or she can incorporate it in the Transfer/Deed of Land.

If also acting for a mortgagee, prepare a separate checklist based on the mortgagee's instructions for completion of the mortgage transaction.

Problems will arise from time to time, for example, when requisitions cannot be satisfactorily answered. In such cases, as the purchaser's solicitor, advise the purchaser, in writing, of the problem and the alternatives available to deal with the problem. The purchaser's instructions to complete the transaction or to terminate it should be documented in writing and, if possible, signed by the purchaser. At the very least, record the client's instructions carefully and confirm these instructions in writing as soon as possible.

5. Preparation of documents

Closing documents should be drafted and circulated for review sufficiently in advance of closing so as to allow the other side a reasonable opportunity to review and comment.

If preparing documents that are to be registered and are unusual, take advantage of the pre-approval procedures at the registry office. In land titles, there is an official procedure whereby you can have your documents pre-approved. Although the registry system has no such formal procedure, someone behind the desk will usually have a look and advise whether he or she thinks that the document is satisfactory.

The *LRRA* provides that five basic categories of documents can be registered on title. They are as follows:

- Transfer/Deed of Land;
- Charge/Mortgage of Land;
- Discharge of Charge/Mortgage;
- Document General; and
- Schedule (if such schedule is required to be attached to any of the aforementioned documents).

The Document General is the cover page to every other document that is not a Transfer, Charge, or Discharge. There is a *Document User Guide* prepared by the Ministry of Government Services — Registration Division, which is invaluable in helping one fill out the various forms. In addition, CCH has published a reference entitled *Document Registration Guide,* which although more up to date, is not officially authorized by the Ministry of Government Services. Reference may also be had to the *Ontario Land Titles Procedural Guide* and the *Land Registrar's Bulletins* to assist in preparing the above-mentioned documents.

E-reg allows conveyancing and numerous other documents to be prepared directly on the office computer using a series of prompts built into the system.

In the paper system, some title documents must be accompanied by supporting evidence before they will be accepted for registration. For example, to register a Transfer in land titles under a power of sale, file the appropriate evidence to show the legislative requirements for carrying out such a sale have been satisfied.

In e-reg, supporting evidence is replaced by compliance with law statements. These compliance statements call for a legal judgment to be made upon certain facts. For example, to register a Transfer under a power of sale, a statement confirming that all of the appropriate requirements have been satisfied for the power of sale to be completed and the Transfer registered must be made.

A law statement will be necessary when any document is provided under a power of attorney given by an individual. The power of attorney should be scanned and registered as a PDF in the e-reg system.

Since supporting evidence will not be filed with the registry office when using compliance statements, obtain and keep the evidence upon which the compliance statements are based. If litigation later arises, the material kept in the files may be the only evidence supporting the compliance statements. Keep this in mind when deciding if real estate files can be safely destroyed.

The Joint Committee on Registration of Electronic Title Documents struck by the Law Society of Upper Canada and the Canadian Bar Association-Ontario is of the view that lawyers may rely on compliance statements made by other lawyers in good standing without having to look behind the statement and review the supporting evidence. This view is endorsed by the Lawyers Professional Indemnity Company (LPIC) because the entire e-reg and land titles system is based on the sufficiency of the register to establish title to real property. The lawyer is entitled to rely on the register. It is important to recognize that documents are not certified immediately upon registration and may not be certified until several weeks after registration. Therefore, there is some risk that a document will be rejected before certification if it comes to light that some aspect of a compliance statement is found to be false.

When a document contains a compliance with law statement, the completeness signature will only be accepted from a registered user who is authorized to practise law in Ontario. Teranet records will show whether a registered user is so authorized. The Law Society of Upper Canada will provide Teranet with timely updates on lawyers' status so that it can register new lawyers and deny access to retired, suspended, or disbarred lawyers.

Even if a document does not contain compliance with law statements, the approval of documents should be

completed by a solicitor who understands the meaning of the document being reviewed.

Before a document is registered, the lawyers involved must show their approval of the document by electronically signing for completeness. If the document contains compliance with law statements, the e-reg system will only accept a completeness signature from a user who is authorized to practise law in Ontario.

According to r. 5.01(2) of the *Rules of Professional Conduct*, even if the complete function is delegated to a non-lawyer, the responsibility for any document ultimately rests with the lawyer handling the file.

When preparing a document in the e-reg system, certain fields of information (for example, the municipal address, the current owner's name, and the legal description) are automatically filled in from data stored in the title database, and that information can be confirmed or changed.

Having prepared the document, the lawyer makes it available electronically to the lawyer representing the other party (Lawyer 2). At the same time, the lawyer grants Lawyer 2 an update capability so that Lawyer 2 can change the document as required.

When both lawyers are satisfied with the document, each signals approval by logging on to e-reg and indicating that the document is complete. These signals are referred to as electronic signatures. The completeness signature must be attached before the transaction can proceed any further.

When ready to release the document for registration, sign for release. This signature can be added by the lawyer, a conveyancer, or another authorized user. Both the completeness and release signatures must be attached to a document before it will be accepted by e-reg for registration.

5.1 Vendor's documents

5.1.1 Transfer/deed of land

This document transfers ownership in the real property to the purchaser. Section 5 of the *LRRA* deems a transfer to include certain covenants and a release by the vendor to the purchaser and persons deriving title under the purchaser. Parties can exclude or vary any of the statutory covenants in a schedule to the Transfer.

There are two aspects of the Transfer/Deed of Land that should be noted: (i) the *Family Law Act* (*FLA*) requirement; and (ii) the *Planning Act* optional statements.

(a) The Family Law Act

If any of the vendors are individuals, then Box 8 of the Transfer must contain an *FLA* statement. There are nine possible statements, and they are attached as Appendix A to this chapter. This section of the Transfer is designed to protect spousal rights regarding the matrimonial home under the *FLA*. If both spouses actually hold title to the property, Box 8 should state "we are spouses of one another." If selling the matrimonial home and one of the spouses is on title and the other is not, both the titled spouse and the non-titled spouse sign the Transfer, the non-titled spouse signing in Box 9. In Box 8, the words "the person consenting below is my spouse" are inserted. If the vendor is not a spouse, Box 8 will contain the statement "I am not a spouse." It is also possible that the person is a spouse but that the property transferred is not a matrimonial home. In this case, the wording "The property transferred is not ordinarily occupied by me and my spouse, who is not separated from me, as our residence" is inserted. There is a process under the *FLA* whereby if both spouses designate a property as their matrimonial home, every other property that they hold is not a matrimonial home. In this case, the statement in Box 8 states that "the property is not designated under s. 20 of the *FLA* as a matrimonial home by me and my spouse, but there is such a designation of another property as our matrimonial home which has been registered and which has not been cancelled." This shows the purchaser that this property is not the matrimonial home. There are other statements that are inserted when the spouses have separated or when the transaction has been authorized by court order.

(b) The Planning Act

One of the most important amendments introduced by s. 50(22) of the *Planning Act* was the inclusion in the Transfer of optional statements by the vendor and his or her solicitor (Box 13) and by the purchaser's solicitor (Box 14) with respect to compliance with the *Planning Act*. The effect of completing these statements in the Transfer is that any prior contraventions of the subdivision control provisions of the *Planning Act*, which otherwise would have the effect of voiding the interest in land, are deemed no longer and never to have had this effect. Previous violations of the *Planning Act* subdivision control provisions will be validated.

For the purchaser to enjoy this feature, three basic requirements must be met:

- The vendor must state that to the best of his or her knowledge and belief, the conveyance does not contravene s. 50 of the *Planning Act*.
- The vendor's solicitor must sign a statement that he or she has explained the effect of s. 50 of the

Planning Act to the vendor, has made the necessary inquiries of the vendor to determine that there has been no contravention of s. 50 of the *Planning Act*, and that based upon the information given by the vendor, there has been no contravention of s. 50 of the *Planning Act*.

- The purchaser's solicitor must state that he or she has investigated title to the property and that there appears to be no contravention of s. 50 of the *Planning Act*.

The solicitor for the purchaser must act independently from the vendor's solicitor so that this feature is not available if one lawyer is acting for both parties.

With the three statements all signed, any *Planning Act* contravention for the purpose of subsequent transfers can be cleared. There is a logistical problem in the paper system of having the purchaser's solicitor sign the third statement when he or she does not have the Transfer/Deed of Land (since it is being prepared by the vendor's solicitor). The usual way of dealing with this is to have the purchaser's solicitor sign a sticker, which is available and contains the statement, deliver the sticker on closing, and affix it to the Transfer/Deed of Land at closing.

It is important to note that the *Planning Act* statements are entirely optional. The lawyer cannot force the vendor or the vendor's solicitor to sign them. Therefore, their signatures should be required as a term of agreements of purchase and sale.

5.1.2 Statement of adjustments

The vendor's solicitor will prepare the statement of adjustments. This document is essentially a balance sheet that lists all of the adjustments to the agreed purchase price necessary to determine what the purchaser will ultimately pay to the vendor on closing. The vendor will obtain credit for such things as the sale price and any expenses that the vendor has prepaid and that are attributable to the time that the purchaser will own the property. For example, if the vendor has paid more than its share of realty taxes for the year, the vendor will be credited for this overpayment in the statement of adjustments.

The purchaser will be credited with having paid a deposit, having possibly assumed some mortgage financing (which amount will be obtained from the mortgage statement for assumption purposes), and for any underpayments that the vendor has made of expenses relating to the property that are attributable to the time that the vendor was the owner of the property.

The statement of adjustments will typically adjust for realty taxes, flat-rate utilities, and accounts between the vendor and any tenants of the property. Typically, the day of closing is paid for by the purchaser. With respect to realty taxes if the municipality has not issued the final realty tax bill for the year, realty taxes for the year will be estimated in the statement of adjustment, and the parties will agree to readjust the realty taxes when the final tax bill is issued. On closing the parties will undertake to readjust the realty taxes at that time.

5.1.3 Direction regarding funds

It is rare to see the entire balance due on closing actually being paid to the vendor. More often what occurs is that closing proceeds are paid by way of a variety of cheques to pay out mortgages, real estate commission, tax and utility arrears (or in the case of a condominium, common expenses arrears), if any, with the balance often being paid to the vendor's law firm in trust so that other accounts, including sometimes the law firm's fees and disbursements, may be paid. For this reason and for convenience, the vendor will often sign a direction authorizing payment to be directed to parties other than itself. For the purpose of flexibility, there are usually two directions signed by the vendor. First, a direction will be signed authorizing the purchaser to make the balance due on closing payable to the vendor's solicitor or to whomever that solicitor may direct. The benefit of doing this is that the client can sign documents in advance, without having to re-attend at his or her solicitor's office once the exact funds owing to various payees are determined. The vendor's solicitor then signs the second direction (or redirection of funds), which specifically authorizes the purchaser to pay the closing funds in a manner that will see the funds paid to the various desired payees (for example, the condominium corporation in payment of common expense arrears).

5.1.4 Declaration of possession

A declaration of possession is the vendor's declaration with respect to various matters relating to the use and occupation of the property during the vendor's ownership, including the location of fences and boundaries and the absence of any third-party claims to adverse possession or prescription. Although there are a number of issues other than possessory title dealt with in a declaration of possession, it normally is not requested or given in a land titles transaction since possessory title is not an issue. The vendor's solicitor should review this declaration carefully and amend the form so that the vendor's liability is not unduly expanded.

5.1.5 Income tax affidavit

The *Income Tax Act* (*ITA*) requires a purchaser buying from a non-resident to withhold a portion of the

purchase price necessary to satisfy the vendor's tax liability. However, the purchaser does not need to withhold this amount if, after reasonable inquiry, the purchaser has no reason to believe that the vendor is a non-resident in Canada. The position of the Canada Revenue Agency (CRA) as to what constitutes "reasonable inquiry" is that the purchaser must take prudent measures to confirm the vendor's residence status (see Information Circular 72-17R5, "Procedures Concerning the Disposition of Taxable Canadian Property by Non-Residents of Canada – Section 116," para. 50). The standard procedure for satisfying the "reasonable inquiry" test is the delivery by the vendor to the purchaser of an affidavit stating that he or she is not a non-resident of Canada within the meaning of the *ITA*. If the vendor is a non-resident of Canada, the purchaser must withhold and remit the appropriate tax or obtain a certificate of exemption from the CRA to exempt the purchaser from its obligations under s. 116 of the *ITA*.

5.1.6 Bills of sale

A bill of sale is delivered when chattels are being transferred to the purchaser along with the land and buildings. Although it is no longer a necessary document as a result of the repeal of the *Bills of Sale Act* in 1989, it is a good idea, from the purchaser's point of view, to have a separate piece of paper evidencing what chattels are being transferred and that they are free from encumbrances. If possible, a purchaser should require its delivery as a closing document in the agreement of purchase and sale, failing which a purchaser could not insist upon its delivery on closing. A bill of sale is particularly important in an apartment building purchase where evidence may be needed as to which chattels do not belong to the tenants.

5.1.7 Insulation warranty

Due to the concern that a structure may be insulated with urea formaldehyde foam insulation, most agreements of purchase and sale contain a warranty by the vendor to the purchaser that there is no urea formaldehyde foam insulation in the structure. The vendor's solicitor should ensure that the warranty given does not expand the vendor's obligations beyond what the vendor must deliver pursuant to the agreement of purchase and sale. There has been a similar concern about asbestos located in a structure, and one may see a similar warranty required with respect to this substance.

5.1.8 Affidavit regarding executions

If acting for a purchaser, the lawyer will have searched executions historically against the owners of the property and the current vendor as part of the title search. If you are acting for the vendor and the purchaser is giving a vendor take-back mortgage, search executions against the purchaser. From the purchaser's point of view, this search should, for expediency, be done at the same time as the title search so that any executions that the land may be subject to can be submitted as requisitions. The execution search should be updated a few days prior to closing to ensure that no new executions have been filed and to avoid surprises on the date of closing.

If there is an execution and it is against the person whom you are dealing with or against an owner who had an interest in the land at the time of the execution, arrange to have it paid and lifted for closing. Be wary of holding back funds on closing to pay out an execution since, depending on the nature of the execution, it is possible that more money will be owed to lift the lien than is held back. Examples of situations where this may be a danger are in executions filed in connection with construction liens and family support orders.

There is a procedure for producing affidavits regarding executions against a party who is not the party the lawyer is dealing with but who has a similar name. First, the party with the similar name to the execution debtor should sign an affidavit stating that he or she is not one and the same person as the execution debtor noted in the execution. This affidavit should be supported by a letter from the execution creditor's solicitor verifying that the client is not one and the same person as the execution debtor. To obtain this letter, the lawyer will typically write to the execution creditor's solicitor with sufficient details regarding the client(s) so that he or she can distinguish the client(s) from the execution debtor. The problem with producing the affidavit alone is that it is obviously self-serving.

If the property is in land titles, the indebtedness under the execution is less than $50,000, and the document being tendered for registration is a Transfer/Deed of Land, then the Transfer/Deed of Land must be accompanied by an affidavit in the form shown in chapter 15 of the *Document Registration Guide*. This affidavit is made by the registered owner or his or her solicitor deposing that the registered owner is not the person named in the writ. If the amount of the writ of execution is over $50,000, the Transfer/Deed of Land being tendered for registration must be accompanied by one of the following:

- a statutory declaration of the solicitor for the registered owner (in the form shown in chapter 15 of the *Document Registration Guide*) or a letter on the solicitor's letterhead unequivocally declaring that his or her client is not the same person as the judgment debtor in the writ.

- a written acknowledgement by the judgment creditor or his or her solicitor indicating that the registered owner is not the same person as the judgment debtor named in the writ. The statement is acceptable in lieu of an affidavit or statutory declaration, provided the statement contains exactly the same information.

If you are trying to clear executions in land titles in connection with any document other than a Transfer/ Deed of Land, the procedure to be followed is the same as with respect to a property registered under the registry system. Executions against a transferor in e-reg are cleared by a party's statement or a solicitor's statement, as the case requires, in the Transfer itself.

5.1.9 Documentation relating to leases

When there are leases that affect the property, the closing documents will include either a general assignment of all of the leases in the building or specific assignments of each particular lease. Section 5 of the *Commercial Tenancies Act* provides that the benefit of every covenant contained in a lease touching and concerning the land passes to the purchaser of the property even without a written assignment. The written assignment will transfer the benefit of covenants regardless of whether they come within this provision of the *Commercial Tenancies Act*. If acting for the purchaser, request an indemnity by the vendor for any defaults on the part of the vendor arising prior to the closing date. The vendor may request a similar indemnity from the purchaser for default by the purchaser occurring after the closing date.

In addition, the vendor will deliver to the purchaser on closing a "notice and direction to tenants," which the purchaser will deliver to the tenants after closing, notifying the tenants of the sale and directing them to pay future rents to the purchaser. This notice is necessary in order to advise the tenant to pay rent to the purchaser.

Sometimes, if the agreement of purchase and sale calls for it, the vendor will deliver to the purchaser acknowledgements or estoppel certificates from each tenant that verify various terms of the lease and confirm that neither the tenant nor the landlord are in default of their obligations under the lease. If the vendor is not able or not willing to obtain tenant acknowledgements, the vendor may be prepared to deliver its own acknowledgement or statutory declaration to the same effect.

5.1.10 Undertakings

An undertaking is given by one party to another to complete a matter after closing that cannot be attended to by the closing date. The giving of undertakings should not replace the completion of matters that could have been attended to prior to closing. Subrule 6.03(10) of the *Rules of Professional Conduct* discusses undertakings and what the lawyer can and cannot undertake to do. There are four types of undertakings that might be delivered or received on closing.

(a) Client's undertaking on own behalf

The most usual example of this undertaking is the vendor's standard undertaking to readjust the statement of adjustments. It is normally prepared by the purchaser's solicitor for the vendor's signature. The vendor's solicitor must be careful in reviewing the undertaking to ensure that the undertakings are no more than the usual obligations of a vendor and do not expand the client's liability. This undertaking usually includes covenants to deliver vacant possession and all keys on closing, to pay all utility and realty accounts to the date of closing, to supply and pay for fuel oil in accordance with the statement of adjustments, to readjust any items on the statement of adjustments due to error or omission, to make all mortgage payments to the date of closing, and to attend to all other matters required pursuant to the particular transaction.

(b) A solicitor's undertaking on behalf of client

Occasionally, the client's absence necessitates signing an undertaking on his or her behalf. Be very careful to observe the following rules if forced to give this sort of an undertaking:

- Neither give nor accept such an undertaking without the client's instructions (if unable to obtain written instructions, then confirm the client's instructions in writing).
- If giving an undertaking on the client's behalf, expressly state that it is given "without personal liability." In the body of the undertaking, use wording like "the undersigned undertakes on behalf of his or her client and without personal liability." Sign the undertaking by using the name of the client and adding the words "by its solicitor and without personal liability." Without these words, the lawyer (and the firm employing the lawyer) could be held personally liable to perform the undertaking.
- If the undertaking is not a customary one to be given in connection with a real estate transaction, be aware that it may not be covered by errors and omissions insurance and avoid these undertakings. The party giving this undertaking is personally liable for its performance.

(c) Solicitor's personal undertaking

Before giving or accepting a solicitor's personal undertaking, make sure that it is fully within the lawyer's power, or the power of the person giving the undertaking,

to fulfill the undertaking. Whether giving or accepting this kind of an undertaking, make sure that the client provides instructions to give it or accept it and that the client is fully apprised of what giving or accepting the undertaking means. If accepting such an undertaking, follow up with the other solicitor to ensure that it is performed promptly. If giving the undertaking, ensure it is completed promptly. These matters should be diarized so that they are attended to after closing.

The most common example of a solicitor's undertaking is with respect to the discharge of institutional mortgages. The Law Society's Practice Management Helpline has established guidelines for solicitor's accepting undertakings to discharge institutional mortgages, and they are attached as Appendix B to this chapter. The following is the most commonly used procedure, with minor variations:

First, as the vendor's solicitor, obtain a mortgage statement for discharge purposes. The mortgage company will often wish to include in its statement the words "errors and omissions excepted" or "E. & O.E." This presents a risk for the solicitor about to give a personal undertaking to discharge a mortgage, since it allows the mortgage company to argue that it is entitled to more money if there is an error. The solicitor may not, by the time the error is discovered, have enough money to cover the balance owing. The solicitor will therefore wish to argue that the mortgage company is estopped from charging the excess claimed, and it will be more difficult for the solicitor to make this point if the statement says that it is subject to errors and omissions.

Secondly, the vendor shall direct the purchaser in the "direction re: funds" to make part of the closing funds payable to the mortgage company in a sufficient amount to pay out the mortgage on closing. The vendor's solicitor then gives the purchaser's solicitor an undertaking that the vendor's solicitor will deliver this cheque forthwith to the mortgagee after closing and will be responsible for any additional money owing to pay out the mortgage that is payable as a result of a delay in delivering the money to the mortgagee. This undertaking will also provide that the solicitor will make every reasonable effort to obtain and register a proper form of discharge as soon as possible after closing. As the vendor's solicitor, argue against setting out a specific number of days in which you will register a discharge, unless the agreement of the mortgage company to provide you with a discharge by this date is obtained. If forced to give such an undertaking, then be aware that the lawyer may have to bring a court application to have the court order a discharge of the mortgage within the required time period.

When acting for a purchaser, ensure that sufficient closing proceeds are made payable and will be delivered to the mortgagee in order to discharge any secured debt that is not being assumed.

In e-reg, a vendor's solicitor should confirm with the financial institution whether the solicitor or the financial institution will prepare and register any discharges of mortgages and should request that the financial institution confirm its decision in writing. If the financial institution authorizes the vendor's solicitor to prepare and register the discharge, then such written authorization should include any applicable terms to be fulfilled before the solicitor is entitled to exercise the authority to register the discharge.

Once the vendor's solicitor knows who will be registering the discharge, the scope of the vendor's solicitor's undertaking with respect to the discharge can then be drafted. If the financial institution authorizes the vendor's solicitor to prepare and register a discharge, then the vendor's solicitor can give the conventional undertaking to obtain and register a discharge. However, if the financial institution is going to register its own discharge, it may be appropriate to change the wording of the undertaking to read, for example, "to cause a discharge of the mortgage to be registered."

Even if the financial institution registers the discharge, the vendor's solicitor must still ensure all of the following:

- The necessary funds (including any additional interest accrued and the discharge registration fee) are forwarded to the financial institution.
- The electronic discharge is prepared and registered by the institution in a timely manner.
- Registration particulars of the discharge are forwarded to the purchaser's solicitor to comply with the solicitor's undertaking with respect to discharging a mortgage.

As stated above, do not give or accept personal undertakings to discharge private mortgages. As the vendor's lawyer, obtain an acknowledgement and direction from the private lender authorizing registration of the discharge on closing. If the lender's acknowledgement is obtained, include a Discharge of Mortgage in the DRA as one of the documents to be registered on closing, subject to compliance with the escrow terms of that agreement. Confirm to the lender that a DRA is being used as part of the closing procedure and that the Discharge of Mortgage will be shown as a document for registration under the agreement, subject to the terms of the escrow.

(d) Best efforts solicitor's undertaking

The fourth type of undertaking is usually given with respect to matters beyond the immediate control of the solicitor, when the other side is looking for the solicitor to do his or her best to complete the undertaking. Exercise caution in giving such an undertaking because the case law is not clear about what efforts will be sufficient to satisfy a "best efforts" threshold. It may be that it will require more of an effort or more money spent than anticipated in fulfilling the undertaking.

5.2 Purchaser's documents

The following are the most common purchaser's documents:

5.2.1 Direction regarding title

If the purchaser wishes title to the property to be taken in any other name than the purchaser's name as set out in the agreement of purchase and sale, it is necessary for the purchaser to direct the vendor accordingly. The purchaser should also indicate how title will be held in the case of multiple purchasers, i.e., joint tenants or tenants in common. If this designation is missing, the multiple purchasers will be deemed to be tenants in common in accordance with s. 13(1) of the *Conveyancing and Law of Property Act*.

5.2.2 Land transfer tax affidavit

The Province of Ontario requires a purchaser to pay a land transfer tax on the registration of any Transfer/Deed. Currently the tax is calculated at the following rates: one-half of 1% on the first $55,000 of the purchase price, 1% on the balance of the purchase price up to and including $250,000, and 1.5% on the balance of the purchase price for property valued at $250,001 and above. Where the property contains one or two single-family dwellings and the purchase price exceeds $400,000, an additional tax is imposed equal to 2% on the balance of the purchase price.

In addition, harmonized sales tax (HST) of 13% is paid on the value of goods and chattels transferred.

The purchaser must provide a statement that contains, among other things, a statement of the value of consideration paid for the property.

The cheque for land transfer tax and HST is payable to the Minister of Finance. This cheque does not have to be certified if it is drawn on the firm trust account, but must be certified if it is drawn on the client's account. This cheque is most often tendered to the land registrar on registration. Sometimes, for specific purposes, it can be tendered directly to the Ministry of Revenue prior to closing.

Since February 1, 2008, purchasers of real property in the City of Toronto have had to pay both provincial and new municipal taxes under the Municipal Land Transfer Tax (MLTT) for transfers of real property in Toronto. The new MLTT mostly mirrors the Ontario *Land Transfer Tax Act*, including the marginal tax rates, and provides broad tax exemptions to Crown-owned properties and certain publicly funded institutions. The MLTT also provides a rebate to first-time homebuyers.

5.2.3 Vendor take-back mortgage

The purchaser may give the vendor a mortgage back as part of the closing proceeds. In the paper system, it is prepared on Form 2B, Charge/Mortgage of Land. Often the mortgage will incorporate Standard Charge Terms No. 9320 (paper) or 200033 (e-reg) (Dye & Durham), but the mortgagee can require that other standard charge terms be used.

In order to reduce the quantity of paper being filed with the land registration office, s. 7(1) of the *LRRA* provides that a charge in the prescribed form shall be deemed to include certain implied covenants. To exclude or vary any of the implied covenants, do so in a schedule to the charge. In the schedule, it is also possible to vary the terms of the standard charge terms that are incorporated by reference.

If the purchaser is giving back a mortgage, the vendor will require the production on closing of a certificate of insurance or binder letter evidencing coverage in accordance with the terms of the mortgage and showing the vendor as a loss payee.

5.2.4 HST

Both the vendor's and purchaser's solicitors will have to address the HST ramifications of the real estate transaction. The provisions of the *Excise Tax Act* relating to real estate transactions are very complicated, so review the legislation in detail.

In general, HST applies to all supplies of real property unless there is a specific exemption. Part I of Schedule V to the *Excise Tax Act* lists various supplies relating to real property that are exempt from HST. These include sales of used residential property, condominium common element expenses, certain sales of farm land, and sales of personal use real property. For other exempt supplies, refer to Schedule V to determine whether the transaction involves such a supply.

On a sale of real property, the vendor has the obligation of remitting the tax on behalf of the purchaser. Pursuant to s. 221(2)(c) of the *Excise Tax Act*, a supplier does not have to collect HST on the sale in certain circumstances including when the purchaser is a registrant under the

Act. On the sale of a used residential property, the vendor usually confirms the nature of the property as being exempt from HST and therefore none should be collected on closing, in compliance with the *Excise Tax Act*. The vendor will provide the purchaser with the vendor's affidavit confirming that the vendor is in compliance with the *Excise Tax Act*.

6. Closing funds

As early as possible prior to closing, as the purchaser's solicitor, determine and communicate to the purchaser the exact amount he or she will need for closing. In order to calculate this, the statement of adjustments is required to determine the balance due on closing. Add land transfer tax and possibly registration costs to this amount. Legal fees and estimated disbursements may also be included. Ask the purchaser to deliver these moneys in certified funds so that they can be dealt with through the trust account without waiting for the funds to clear.

If also acting for the lender, review your client's instructions and develop a checklist, then forward an interim report to the lender and requisition mortgage funds. Make a final review of the checklist prior to closing to verify that all funds for closing have been received from all sources.

7. Pre-closing

It is wise to regularly review and update the closing agenda as the transaction progresses.

It will be necessary to obtain oral updates of utility and tax accounts and to communicate any arrears to the vendor's solicitor.

A day or two prior to closing, executions should be checked against the vendor to ensure that no further executions have arisen since the original check. Executions should also be searched against the purchaser if the purchaser will be granting a mortgage on closing, whether it is a vendor take-back mortgage or from a third-party lender.

Arrange to meet with the client as close to closing as possible so that any last-minute changes to documentation will have already been incorporated. If the client is going to be out of the country for closing, consider preparing a limited power of attorney for the client to give to someone who will be in the country to facilitate closing. In any event, ensure that there is a phone number where the client can be reached for closing.

Review with the client any problems, including title requisitions, that have been raised and thoroughly discuss how these have been resolved. It is helpful to summarize these issues in writing to the client before closing. This is extra work before closing, but it is an extremely good defensive tool and makes reporting the transaction after closing much easier.

If acting for the purchaser or vendor of a home, ask the client when the client plans to move out or in and how the client wishes to retrieve the key. Have a phone number where the client can be reached for instructions should problems arise on the day of closing. If acting for the vendor who needs money to purchase another property the same day, review the potential problems that can arise if closing does not actually take place that day for unforeseen reasons. Canvass the possibility with the client of his or her obtaining bridge financing to avoid the panic that can occur if the sale is not completed.

When meeting with the client, review all documentation explaining at least the substance of each document before the client signs. Also review the statement of adjustments and funding in detail.

At the meeting with the client, it is prudent to provide the client with a folder containing a copy of all relevant information. If acting for the purchaser, this would typically include

- the statement of adjustments;
- draft transfer and draft charge;
- the survey;
- draft title insurance policy; and
- draft trust statement and account.

If acting for the vendor, this would typically include

- the statement of adjustments;
- the mortgage discharge statement;
- the real estate commission statement; and
- draft trust statement and account.

The folder would also include any acknowledgements or consents relating to any special issues that arose in the transaction.

If closing is to be completed by electronic registration, then e-reg documents are completed and electronically signed by solicitors or their designates and not by a solicitor's client. In e-reg, supporting evidence is replaced by compliance with law statements. These compliance statements require a legal judgment to be made upon certain facts. Since lawyers do not file supporting evidence with the registry office when they use compliance statements, they must obtain and keep the evidence upon which they base their compliance statements. Lawyers may rely on compliance statements made by lawyers in good standing without having to look

behind the statement and review the supporting evidence. It is important to recognize that documents are not certified immediately upon registration and may not be certified until several weeks after registration. There is some risk that a document will be rejected before certification if it comes to light that some aspect of a compliance statement is found to be false.

Only a lawyer may sign for completeness any document that contains a compliance with law statement. In addition, a lawyer is prohibited from permitting others, including non-lawyer employees, to use the lawyer's diskette and from disclosing his or her personalized e-reg pass phrase used to access the electronic registration system (*Rules of Professional Conduct*, r. 5.01(3)).

Have the client sign an acknowledgement and direction authorizing you to complete the transaction and register electronically. The acknowledgement and direction should further authorize the lawyer to enter into the DRA, and a copy should be attached to the acknowledgement and direction. All off-title documents should be executed by the appropriate party.

The e-reg system produces the acknowledgement and direction for the solicitor to have the client sign. Many lawyers who have experience with the system choose to use their own acknowledgement and direction and attach a "Document in Preparation," rather than using the system-generated document. The acknowledgement and direction is designed to summarize the basic terms of the Transfer, Charge, and other documents and to provide a written record of specific instructions from the client to the lawyer concerning delivery and registration of documents. The system-generated acknowledgement and direction contain the same five basic points, namely

- acknowledgements of accuracy of information;
- authorization to electronically register documents;
- authorization to enter into the DRA;
- acknowledgements of understanding of content and effect of electronically registered documents; and
- warranty as to identity.

With respect to guarantors, although a guarantor may be identified in the electronic form of charge, he or she should sign a separate paper guarantee to bind him or her to the covenants. Make sure that this document is consistent with any guarantee provisions found in the Charge and the standard charge terms.

Keep a signed copy of the acknowledgement and direction in the file as written verification of the client's instructions.

The purchaser's solicitor should then sign the DRA, or an agreement to use the DRA as a protocol, and fax a signed copy to the vendor's solicitor.

8. Closing the transaction

8.1 Personal attendance at registry office

On the day set for closing, the purchaser's solicitor or his or her clerk should attend at the registry office or the land titles office before the time fixed for closing in order to conduct a subsearch of title from the last instrument shown on the initial title search. This is to determine whether anything new has been registered since the date of the original search. In registry, this entails looking at the abstract book and then updating the records through the "daybook." On busy days, even the daybook may not be completely up to date, and therefore it is advisable to check with the registration clerk to see if there are other documents that have been registered against the property from the time of the last registration shown in the daybook. The subsearch must be conducted just before registering the documents.

The purchaser's solicitor's second task will be to obtain an execution certificate against the vendor. If acting on the purchase of a condominium, it is prudent to also obtain an execution certificate against the condominium corporation, since any judgment against the condominium corporation is also a judgment against each unit owner at the time of the judgment. Execution certificates are good until 5:00 p.m. on the day they are obtained.

If the execution certificate reveals a name similar to the name searched, then unless the lawyer is satisfied by virtue of inquiries that the execution debtor is not the same party as the party he or she is dealing with, it is wise to postpone the closing in order to have the execution lifted or proven not to affect the property. If a postponement is not possible, consider withholding part of the closing proceeds to satisfy the indebtedness to the execution creditor so long as this can be ascertained without qualification. Be wary of accepting a solicitor's undertaking to obtain a statutory declaration to the effect that the party is not one and the same person as the judgment debtor, since the solicitor offering this undertaking may not be able to fulfill this sort of an undertaking. Make inquiries of the judgment creditor's solicitor to assist in distinguishing the judgment debtor from the party that the lawyer is dealing with.

After completing the subsearch of title and the execution search and ascertaining that these searches are satisfactory, meet with the vendor's representative to close the transaction.

The vendor's representative, in the meantime, should have obtained an execution certificate against the purchaser if the purchaser is giving back a mortgage to the vendor.

The closing procedure involves an exchange of documents, keys, and cheques.

If acting for the purchaser, expect to receive a fair number of documents. It is advisable to have drafts of the expected documents so that they can be compared to the originals to ensure that the documents received have not been amended.

Once all of the documents have been exchanged, the purchaser's solicitor will proceed to the registration desk, and the vendor will hold the cheques in escrow. If the vendor's solicitor is registering a vendor take-back mortgage, he or she too will proceed to the registration desk. If the documents are in order, they will be accepted for registration, the time and date of registration will be stamped on the instrument, and an instrument number will be given. The registration costs and land transfer tax must be paid on registration. Specify to the parties registering the order in which documents should be registered.

In the registry office, the duplicate registered copy of the instrument is typically returned to the party who registered it immediately following registration or later the same day. In the land titles office, the duplicate registered copy is returned to the party who registered it immediately following registration, and the original certified copy remains at the land registry office.

8.2 Closing electronically

In order to be able to use the remote capability afforded by e-reg, an escrow closing procedure is required.

In an attempt to establish a province-wide escrow closing process for use with e-reg, the Joint Committee on Electronic Registration of Title Documents developed the DRA to govern the relationship between the parties until all documents and funds have been exchanged and registration effected. This DRA can be found on the Law Society of Upper Canada website.

The DRA includes the following basic provision:

> 1. The Vendor's Solicitor and the Purchaser's Solicitor shall hold all funds, keys and closing documentation exchanged between them (the "Requisite Deliveries") in escrow, and shall not release or otherwise deal with same except in accordance with the terms of this Agreement. Both the Vendor's Solicitor and the Purchaser's Solicitor have been authorized by their respective clients to enter into this Agreement. Once the Requisite Deliveries can be released in accordance with the terms of this Agreement, any moneys representing payout funds for mortgages to be discharged shall be forwarded promptly to the appropriate mortgage lender.

This clause sets out the fundamental purpose and core obligation under the DRA, namely, that all funds and documentation are to be held in escrow in accordance with the terms and provisions of the agreement itself.

> 2. Each of the parties hereto shall notify the other as soon as reasonably possible following their respective receipt of the Requisite Deliveries (as applicable) of any defect(s) with respect to same.

This provision is designed to ensure that problems with documents and other items exchanged between solicitors are promptly identified and, to the extent possible, rectified.

> 3. The Purchaser's Solicitor shall be responsible for the registration of the Electronic Documents (as hereinafter defined) unless the box set out below indicating that the Vendor's Solicitor will be responsible for such registration has been checked. For the purposes of this Agreement, the solicitor responsible for such registration shall be referred to as the "Registering Solicitor" and the other solicitor shall be referred to as the "Non-Registering Solicitor":
>
> Vendor's Solicitor will be registering the Electronic Documents. ☐

The DRA allows the parties to the agreement to select who should be responsible for registration. For example, in cases involving bulk closings, such as the sale of new condominium units, the vendor's solicitor may be the best party to handle registrations. In its present format, the DRA accommodates both perspectives since it defaults automatically to the purchaser's solicitor registering, unless a contrary intention is indicated on the face of the agreement (i.e., the vendor registration box is checked).

> 4. The Non-Registering Solicitor shall, upon his/her receipt and approval of the Requisite Deliveries (as applicable), electronically release for registration the Electronic Documents and shall thereafter be entitled to release the Requisite Deliveries from escrow forthwith following the earlier of:
>
> a) the registration of the Electronic Documents;
>
> b) the closing time specified in the Purchase Agreement unless a specific time has been inserted as follows [___ a.m./p.m. on the Closing Date] (the "Release Deadline"), and provided that notice under paragraph 7 below has not been received; or
>
> c) receipt of notification from the Registering Solicitor of the registration of the Electronic Documents.
>
> If the Purchase Agreement does not specify a closing time and a Release Deadline has not been specifically inserted the Release Deadline shall be 6.00 p.m. on the Closing Date.

This provision deals with when the non-registering solicitor can release documents and funds. In the absence of either a closing time in the agreement of purchase and sale or the DRA, the Release Deadline is set at 6:00 p.m. on the closing day.

> 5. The Registering Solicitor shall, subject to paragraph 7 below, on the Closing Date, following his/her receipt and approval of the Requisite Deliveries (as applicable) register the documents listed in Schedule "A" annexed hereto (referred to in this agreement as the "Electronic Documents") in the stated order of priority therein set out, as soon as reasonably possible once same have been released for registration by the Non-Registering Solicitor, and immediately thereafter notify the Non-Registering Solicitor of the registration particulars thereof by telephone or telefax (or other method as agreed between the parties).
>
> 6. Upon registration of the Electronic Documents and notification of the Non-Registering Solicitor in accordance with paragraph 5 above, the Registering Solicitor shall be entitled to forthwith release the Requisite Deliveries from escrow.
>
> 7. Any of the parties hereto may notify the other party that he/she does not wish to proceed with the registration [for the purpose of the DRA, "registration" shall mean the issuance of registration number(s) in respect of the Electronic Documents by the appropriate land registry office] of the Electronic Documents, and provided that such notice is received by the other party before the release of the Requisite Deliveries pursuant to this Agreement and before the registration of the Electronic Documents, then each of the parties hereto shall forthwith return to the other party their respective Requisite Deliveries.

The effect of paras. 5–7 of the DRA is to provide the solicitor with two specific courses of action after receipt and approval of all Requisite Deliveries. The first is to proceed with registration of the electronic documents and notify the other solicitor of the registration. The second possible course of action is for either solicitor to notify the other solicitor that he or she will not be proceeding with the registration of the electronic documents, in which case so long as this notice is received before registration of the electronic documents then each of the parties will give back the items each holds in escrow under the agreement.

> 8. This Agreement may be signed in counterparts, and shall be read with all changes of gender and/or number as may be required by the context.
>
> 9. Nothing contained in this Agreement shall be read or construed as altering the respective rights and obligations of the Purchaser and the Vendor as more particularly set out in the Purchase Agreement, and in the event of any conflict or inconsistency between the provisions of this Agreement and the Purchase Agreement, then the latter shall prevail.

Paragraph 9 was inserted because of concerns expressed by user groups that the DRA should not change the substantive rights of the parties to the agreement of purchase and sale.

> 10. This Agreement (or any counterpart hereof), and any of the closing documents hereinbefore contemplated, may be exchanged by telefax or similar system reproducing the original, provided that all such documents have been properly executed by the appropriate parties. The party transmitting any such document(s) shall also provide the original executed version(s) of same to the recipient within 2 business days after the Closing Date, unless the recipient has indicated that he/she does not require such original copies.

The DRA currently requires that documents may be exchanged by facsimile but must be followed by originally executed copies within two business days after the closing date unless the recipient has indicated that he or she does not require such original copies.

The DRA is signed by the parties' lawyers who in turn obtain authorization to enter into the DRA through the client's execution of the acknowledgement and direction. When a solicitor signs a DRA, he or she is undertaking professional obligations as to the handling of the client's documents and funds. The client's execution of the acknowledgement and direction gives the solicitor the written authority to make those undertakings.

It is recognized that the standard DRA will not apply to all situations. Lawyers will still need the ability to customize their arrangements in circumstances that do not fit within the typical model.

In the initial retainer letter, request the client's approval to use a DRA and to close in escrow.

The following is a brief description of the process that may be followed on the day of closing in e-reg.

The purchaser's solicitor would receive the closing funds, deposit the funds into his or her trust account and draw closing cheques according to the vendor's direction regarding funds.

The vendor's solicitor would deliver to the purchaser's solicitor the vendor's deliveries, which could include off-title documentation and keys.

The purchaser's solicitor would deliver the purchaser's off-title deliveries and closing cheques to the vendor's solicitor and ask for immediate confirmation by telephone or facsimile transmission that the funds and documents have been received and that the Transfer has been released for registration.

Once confirmation has been received that the Transfer has been released, the registering party will log onto

Teraview, open the appropriate docket, select "register," and select the documents to be registered and the order of registration. The registering solicitor will confirm that he or she wishes to conduct a subsearch. The system completes the subsearch and advises of the last registered instrument. The registering solicitor will confirm that the last registered instrument is that shown in his or her title search. Teraview will search executions. A certificate will be printed at this time, and a copy of each registered instrument is printed immediately following registration. The registration process described above is usually completed in a matter of minutes. Then the registering solicitor will log out of the document and open his or her administration docket. The solicitor will print a "Tax and Fee Summary" so that it may be posted to the correct file and the appropriate amount may be deposited to the solicitor's Teraview transition account for payment of land transfer tax and registration fees. Access to Teraview is now available online.

If a lawyer chooses this form of access, there are no charges for online time and therefore the need to move from the docket relating to the transaction to an administration docket is not necessary. Immediately telephone or fax the non-registering solicitor confirming completion of the transaction and providing particulars. The registering solicitor should draw a cheque to cover land transfer tax and registration costs for deposit to the Teranet transition account at the end of the day. Teranet will clear accounts at the end of each day, taking all registration fees and land transfer tax incurred that day. The purchaser's solicitor should then send signed original copies of the DRA and the purchaser's deliveries not previously forwarded to the other solicitor.

8.3 Electronic funds transfer

Increasingly, closing funds are delivered by way of wire transfer to a solicitor's trust account or financial institution, or the parties might use remote deposit at another branch of the vendor's solicitor's bank.

Every person who wishes to use e-reg must become a subscriber with Teranet. Each subscribing lawyer or law firm will need to establish an account with Teranet for payment of user fees, access charges, and online charges. Registration fees and land transfer taxes can be paid from lawyers' special trust accounts or general accounts.

Teranet also offers its Closure service, which is Internet based and designed to securely manage the transfer of real estate closing funds online from a law firm's office, reducing the need for certified cheques, bank drafts, direct deposit, and couriers. A purchaser's law firm can send closing proceeds to the vendor's law firm, to registered lenders, to other registered Closure users, and to builders or developers. Funds are transferred by wires, and all payments are final and irrevocable. The advantages to this service are the elimination of attending at a bank to deposit funds, certified cheques, etc. *Per diem* charges are also avoided as lenders registered with this service have agreed to credit the mortgage the day funds are received. Provided the deal is closed through the Closure service prior to 5:00 p.m., the lender will apply those funds to the mortgage that day. This service also facilitates a chain or stack of residential deals to be closed in one day. Money to be applied to the next deal in the chain simply moves within the Closure service until the last sale, where the money is transferred into the vendor's law firm trust account and any lenders that have been identified for that deal. This provides a clear audit trail of money movement. This service also reduces office overhead and eliminates a number of courier runs, which can be especially convenient for out-of-town transactions.

9. Escrow closings

Electronic registration necessitates closing in escrow pursuant to a DRA. However, there are also other types of escrow closings. The term "escrow" means the conditional delivery of documents pending a certain event happening.

Often an escrow closing will be necessary when the registry office is about to close and the purchaser's and vendor's representatives have run out of time to close the transaction and register the documentation requiring registration. This is a very common occurrence during the periods of time when the registry office is busy.

The safest thing to do with the client's instructions is to extend the date of closing, rather than closing the transaction in escrow. Any change to the closing date requires an amendment to the agreement of purchase and sale and must be confirmed by the client. However, this solution is not always available if the purchaser is sitting outside with the moving truck, waiting to move into the property, or for some other reason possession is necessary. In these circumstances, the ability to possess the property passes on escrow closing, but registration of the documentation has not yet taken place.

It is dangerous to enter into an escrow arrangement without a written agreement of the terms of the escrow. While an escrow can be implied, there is always the risk that the parties will later disagree about what the terms of the escrow were. Therefore, if entering into an escrow closing, try to incorporate the following terms into an agreement:

- All documents, funds, and keys are exchanged and are to be held in escrow pending fulfilling certain conditions.
- The purchaser's solicitor undertakes to attend to the registration of the Transfer/Deed of Land on a specified future date, subject only to a subsearch indicating no further registrations from the escrow closing date, no *Planning Act* impediment having arisen, and no executions having been filed since the escrow closing date that would affect the property and acceptance of the documents by the registry office (if the vendor's solicitor is to register documentation that matters, this should also be specified).
- All of the deliveries must be held in escrow by the respective solicitors to be released only once the purchaser's solicitor has advised the vendor's solicitor regarding registration.
- If registration does not occur by a given time, all deliveries are to be returned to the solicitor that delivered them. From the vendor's point of view, the solicitor will want to provide that the purchaser must register and advise of registration or inability to register by a certain time, failing which the vendor's solicitor is free to release funds and documents to his or her client.
- If the purchaser is to take possession, then the escrow agreement should provide for permission of the vendor to do so. Usually the vendor's solicitor will want to address the purchaser's responsibility for damages caused to the property from the time the purchaser moves in.
- If acting for the vendor, request a waiver of the purchaser to object to the transaction on any other basis but the escrow conditions. The lawyer does not want to have a new requisition raised as part of the final closing.
- If the purchaser is being allowed to possess the property, it should be provided that if the transaction does not close when scheduled because of a failure of a condition of the escrow, the purchaser will give up possession forthwith and shall deliver up the property in the same condition as it was when the purchaser took possession.
- Remember, if acting for a mortgagee as well as a purchaser, obtain the mortgagee's express instructions to permit funds to be held by anyone. Therefore, if your escrow necessitates delivering the mortgage funds to the vendor's solicitor, obtain the mortgagee's consent to the escrow arrangement.
- If the transaction must be unwound as a result of failing to fulfill one of the escrow conditions, it is wise to have the escrow agreement contain an acknowledgement that a relationship of landlord and tenant will not have been created.

The insurance company for each of the vendor and the purchaser should be made aware of the escrow situation, and its concurrence in continuing to extend insurance coverage should be obtained.

If it appears that a transaction is not going to be fully completed, you must obtain your client's instructions regarding whether to simply extend the time for closing or to close the transaction in escrow. If it is determined to simply extend the time for closing, you should confirm with the other party in writing, at least the following:

- the new date for closing;
- that all other terms of the agreement of purchase and sale are to remain the same (unless otherwise noted);
- that adjustments shall be as of the old date of closing (or whatever date is agreed upon); and
- that time shall remain of the essence.

If the lawyer fails to extend a transaction properly, it can raise a question as to whether the date of closing has been extended and whether time has continued to be of the essence.

10. Post-closing

Immediately after closing, call the clients and advise them that the deal has closed and, if acting for the purchaser, deliver the keys. As the vendor's solicitor, immediately disburse the closing funds.

The purchaser's solicitor should forward payment to the title insurance company for a title insurance policy (if title insurance was obtained) and write to the tax department and utilities department to advise them of the change of ownership so that future bills will be sent to the purchaser.

The solicitor should then follow up the telephone call with a brief letter to the client confirming the closing of the transaction and advising of any details that the client needs to know about right away, for example, upcoming mortgage, tax, or utility payments. This letter can further provide that a full report will follow in due course.

It is very important for the solicitor to diarize the file in order to ensure completion of the following:

- receipt of confirmation of registration of all discharges, together with a copy of the registered discharge for his or her file;
- compliance with all undertakings; and
- reporting to the client and sending out the statement of account.

If the lawyer has obtained moneys for his or her fees and disbursements, in trust, these fees and disbursements cannot be transferred to the general account until a report regarding the transaction is delivered to your client.

Do the report on the transaction as soon as possible. The reporting letter will serve several important functions. First, if acting for the purchaser, it is your legal opinion to your client on the transaction. Second, it should be a good record of what took place:

- what your client's instructions were;
- what you did in response to the instructions; and
- other material matters with respect to the property.

It will form an excellent defensive tool, as well as a good starting point if the client decides to sell the property.

When you are reporting to a purchaser, your report will include the following:

- The opinion on title: The opinion will usually say "that the purchasers have a good and marketable title in fee simple, subject to the following exceptions." Then recite all of the exceptions. Any qualifications to good title should be items that have been discussed with the client before closing and on which the client's instructions have been obtained. Any waivers by the client should be detailed—for example, instructions on not obtaining an up-to-date survey of the property, waiver of a condition, and any other material instructions.
- Details regarding the statement of adjustments and how funds were dealt with on closing.
- Full particulars of any mortgages: Be sure to let the purchaser know when mortgage instalments are payable and the manner of making such payments. It is wise to put this in a preliminary report so that if the report is delayed at all, the purchaser still has this information in a timely fashion.
- Responses to search letters, including the status of zoning and building searches, tax account and utility status, and all other non-title searches.
- Factual information such as the date of closing, how title was taken, and a short description of the various closing documentation.
- Insurance arrangements.
- Any unusual aspects of the transaction should also be set out.

The report on a sale tends to be somewhat shorter. This letter is largely focused on the statement of adjustments and the disbursement of funds. If mortgages have been discharged, the details of the discharges should be set out. If there has been a mortgage back, the details of the mortgage back should be fully set out, as well as any waivers obtained from the client and instructions on any unusual matters. Helpful factual information, such as the date of closing and confirmation of payment of realty taxes and other payments, is useful. A short description of the closing documentation should also be included.

Keep a copy of the reporting letter with all documents together, either in a bound form or in one subfolder. This will avoid sifting through the file at a later date and will save a great deal of time and frustration if the file has to be recalled for any reason.

Appendix A

Family Law Act Statements
Ontario Ministry of Consumer and Commercial Relations[1]

Property Rights Division

Legal and Survey Standards Branch

BULLETIN NO. 86001

The *Family Law Act, 1986*

DATE: February 10, 1986

TO: ALL LAND REGISTRARS

NEW PROCEDURES

The *Family Law Act, 1986*, which replaces the *Family Law Reform Act*, comes into force March 1, 1986. The following changes in procedures should be noted by Land Registrars -

1. Part II of the *Family Law Act, 1986*, which concerns itself with the "MATRIMONIAL HOME" provisions, has been amended somewhat so that the statements of compliance regarding spousal status as noted on the back of the forms prescribed under the *Land Registration Reform Act, 1984* will no longer be applicable. A disposition or encumbrance pursuant to the *Family Law Act, 1986* will require one of the following statements.

    1. We are spouses of one another.
    2. The person consenting below is my spouse.
    3. I am/I am not a spouse.
    4. The property transferred (charged, etc.) is not ordinarily occupied by me and my spouse, who is not separated from me, as our family residence.
    5. I am separated from my spouse and the property transferred (charged, etc.) was not ordinarily occupied by us at the time of our separation as our family residence.
    6. The property is not designated under s. 20 of the *Family Law Act, 1986* as a matrimonial home by me and my spouse, but there is such a designation of another property as our matrimonial home which has been registered and which has not been cancelled.
    7. My spouse has released all rights under Part II of the *Family Law Act, 1986* by a separation agreement.
    8. This transaction is authorized by court order under s. 23 of the *Family Law Act, 1986* registered as Instrument No._____ which has not been stayed.
    9. The property transferred (charged, etc.) is released from the application of Part II of the *Family Law Act, 1986* by court order registered as Instrument No._____ which has not been stayed.

    An instrument requiring a statement regarding spousal status presented for registration on or after March 1, 1986, must have one of the following -

    (a) one of the above new statements as per the *Family Law Act, 1986*; or

    (b) an old statement as per the *Family Law Reform Act* provided -

        (i) the instrument is submitted for registration prior to May 1, 1986; or

        (ii) the instrument is executed before March 1, 1986 and a statement accompanies the instrument indicating that it was irrevocably and unconditionally delivered before March 1, 1986.

    An instrument presented for registration before March 1, 1986 must use a statement in accordance with the *Family Law Reform Act*, as set out on the back of the existing forms prescribed under the *Land Registration Reform Act, 1984*.

2. Section 20 of the *Family Law Act, 1986*, in addition to the joint designation of a matrimonial home by both spouses, now authorizes one spouse to designate property as a matrimonial home. A single designation does not, as in the joint designation, release other properties from being the matrimonial home. The single designation only gives notice of a potential spousal interest. In the land titles system, land registrars may accept registrations notwithstanding that a statement in an instrument may conflict with the statement in the single designation. The single designation, however, will continue to be shown on the parcel register until it is removed by the spouse who registered it.

3. Subsection 21(4) of the *Family Law Act, 1986* provides that a statement made in accordance with s. 21(3) by an attorney on the basis of the attorney's personal knowledge is sufficient proof that the property is not the matrimonial home.

    The statement by the attorney must still be unequivocal (not based on knowledge and belief), but the attorney need not indicate that he/she is making the statement in his/her personal capacity as presently required in Bulletin 85001. The land titles system will continue to guarantee unequivocal statements made by any person having knowledge of the facts. It should be noted that statements based upon knowledge and belief are still allowed in restricted circumstances. In

1 Bulletin 86001 continues to apply, except with respect to the last sentence in paragraph 2 on single designations, which was revoked and replaced by Bulletin 90003, Cautions Designation of Matrimonial Home, December 14, 1990, by the Ministry of Consumer and Commercial Relations, Registration Division, Real Property Registration Branch.

this regard, see page 5201 of the Land Titles Procedural Guide and Bulletin 85007.

4. Subsection 26(1) of the *Family Law Act, 1986* provides as follows -

"If a spouse dies owning an interest in a matrimonial home as a joint tenant with a third person and not with the other spouse, the joint tenancy shall be deemed to have been severed immediately before the time of death."

As a result of the above noted subsection, the affidavit in support of a survivorship application in the land titles system must have one of the following additional statements by the surviving joint tenant or one of the surviving joint tenants, provided the death occurred on or after March 1, 1986 -

(a) (Deceased) and (one of surviving joint tenants) were spouses of each other when (deceased) died;

(b) (Deceased) was not a spouse at the time (deceased) died;

(c) The property was not a matrimonial home within the meaning of Part II of the *Family Law Act, 1986* of (deceased) at the time when (deceased) died.

Bulletin 85001 is superseded.

Appendix B

The Adviser: Supplement

The Law Society of Upper Canada/ Barreau du Haut-Canada[2]

September 1992

Undertakings to Discharge Mortgages

As part of the Law Society's ongoing review of current issues aimed at risk management and loss prevention in the professional practice of law, the Practice Advisory Service [now the Practice Management Helpline] has reviewed the February 1981 recommendations respecting the procedure for dealing with the discharge of an existing mortgage at the time of closing a real estate transaction.

The 1981 recommendations stated that when a mortgage to be discharged by the vendor is held by a private lender (being a person or corporation not regarded as one of the regular institutional mortgage lenders), the discharge should be made available for delivery and registration at the time of closing. However, when the mortgage is held by a regular recognized mortgage lending institution, either the vendor's solicitor or the purchaser's solicitor might accept the other solicitor's undertaking to obtain and register the discharge of mortgage after closing, providing funds required to pay off the mortgage can be paid by certified cheque drawn by the purchaser (or the purchaser's solicitor) out of the balance of the purchase price payable on closing, and certain other safeguards are followed.

These revised guidelines contain new recommendations respecting the discharge of mortgages held as collateral security for revolving credit, as well as additional commentary on the mortgage discharge provisions in sale agreements. The Professional Standards Committee of Convocation has also approved a new definition of the term institutional mortgage as used in the guidelines.

Discharge of Mortgage after Closing

Most institutional lenders are still unable or unwilling to make the mortgage discharge available at the time of the closing of a real estate sale. It therefore requires co-operation between the solicitors involved in order to complete the transaction. The common practice is for the vendors statement of adjustments to divide the balance on closing to show the amount payable to the lending institution to discharge the mortgage (in accordance with the written mortgage statement delivered to the purchaser's solicitor) and the balance to be paid to the vendor, or to the vendor's solicitor, all in accordance with a written direction signed by the vendor. The purchaser's solicitor issues and certifies cheques in accordance with this arrangement and delivers them to the vendor's solicitor on closing in return for the vendor's solicitor's undertaking to deliver the mortgage pay-out cheque forthwith to the mortgagee and to obtain and register the required discharge of mortgage without delay.

This procedure continues to be appropriate only in the case of a discharge of a mortgage held by one of the conventional mortgage lending institutions. If the vendor has contracted to deliver clear title on closing, the purchaser's solicitor should insist that the required discharge of a mortgage held by a private mortgagee be produced and registered on or before closing. As a general rule, an undertaking to obtain and register the discharge of a private mortgage at a later date should not be given or accepted.

Contractual Obligations

Many printed forms of Agreement of Purchase and Sale now specifically provide for the giving and receiving at the time of closing of the vendor's solicitor's undertaking to obtain and register a discharge of an existing registered mortgage. Usually this clause is restricted to the discharge of institutional mortgages.

The Practice Advisory Service has become aware of a number of situations in which the Agreement of Purchase and Sale stipulates that the purchaser will accept an undertaking to obtain and register the discharge of a private mortgage after closing. In some cases the agreement stipulates that the purchaser will accept the vendor's undertaking rather than the undertaking of the vendor's solicitor. Lawyers representing vendors should recognize that they may not be acting in the best interests of their clients by inserting such clauses in Agreements of Purchase and Sale. They may, in fact, create a situation in which the purchaser is unable to obtain new mortgage funds required to complete the transaction because the purchaser's lawyer, or the lawyer acting for the proposed new mortgagee, cannot give the unqualified certificate of

2 The Law Society's 1992 practice guideline regarding Undertakings to Discharge Mortgages contained in The Adviser Supplement continues to apply to mortgage transactions other than transactions where the electronic real time cleared funds transfer capability is utilized. Refer to Practice Guideline 5 of the Law Society's *Practice Guidelines for Electronic Registration of Title Documents* for guidance on the electronic discharge of mortgages.

title required to permit mortgage funds to be made available.

If the purchaser's solicitor has the opportunity of reviewing the proposed agreement before the client signs, any such inappropriate provision respecting an undertaking to be given on closing should be corrected or deleted. If the provision respecting an undertaking for the discharge of a mortgage is an enforceable term of a contract already entered into by a client, the lawyer who agrees to act for that client may have no alternative but to complete the transaction in accordance with that term.

As with all other terms of a contract, this provision should be reviewed and explained to the client, and if there appears to be any unusual risk to the purchaser in accepting the stipulated undertaking, the purchaser's lawyer should attempt to protect the purchaser's position by all reasonable means. This may include, upon the client's instructions, attempting to negotiate more suitable terms for the discharge of the mortgage while preserving the client's existing rights under the Agreement of Purchase and Sale.

Revolving Credit Mortgages

Special problems arise when the property being sold is subject to a collateral mortgage to secure a revolving line of credit such as those offered by some banks and trust companies which allow preferred customers to draw against that secured credit by credit card or special cheque. The lawyer acting for the owner of the property at the time of sale or refinancing needs to know exactly the amount required to discharge the collateral mortgage as at the transaction date.

However, the mortgagee says it will only confirm, sometimes by telephone on the transaction date, the balance outstanding according to its records as of that date. The mortgagee does not want to discharge the mortgage until a later date, which may be as much as 90 days after the transaction date. If further drawings against the line of credit show up on the customer's account during that period, the mortgagee wants to withhold the discharge of mortgage until those additional charges have been paid off. The lawyer handling the transaction could not therefore obtain an unqualified statement from the lending institution confirming the exact amount required to obtain a discharge of mortgage. This would put the lawyer in an impossible position. In order to complete the sale of the mortgaged property, the lawyer may be required to give a personal undertaking to obtain and register a discharge. In the case of refinancing, funds under the new mortgage loan will probably be required to pay off the outstanding line of credit, but the lawyer must give an unqualified certificate of title to the new mortgagee in order to be able to advance the funds. If an additional amount were to be demanded by the original mortgagee before the discharge of the collateral mortgage could be obtained, and if the client should be reluctant or unable to pay that additional amount, it would become necessary for the lawyer to make the payment out of his or her own personal funds to obtain the discharge of mortgage required to honour the lawyer's undertaking to the purchaser or the certificate of title to the new mortgagee. Lawyers should not accept this risk.

RECOMMENDED PROCEDURES

The Practice Advisory Service makes the following recommendations:

A. Institutional Mortgages — Full Discharge

For the purpose of these recommendations, the term institutional mortgage refers to a mortgage held by a bank, trust company, insurance company, credit union or finance company. The term private mortgage refers to mortgages held by other corporations or individuals.

1. **Mortgage Discharge Statements:** The purchaser's solicitor should write directly to the mortgagee and require that a discharge statement be addressed to him or her. It should be made clear that
   i) the purchaser's solicitor will be relying upon the accuracy of the statement and will be issuing a cheque payable to the mortgagee, to be deducted from the closing funds at the time of completion of the purchase, for the purpose of completely discharging the mortgage;
   ii) the purchaser's solicitor will not be bound by any qualification of the statement whether by use of the abbreviation E. & O. E. or otherwise. The purchaser's solicitor should do everything possible to establish an estoppel against the mortgagee claiming additional funds on the basis of an error in the mortgage statement.
2. **Closing Funds:** On the statement of adjustments, the balance due on closing should be divided to show the amount payable to the mortgagee in accordance with the mortgage pay-out statement and the balance of the funds payable to the vendor or to the vendor's solicitor in trust. A written direction signed by the vendor is required for payment of funds to anyone other than the vendor.
3. **Closing Procedure:** On closing, the purchaser's solicitor delivers to the vendor's solicitor a certified cheque payable to the mortgagee in accordance with the vendor's written direction, together with a covering letter addressed to the mortgagee stipulating that the funds are to be applied to payment of the mortgage debt. The purchaser's

solicitor will require the personal undertaking of the vendor's solicitor

i) To deliver the cheque and letter to the mortgagee forthwith;

ii) To be responsible for any additional moneys payable for the discharge of the mortgage as a result of any delay in delivery of the discharge of funds; and

iii) To make every reasonable effort to obtain and register a proper form of discharge of the mortgage as soon as possible after closing.

The purchaser's solicitor will also require the vendor's personal undertaking that the vendor will be responsible for any additional amounts payable to the mortgagee by reason of any error, omission, or other change in the mortgage statement.

B. Blanket Mortgages — Development Lands and Condominiums — Partial Discharges

It is still the practice of some land developers and condominium developers to include in their standard printed form of Agreement of Purchase and Sale a provision requiring the purchaser of a lot or unit to accept the vendor's undertaking to register a partial discharge of a blanket mortgage after closing of the transaction. Such provision should be deleted from the purchase agreement if the purchaser's solicitor has an opportunity of examining the agreement before it is executed.

If the purchaser does not wish to delete this provision (e.g., for fear of losing the transaction), such instructions should be reduced to writing immediately and acknowledged by the clients signature. Consideration might be given to the right of rescission given to a purchaser under s. 52 of the *Condominium Act* [s. 72 of the current *Condominium Act, 1998*].

When acting in a transaction pursuant to an Agreement that contains such a provision, the following procedures should be carefully considered:

i) Insist on a partial discharge before closing.

ii) Pay the funds to the vendor's solicitor in return for a personal undertaking to obtain and register a partial discharge.

iii) Make the cheque payable to the developer and mortgagee jointly or to the mortgagee and obtain a partial discharge.

iv) At the very least, find out the amount required to obtain a partial discharge and try to obtain one directly from the mortgagee.

v) Refuse to close and tender, though this might be unrealistic for practical reasons.

It is recommended that a combination of items i) and iv) might be the best course. In the letter of requisitions the vendor's solicitor should be advised that, notwithstanding the provision in the agreement, a partial discharge will be required to be available for registration at the time of completion of the transaction. The purchaser's solicitor might advise that, as an alternative, he or she will accept a statement addressed to him or her from the mortgagee to confirm the amount required for the partial discharge and that a partial discharge in registrable form will be delivered immediately upon receipt of the funds. The purchaser's solicitor should then follow the procedures outlined above in relation to full mortgage discharges on closing.

Reference should also be made to subsections 7(9)–(10) of the *Condominium Act* [ss. 14(1)–(2) of the current *Condominium Act, 1998*] which give a right to discharge any unit from an encumbrance by payment to the claimant of a portion of the sum claimed, determined by the proportion specified in the Declaration for sharing the common interests.

C. Discharges of Revolving Credit Mortgages

1. At the time a collateral mortgage is given to secure revolving credit, the borrower client should be informed that special arrangements to discharge the mortgage may have to be made if the property is to be sold or refinanced. The client should be advised not to enter into an agreement to sell the property until appropriate arrangements can be made to discharge the mortgage.

2. Before a solicitor agrees to act on the sale of property which is subject to an institutional mortgage securing revolving credit, it must be explained to the client that the solicitor may be required to give his or her personal undertaking to obtain and register a discharge of the mortgage and a solicitor cannot give such an undertaking without first receiving from the mortgagee a written statement showing the exact amount required to pay off the mortgage on the transaction date. The client should therefore get in touch with the lending institution immediately to make whatever arrangements may be required to permit the necessary mortgage pay-out statement to be obtained by the solicitor. This will probably require the immediate surrender to the lending institution of all credit cards and special cheques relating to the line of credit.

3. In the letter to the mortgagee requesting a statement showing the amount required to discharge the collateral mortgage as of the transaction date, the solicitor should emphasize that a written mortgage statement is required and that the lawyer will have to rely on that statement as showing the exact and only amount required to

obtain a discharge of the mortgage because additional funds may not be available after the transaction date. Any attempt by the mortgagee to qualify the written statement, whether by use of the abbreviation E. & O.E. or otherwise, will be unacceptable.

4. If there is any reluctance on the part of the mortgagee to give the required unqualified mortgage statement, it could be suggested that any drawings against the line of credit which do not show on the client's account at the time the statement is prepared might be included in the unsecured line of credit for that client and should not therefore prevent the issue of the required discharge of mortgage.

5. Failing that, it may be necessary for the client to authorize the solicitor to pay the full balance of the proceeds of the sale (after payment of prior encumbrances and deduction of real estate commission, legal fees, and expenses) to the mortgagee to be held and applied for the credit of the client in return for an agreement by the mortgagee to provide a discharge of the collateral mortgage. This would, of course, mean that no proceeds from the sale would be available to that client on the transaction date for the purchase of other property or for any other purpose.

6. As an alternative, the client and the solicitor may be able to negotiate an agreement with the mortgagee that if the proceeds of the sale are immediately applied to the purchase of other property, the existing collateral mortgage held by the mortgagee will be replaced at the time of closing by a new mortgage on the property purchased and that upon receipt of the new mortgage the mortgagee will issue a discharge of the original mortgage on the property which has been sold.

7. The solicitor acting on the sale of property which is subject to an institutional mortgage securing a revolving line of credit should not give an undertaking to discharge that mortgage unless he or she has received the clients written direction to pay out of the proceeds of the sale the exact amount required to discharge the mortgage as shown by an unqualified mortgage statement obtained by the solicitor from the mortgagee, or arrangements have been made, confirmed in writing, and approved by the client that the mortgagee will provide a discharge of the mortgage on receipt of all of the net proceeds of the sale or a replacement mortgage on other property.

D. Discharges of Private Mortgages

As previously mentioned, it is usually inappropriate to give or accept an undertaking to obtain and register a discharge of a private mortgage after closing. Subject to any provision in the Agreement of Purchase and Sale which may affect the purchaser's right to demand clear title on closing, the purchaser's solicitor should require the production and registration of a discharge of a private mortgage on or before closing.

Chapter 55

Special concerns for residential rental properties

1. Introduction

All rental residential property in Ontario is currently subject to the *Residential Tenancies Act, 2006* (*RTA*), which regulates the price at which residential rental accommodation is available in Ontario, as well as all other aspects of the residential landlord and tenant relationship. The *RTA* was proclaimed in force January 31, 2007, replacing the following statutes (among others): *Rent Control Act, 1992*; *Rental Housing Protection Act*; Part IV of the *Landlord and Tenant Act*; and the *Tenant Protection Act, 1997*.

The *RTA* applies with respect to rental units in residential complexes, despite any other Act and despite any agreement or waiver to the contrary (s. 3(1)). The only provincial statute that takes priority in a conflict is the *Human Rights Code* (*RTA*, s. 3(4)).

The *RTA* has the stated purposes of protecting residential tenants from unlawful rent increases and evictions, regulating residential rents, balancing the rights and responsibilities of residential landlords and tenants, adjudicating disputes, and informally resolving disputes.

Substantive changes in the *RTA* include

- an exemption for residential complexes forfeited to the Crown under federal or provincial legislation relating to unlawful activities;
- provisions permitting landlords to obtain expedited evictions of tenants where they or their invitees wilfully cause undue damage or use the rental unit in a manner that is inconsistent with use as residential premises or cause a disturbance in a small rental building where the landlord also resides;
- a change in the calculation of the annual rent increase guideline and in interest payable on rent deposits; and
- special provisions allowing landlords to obtain vacant possession of a rental unit for the purpose of occupation by a caregiver to the landlord or member of the landlord's family.

2. Main features of rent control

2.1 Vacancy decontrol

Rents are regulated in Ontario for many residential rental properties (s. 110). Each time a unit is rented to a new tenant under the *RTA*, a new lawful rent may be set (s. 113). The landlord and the tenant may negotiate to determine an amount of rent, and that amount sets the starting lawful rent for the time the tenant lives in the unit. There may be cases where an Order Prohibiting a Rent Increase (OPRI) is in effect, in which case a landlord may only collect the previous lawful rent from a new tenant until such time as the OPRI ceases to apply.

After the initial setting of the new rent, future rent increases are subject to the guideline, and requirements for annual increase notices apply. Under vacancy decontrol, rent control effectively applies to the tenant or the tenancy, not the unit itself.

The ability to set a new lawful rent upon a unit "turning over" is intended to mitigate the overall rigidity of rent control in Ontario. In theory, it would allow rents to rise (or fall) with market demands. However, for landlords with long-term tenants or large complexes where turnover is, in general, "bad for business," rent control continues to be a significant factor for the rental residential business and for conveyancing lawyers.

Rents cannot be arbitrarily increased on a change in ownership or when capital expenditures are incurred. The legal rent runs with the building, at least until individual units become vacant. Subject to the express statutory exemptions, a rent increase order or tenant agreement is required to increase rents above the annual guideline.

There are extensive provisions in the *RTA* addressing

- assignments, to ensure a balanced process for a tenant wanting to assign his or her unit, since an "assignment" prevents the landlord from being able to set a new rent for a new occupant (ss. 95–96); and
- harassment, to discourage landlords from using inappropriate strategies to obtain possession of units to re-rent at new, lawful rents (ss. 23 and 29–30).

2.2 Abolition of maximum rent

Where a tenancy commenced on or after June 17, 1998, being the date of proclamation of the *Tenant Protection Act, 1997* ("Proclamation Date"), the lawful rent was usually determined by the first rent charged to the new tenant plus lawful increases actually taken. For example, if landlords chose not to take an increase in one year,

they would not be able to take a bigger than guideline "catch-up" increase in a later year.

Prior to May 3, 2006, sitting tenants as of the Proclamation Date were also subject to possible rent increases up to the maximum rent that was formerly allowed by the *Rent Control Act, 1992*. As of May 3, 2006, however, maximum rent was abolished, and starting on January 31, 2008, the new Landlord and Tenant Board (LTB) ceased to provide Rent Registry information to members of the public (*RTA*, s. 245(2)).

2.3 Annual increases/decreases

Although, subject to OPRI's, landlords are entitled to set lawful rents for new tenancies under the *RTA* without regard to past rents, the new rents negotiated then become subject to the normal rent control regime as set out in the *RTA*.

The Ministry of Municipal Affairs and Housing sets the guideline for the annual maximum percentage increase permitted for residential rents, subject to some exceptions. It is inflation-driven, based on the CPI for Ontario. The guideline is fixed every August for the next calendar year.

Rent can be increased only once every 12 months on at least 90 days' written notice properly served according to ss. 116 and 119 of the *RTA* on the proper form.

For "care homes" (such as retirement homes), only the rent portion of the fees charged is subject to the guideline restriction on increases; increases on fees for meals and care services are unrestricted (s. 1(1), "rent"). However, a prescribed notice must be given before any type of increase (s. 150).

There are two ways that the rent can increase on the anniversary date by more than the guideline:

- The landlord has brought an application for an above-guideline increase (s. 126).
- The landlord and tenant have entered an above-guideline agreement in the required form, pursuant to which the landlord will undertake a specific capital expenditure or provide a new or additional service and the tenant agrees to a rent increase of up to 3% above the guideline (s.121).

Such agreements have a "cooling off" period and are subject to relief if the landlord does not undertake the necessary work or provide the services under the agreement (ss. 121(5)–122).

Rent can also increase during the tenancy year (i.e., not on the anniversary date) if the landlord and tenant agree that the landlord will provide a service as defined in the *RTA* or the regulations (such as a parking space) (s. 123). No rent increase notice is required, and there is no percentage cap on the amount of the increase, but it must be related to the cost of the service, as prescribed.

The only reason for an automatic rent decrease is a realty tax reduction. The lawful rent is automatically reduced the following January 1st if municipal realty taxes decline by more than 2.49% in a calendar year (*RTA*, s. 131; O. Reg. 516/06, made under the *RTA*, s. 41).

2.4 Above-guideline applications

All applications for a rent increase must be approved by the LTB.

The grounds for above-guideline rent increases are

- extraordinary operating costs (EOC) of municipal taxes and charges, heat, water, or hydro;
- capital expenditures; and
- operating costs for building security services provided by persons not employed by the landlord (s. 126).

EOC, capital expenditure, and building security increases can be capped at 3% above the guideline for up to a maximum of three years (s. 126(11)). The rules relating to calculation of above-guideline rent increases are extremely complex under the *RTA* regulations (O. Reg. 516/06, ss. 18–34).

Where a landlord has been awarded an increase on account of utility costs (such as gas, water, or hydro), there is now an ability for tenants to seek a rent reduction in future years if costs decline. There is a corresponding obligation on landlords to supply tenants with utility cost information annually for a period of five years after an above-guideline rent increase has been ordered based on increased utility costs (*RTA*, s. 128(2); O. Reg. 516/06, ss. 35–37).

A capital expenditure will only be allowed in an above-guideline application if it is "eligible." A capital expenditure is eligible if it meets the following criteria (s. 126(7)):

- is necessary to protect or restore the physical integrity of all or part of the building;
- is necessary to achieve maintenance, health, safety, or other housing-related standards required by law;
- necessary to maintain plumbing, heating, mechanical, electrical, ventilation, or air-conditioning systems;
- increases access for the disabled;
- promotes energy or water conservation; or
- maintains or improves security.

However, capital expenditures based on replacement of a system or thing are not eligible if the LTB determines

that the system or thing did not require repair or replacement unless the expense promotes (s. 126(8))

- access for persons with disabilities;
- energy or water conservation; or
- security of all or part of the residential complex.

An above-guideline order does not apply to any tenant who moves in later than 90 days before the first effective date under the order (s. 126(14)). In other words, tenants who were not living in the complex when an above-guideline application was filed cannot be affected by it.

If the landlord does not comply with detailed filing requirements or if the landlord is in breach of certain statutory obligations to maintain and repair, the LTB may dismiss the landlord's above-guideline application or may postpone any justified rent increase (s. 126).

3. Occupancy and security of tenure

3.1 Setting up a new tenancy

In selecting prospective tenants, landlords must comply with *Business Practices Permissible to Landlords in Selecting Prospective Tenants for Residential Accommodation*, O. Reg. 290/98, made under the *Human Rights Code* (s. 48(1)(a.1)).

There is generally no requirement to have a written tenancy agreement or lease in Ontario, although it is highly recommended. Where there is no written lease, the landlord must still give the tenant written notice of its legal name and address for service within 21 days of the commencement of the tenancy (s. 12(3)). If there is a written lease, that information must be included in it, and a copy of the lease (signed by the landlord and the tenant) must be provided to the tenant within 21 days of the tenant signing and giving it to the landlord (s. 12(2)). Failure to meet these informational requirements will suspend the tenant's obligation to pay rent until they are fulfilled (ss. 12(4)–(5)).

A tenancy agreement can be for a fixed term of one or more years, days, weeks, or months, and upon expiry, it is deemed to have been renewed as a monthly tenancy agreement on the same terms and subject to any increases in rent charged in accordance with the *RTA* (s. 38(1)).

A tenancy agreement prohibiting pets and any provision in the agreement that is inconsistent with the *RTA* or the regulations thereunder is void (ss. 14 and 4).

The amount of money that can be taken from the tenant upon establishing a tenancy is strictly regulated. Basically, the landlord is limited to requiring a rent deposit equal to one month's rent (ss. 105–106), and variable interest equivalent to the annual guideline must be paid on the deposit annually (s. 106(6)).

Any other type of payment from tenant to landlord (or an agent or employee of the landlord) can be attacked as "key money," which is illegal. A landlord is prohibited from collecting or attempting to collect "a fee, premium, commission, bonus, penalty, key deposit or other like amount of money whether or not the money is refundable" (s. 134(1)(a)). Nor can a landlord require a tenant to pay for other goods or services as a condition for granting the tenancy (s. 134(1)(b)). Rent acceleration clauses are also void (s. 15).

Notwithstanding the foregoing, *General*, O. Reg. 516/06, made under the *RTA*, does exempt a number of reasonable payments, including

- payment for additional keys, remote entry devices, or cards requested by the tenant, not greater than the direct costs;
- payment for replacement keys, remote entry devices, or cards, not greater than the direct replacement costs, unless the replacement keys, remote entry devices, or cards are required because the landlord, on the landlord's initiative, changed the locks;
- payment of a refundable key, remote entry device, or card deposit, not greater than the expected direct replacement costs;
- payment of NSF charges charged by a financial institution to the landlord;
- payment of an administration charge, not greater than $20, for an NSF cheque; and
- payment by a tenant or subtenant in settlement of a court action or potential court action or an application or potential application to the LTB.

Since a residential tenancy may only be terminated in accordance with the *RTA* (s. 37(1)), there is no need for a tenant to register notice of its leasehold interest on title.

3.2 Access to rental unit

Once a tenant has commenced occupancy, landlords have only limited rights to enter the rental unit without written notice, such as in an emergency or where the tenant consents at the time of entry (s. 26). Even where written notice is given 24 hours before the time of entry, specifying the reason, day, and time of entry (which must be between 8 a.m. and 8 p.m.), the landlord must have an approved reason for entry (s. 27).

The landlord cannot alter the locks on the rental unit or the complex unless the tenant is given replacement keys (s. 24). Similarly, a tenant must have the landlord's consent to change the locks (s. 35).

3.3 State of the property

The landlord is responsible for the physical state of the property and for the various services and facilities that the landlord provides to the tenants. Specifically, the landlord must maintain the property in a "good state of repair and fit for habitation," and comply with health, safety, housing, and maintenance standards (s. 20(1)). This applies even if the tenant was aware of any non-repair before entering the tenancy agreement. Tenants have many remedies if the landlord does not meet these obligations.

The tenant, on the other hand, is generally responsible for ordinary cleanliness and for repair of damage caused by wilful or negligent conduct (ss. 33–34). The tenant is entitled to freedom from substantial interference with his or her reasonable enjoyment of the rental unit and residential complex (s. 22).

One of the most contentious areas in landlord-tenant relations under the *RTA* has been the entitlement of tenants to rent abatements for loss of enjoyment while repairs are in progress. Landlords argue that they are required by the *RTA* to maintain their buildings and that the inconvenience suffered by tenants during temporary changes to parking arrangements or loss of access to balconies is no different from the temporary inconveniences suffered by homeowners during renovations. Homeowners do not receive abatements in realty taxes or mortgage payments or other compensation in such circumstances. Given that the *RTA* was designed to allow landlords to recoup the cost of prescribed repairs through above-guideline applications, this intent is defeated at least in part when future increases are offset against renovation-period abatements. The regulations to the *RTA* have substantially increased the ability of tenants to obtain abatements based on interference with their use of their rented premises caused by renovation work carried out by the landlord. Landlords contemplating major repair work should carefully review s. 8 of O. Reg. 516/06 and, in particular, the criteria in s. 8(4) in order to minimize exposure to substantial abatement liability.

3.4 Remedies for non-payment of rent

Unlike commercial landlords, a residential landlord is relatively limited in its remedies when a tenant fails to pay rent. For example, the landlord cannot, without legal process, seize the tenant's goods (s. 40).

The usual course of action, pursuant to s. 59, is to bring the matter before the LTB, seeking termination of the tenancy and eviction of the tenant, as well as a judgment for rent arrears (ss. 74 and 87). However, the landlord could choose only to pursue the arrears and not seek termination, if it so desired.

Assuming the landlord wishes to terminate the tenancy as well as obtain a judgment for arrears, the landlord must serve the tenant with a notice to terminate a tenancy early for non-payment of rent. The usual notice period is 14 days (s. 59(1)), after which the landlord must file an application with the LTB. The landlord may not make an application until the day following the termination date specified in the notice (s. 74(1)).

A tenancy may also be terminated at the end of the term for persistent failure to pay rent on the date it becomes due (s. 58(1)).

3.5 Landlord's rights to obtain possession of the rental unit

There are limited grounds in the *RTA* the landlord can use to obtain possession of the unit from the tenant. The tenant does not have to vacate the premises simply because a fixed-term lease expires. The tenancy automatically converts to a month-to-month tenancy, subject to any rights the landlord may have to terminate it (s. 38(1)).

There are "fault" grounds for terminating a tenancy (such as under s. 62(1), where the tenant has damaged the building) and "non-fault" grounds (such as under ss. 48–49, where the landlord or a purchaser wants possession for personal occupancy or for occupancy by a person who will provide "care services" to the landlord or purchaser). The need for renovations is another non-fault ground (s. 50(1)(c)).

In every case, there are many specific qualifications to be met before the landlord can rely on the selected grounds for termination, including lengthy notice periods in some cases (such as 120 days' notice for demolition or repairs (s. 50)). The most expedited termination notice period (10 days) applies to drug-related illegal acts (ss. 61 and 63). Furthermore, it is not uncommon for the tenant to have rights to atone for his or her conduct (such as by paying the rent arrears or repairing the damage) and thus halt the termination proceedings.

Where a vendor is giving notice of termination on behalf of a purchaser under an agreement of purchase and sale, the property must have three or fewer units (s. 49(1)). This restriction does not, however, apply to units for sale in a condominium (s. 49(2)). A landlord may only seek possession for personal occupancy at the end of the term of the tenancy, and 60 days' notice must be given (s. 49(3)).

Unless the tenant leaves voluntarily in response to a notice of termination, the landlord must file an

application with the LTB in order to regain possession. Unless the *RTA* specifies to the contrary, the application may be commenced immediately upon service of the notice (s. 71). At the latest, this application usually must be commenced within 30 days of the termination date specified in the notice (s. 69(2)).

An order evicting a tenant expires six months after the date on which it takes effect if it is not yet filed with the sheriff (s. 81).

Agreements terminating a tenancy are void if they were signed at the time that the tenancy is created (s. 37(5)). If the tenant fails to honour an enforceable agreement to terminate, the landlord must bring an application to regain possession of the unit (s. 77(1)(a)).

There are specific rules governing termination of a tenancy where a tenant dies (ss. 91–92).

3.6 Special categories of properties

There are special rules in Part IX of the *RTA* governing care homes and in Part X for mobile home parks and land lease communities.

Care homes in particular have rigorous disclosure requirements vis-à-vis new and existing residents (ss. 139–141). Under s. 142, operators of care homes have special access rights to check on the condition of the tenant, if required to do so by the tenancy agreement, and may apply to the LTB for an order transferring the tenant where the tenant no longer requires the level of care provided by the landlord or requires a higher level of care than the landlord is able to provide (s. 148).

Many of the special provisions regarding mobile home parks and land lease communities relate to the fact that in those settings, the tenant will often own the actual housing, the landlord providing only the land and the service infrastructure. There are certain personal property issues to be mindful of when dealing with mobile homes under the *RTA*. If a lease in a mobile home park is terminated by way of a notice of termination from either the landlord or the tenant, an agreement between the landlord and tenant, or an order of the LTB terminating the tenancy or evicting the tenant and the tenant leaves behind his or her mobile home, then a landlord may sell, retain for the landlord's own use, or dispose of the mobile home (ss. 162(1) and (3)). In order to do so, the landlord must wait 60 days after both sending the tenant a notice by registered mail to the tenant's last known mailing address and having the notice published in a newspaper with general circulation in the locality where the mobile home park is located (s. 162(2)). If the tenant contacts the landlord within 6 months from the date the landlord mailed and published the above-mentioned notice, then the landlord must return the mobile home to the tenant or, in the event of a sale, pay the tenant the proceeds from the sale of the mobile home. However, before the landlord returns the mobile home or proceeds from the sale to the tenant, the landlord may require the tenant to pay arrears of rent, and the landlord may deduct reasonable out-of-pocket expenses it has incurred with respect to the mobile home (ss. 162(4)–(6)).

3.6.1 Life leases

Life leases are a relatively new form of housing tenure in Ontario that cater primarily to the elderly. In a life-lease arrangement, individuals purchase the right to occupy a dwelling unit by making an up-front, lump-sum payment and monthly maintenance fees to the life-lease sponsor (typically an entity that may be a profit or not-for-profit organization). Life leases are terminated upon the death of the resident (or his or her last surviving spouse) or when the resident decides to move out. Upon termination of the contract of the life lease, the resident (or his or her estate in the event of termination due to death) may be able to recoup some of the up-front payment, depending on the nature of the life-lease agreement between the parties.

While life-lease arrangements have been mentioned in Ontario legislation and regulations (e.g. the *Land Transfer Tax Act*), there is currently no legislation or regulation in Ontario that specifically governs life-lease arrangements; rather, life-lease arrangements are governed by common law. Therefore, life-lease residents and sponsors must rely on the terms of their contract. There is significant variation in how life-lease projects are managed, so it is important to review life-lease agreements carefully to ensure that a client's rights are appropriately protected.

4. Rules governing conversions

Depending on the landlord's plans for converting rental residential properties to other uses or undertaking extensive renovations, there are provisions in the *RTA* that protect the tenants' interests by

- granting rights of first refusal to buy or re-occupy units;
- prohibiting the giving of notices of termination in certain circumstances;
- maintaining rents at pre-renovation levels; and
- providing substantial compensation to tenants for their inconvenience.

In Toronto, By-Law 885-2007 was passed in July 2007 under s. 111 of the *City of Toronto Act, 2006*, which gives the City of Toronto enhanced authority to protect rental

housing from demolition and conversion to non-rental purposes (e.g., condominiums, offices, or other non-rental uses). The policies and the by-law apply to properties containing six or more rental units. Under the by-law, a property owner must obtain a permit from the city to convert their rental buildings to another use, demolish their buildings, perform renovations that change the number or type of rental units, or sever rental property. The by-law makes it an offence to demolish or convert rental housing to non-rental purposes without a permit issued by the city under the new Chapter 667 of the *City of Toronto Municipal Code*. By-Law 885-2007 complements the notice and compensation provisions set out in the *RTA*.

Regarding condominium conversions, the registration of a declaration and description does not terminate a tenancy, constitute grounds for a notice of termination, or affect the rights of the tenants at the time of registration (see ss. 4(2)–(3) of the *Condominium Act, 1998*). Restrictions on giving notice of termination do not apply to certain complexes when the condominium declaration is registered within two years of the first rental in the complex (s. 51(3)).

5. Remedies and enforcement provisions

5.1 Tenant applications

There are many grounds for tenants to make application to the LTB for rent decreases, abatements, rebates, or damages, including

- reduction or discontinuance of a service or facility (s. 130);
- reduction in municipal taxes and charges (s. 131);
- imposition of illegal charges, such as “key money” (s. 134);
- collection of illegal rent, such as a rent increase that exceeds the guideline or a rent increase taken without proper notice (s. 135);
- the landlord’s failure to maintain the unit and the complex in a good state of repair and fit for habitation and to comply with health, safety, housing, and maintenance standards or causing damage to tenants’ property (s. 29(1)).

Section 82 allows tenants to raise any of the above issues at a hearing in response to a landlord’s application for eviction based on arrears of rent or an application for judgment for arrears of rent only. The tenant does not have to give notice of the issues prior to the hearing, and the LTB can award any relief to the tenant that could have been awarded had the tenant brought the application under the *RTA*.

In general, the limitation period for a tenant to commence an application is one year after the alleged infraction or breach. In particular, rent charged one or more years earlier is deemed to be lawful rent unless an application to dispute the lawfulness is made within one year after the date that amount of rent was first charged (s. 136).

The monetary jurisdiction of the LTB for payment orders (such as rent rebates) is capped at $10,000 or the monetary jurisdiction of the Small Claims Court in the area of the residential complex, if higher (s. 207(1)).

In some applications (such as for harassment), the LTB can also impose an administrative fine, with the same monetary jurisdiction as set out above.

5.2 Provincial offences

There are many offences in the *RTA*, several of which no longer require intent (s. 234). For example, it is an offence to charge rent in an amount greater than permitted under the *RTA* or to fail to pay annual interest on a deposit. It is also an offence if the landlord knowingly interferes with the supply of utilities to the property (s. 233(a)).

The fines are up to $25,000 for an individual or up to $100,000 for a corporation.

6. Exemptions

Some types of accommodation are exempt from the entire *RTA*, some from the annual guideline, and some from rules relating to increase notices or anniversary dates for increase.

Under s. 6(2), the following are not generally subject to rent control (except for rules relating to increase notices and anniversary dates):

- rental units never occupied before June 17, 1998;
- rental units never previously rented since July 29, 1975; or
- rental units in a building, mobile home park community, or land lease no part of which was occupied for residential purposes before November 1, 1991.

In other words, rent control (insofar as it relates to the guideline limit on increases) is not applicable to new units. In theory, it could eventually disappear completely as old units are demolished and new units, which fall within the above exemptions, enter the market. Such “exempt” units are not, however, exempt from OPRI’s, which means that if a rent freeze is in effect, no increase can be implemented until such time as the freeze comes to an end (s. 30(1)).

The rent control requirements of the *RTA* do not apply to interim occupancy and monthly occupancy fees charged to purchasers under s. 80 of the *Condominium Act, 1998*.

There are also special partial exemptions for properties governed by other statutes (such as the *Homes for Special Care Act* or the *Developmental Services Act*), government housing, non-profit projects, and rent geared-to-income tenancies (ss. 6-8).

The *RTA* does not apply at all to units in which the tenant is required to share bathroom or kitchen facilities with the owner (s. 5(i)). Certain living accommodations (e.g., in hotels, prisons, emergency shelters, educational institutions, hospitals, nursing homes, and rehabilitative or therapeutic facilities) may also be exempt if the specific requirements of the statute are met (s. 5).

A landlord or tenant may apply to the LTB for an order determining whether the *RTA* applies (s. 9(1)).

7. Acting for a purchaser or borrower

7.1 Drafting the agreement of purchase and sale

The purchaser's solicitor should consider including the following in the agreement of purchase and sale:

- a right in favour of the purchaser to terminate the agreement if the purchaser is not satisfied that all rents currently being charged are legal, that appropriate notices have been given to validate any rent increases, and that any statutory rebates have been paid.
- a requirement that the vendor deliver certain documents to the purchaser, old rent control orders, documentation relating to any applications outstanding, current rent-rolls, past rent records, directions to tenants regarding payment of future rents to the purchaser, etc. Most importantly, the vendor must deliver a list of the dates when each tenant commenced occupancy and the rent first charged. Tenants' acknowledgments or estoppel certificates will be valuable to prove rent legality, since lawful rent is determined based on the first actual rent plus subsequent guideline increases taken.
- a requirement that the vendor advise the purchaser of any above-guideline rent increase orders, any outstanding OPRI's, and applications or investigations commenced prior to closing.
- extensive representations and warranties relating to compliance with the *RTA* (and all prior rent control legislation) as well as confirmation of compliance with all municipal property standards and other by-laws or orders with a statutory declaration confirming the above to be delivered on closing.
- some financial recourse or security to protect the purchaser in the event any of the representations are inaccurate or in the event there is an outstanding OPRI affecting the asset.
- a requirement that the vendor deliver certain information needed in order to make a rent control application subsequent to closing, such as revenues and expenses for the past several years and supporting invoices and deposit receipts.
- a vendor's obligation to provide information and documentation when necessary post-closing to defend a tenant's application.
- a provision for adjusting rent deposits (including statutory interest) and any arrears.
- a requirement that the vendor provide an authorization for a search of the "Case Load System" of the LTB.

7.2 Searches

The following searches are advisable:

- the LTB regarding a search of the "Case Load System," for which vendor authorization may be necessary, to determine if there are any applications pending necessary to support the rents represented (such as an above-guideline application or OPRI) or that might reduce the cash flow for the complex (such as a tenant rebate application);
- the Ministry of Municipal Affairs and Housing regarding any work orders applicable if the complex is located in an unorganized territory or where there is no property standards by-law; and
- the local municipality regarding any realty tax reductions that may cause an automatic rent reduction or give grounds for a tenant application or any outstanding municipal work orders affecting the property.

7.3 Requisitions

If the obligation to deliver rent-related documents has not been included in the agreement of purchase and sale, a request for them should be included in the letter of requisitions.

7.4 Financing documents

Beware of any broad statements found in the commitment or mortgage document itself to the effect that the property complies in all ways with the *RTA* (or all applicable laws), unless the purchaser is in a position to satisfy itself and the lender as to these matters.

7.5 Opining and reporting

An opinion on the legality of rents should be given to the client in writing before closing and will depend very much on the type of information available. To the extent that most or all of the tenants were existing tenants on the Proclamation Date, seek instructions to give an opinion on whether the rents being collected are

apparently lawful based on information provided by the vendor plus permissible increases under applicable rent control legislation. The opinion would not be on the lawfulness of the actual rents (which involves an examination of the form, timing, and service of rent increase notices), but on the apparent legality of the quantum of rent.

Determine with the client whether all tenancies will be reviewed or just a spot check will be conducted. For an opinion as to the apparent lawfulness of rents, you would have to determine the lawful rent as of each tenant commencing occupancy and then update by guideline or by other applicable grounds for increase (such as a tenant agreement) less any rent freeze orders. Seek instructions regarding any review of individual notices of increase, its timing, and its service procedures.

It is always prudent to qualify any opinion on rent legality with respect to the provisions in the *RTA* for retroactive rent reductions.

Depending on the complex, the opinion may be on whether some or all of the units are exempt from the *RTA* in whole or in part, which opinion will require verification of different types of representations.

The scope of the retainer should be clearly described and confirmed in the reporting letter. Any information or advice given to the purchaser before closing should be reconfirmed or incorporated by reference to earlier correspondence. Given the complexity and amount of work required to ensure continuity of income stream as part of the due diligence process, counsel should clearly articulate, in writing, any limits on the scope of their retainer with respect to the lawfulness of rents.

7.6 Advising the potential purchaser

Owning and managing a rental residential property in Ontario is a highly regulated business. It presents many potential pitfalls for the novice landlord who might, out of ignorance, breach the *RTA*. For example, consider the following scenarios:

- The client has owned the property for two years. The realty taxes have declined by 5% each year. The client is charged with failing to reduce the rents appropriately under the *RTA* and is facing a possible fine of $10,000.
- The client bought the property to demolish and build a corner store. Since the tenants may refuse to leave voluntarily, he or she has cut off the utilities to the property as of the proposed date of termination, an offence under the *RTA*.
- The client voluntarily decided to do work on the property and verbally asked the tenants to pay an extra 50% in rent. Now the tenants have discovered that this was illegal for a number of reasons and have stopped paying the extra. As a result, the client cannot pay the balance that is owing to the contractor.

In each of the above cases, an uninformed landlord may not know that he or she was acting within a highly regulated framework and, therefore, took a course of action that could have been avoided. Prior to purchasing the property, the landlord needed to be advised to

- become personally knowledgeable about the legal parameters affecting the business;
- seek expert advice post-closing regarding business management; or
- consider retaining an expert property manager.

The issue for the conveyancing lawyer is not necessarily to teach the new landlord the law, but to highlight the types of regulatory issues involved or, in the alternative, obtain a clear waiver.

Consider the level of business and property management experience of the client, and consider some of the following issues when advising a potential purchaser of a rent-controlled property:

- The legality of the rent affects the value of the property and the anticipated cash flow, since legal rents are subject to reduction and increases in rent are strictly controlled.
- The use of the property cannot necessarily be changed without significant cost.
- Financing should be structured to ensure that the purchaser can at least pay debt service and operating costs out of existing legal cash flows.
- Since a purchaser will be unable to increase rents to cover losses from operations or capital expenditures (except in a limited fashion), the purchaser should realize that the ongoing viability of the investment must be determined from the outset.
- The ability to charge and collect rent and the obligation to repair and use the property are government regulated, and the client is not free to do as the client wishes with the property, the rents, or the tenants.
- If the agreement of purchase and sale has been executed without legal advice, any deficiencies or limitations on the client's rights and remedies arising from the agreement should be reviewed with and summarized in writing to the client.

8. Acting for the vendor

8.1 Advising the vendor regarding the potential sale

The vendor should be made aware that the true value of the property will be directly related to its cash flow, and therefore, it should be prepared to prove the legality of the rents to the purchaser.

8.2 Representations and warranties in the agreement of purchase and sale

The vendor's solicitor should be prepared to explain to the vendor the nature and intent of all representations and warranties found in the agreement of purchase and sale regarding the *RTA* and to ensure that the vendor has the necessary advice to determine the compliance of the property with the *RTA*, even if that involves seeking outside assistance.

8.3 Closing documents

Depending on the terms of the agreement of purchase and sale, the vendor should be prepared to produce extensive documentation on closing, such as tenants' acknowledgments, assignments of leases or tenancy agreements, statutory declarations, and directions to tenants regarding future payment of rent. The vendor's financial information will have to be completely up to date to enable his or her lawyer to prepare the statement of adjustments for the transaction.

9. Acting for the mortgagee

The lender's solicitor's role in a loan transaction should also be defined and limited where appropriate. The lender's solicitor should consider the legislation at the following stages of the transaction.

9.1 The commitment

The commitment may require the borrower to deliver all documentation needed to establish the legality of the rents, such as registration forms, old rent review orders, current applications, and a current rent-roll with a commencement date for each tenancy. It may also contain representations and warranties regarding compliance with the *RTA* and, in particular, a warranty that all rents are legal and that any required rebates have been paid.

9.2 Searches

The same searches that the purchaser's solicitor performs will usually be appropriate.

9.3 Mortgage documentation

Depending on the terms of the commitment, the loan may become due and payable in full at the option of the lender in the event that illegal rents are discovered or an illegal conversion or renovation is attempted.

9.4 Scope of retainer and reporting

Beware of broad statements in the instructions to the solicitor and in the interim or final reports on title. It is impossible for a solicitor to give an unqualified opinion on the legality of rents and the compliance of a rental operation with the *RTA*. The lender's solicitor should seek instructions at the outset as to the solicitor's role and the opinions the solicitor will be required to give.

10. Acting for landlord or landlord's agent

The landlord's solicitor should become familiar with the following, at a minimum:

- procedure for obtaining a rent increase, especially filing deadlines, required documentation, and time frames;
- residential rental guidelines and their impact;
- grounds for tenant applications (such as rent reductions, rent rebates, and illegal charges) as well as grounds on which tenants may obtain rent decreases (property tax reductions and rent freezes);
- provisions regarding change of use, renovation, or conversion;
- grounds for termination of tenancies; and
- statutory compliance requirements for all tenancies, such as provisions regarding rent deposits, annual interest, rights of entry, handling of tenants' possessions, and so forth.

11. Acting for more than one party in a real estate transaction

If a lawyer is acting for more than one party in a real estate transaction, the lawyer must comply with r. 2.04 of the *Rules of Professional Conduct* with respect to avoidance of conflicts of interest. Subrule 2.04(6) provides that before a lawyer accepts employment from more than one client in a matter or transaction, the lawyer must advise the clients that the lawyer has been asked to act for both or all of them, that no information received in connection with the matter from one can be treated as confidential so far as any of the others are concerned, and if a conflict develops that cannot be resolved, the lawyer cannot continue to act for both or all of them and may have to withdraw completely. In addition, under r. 2.04(8), the lawyer must obtain the clients' consent to act on this basis.

The consent process between a lawyer and institutional lender clients (who are generally sophisticated) is simplified under r. 2.04(8.2): if a lawyer is jointly retained by a client and by a lending client in respect of a mortgage or loan, the lending client's consent is deemed to exist upon the lawyer's receipt of written instructions to act from the lending client. This rule also applies where there is a guarantee of such a loan. The lawyer is not required to provide advice and obtain consent as described in rr. 2.04(6)–(8).

Chapter 56

Remedies – what to do in the event of default

The purpose of this chapter is to discuss various steps that can be taken when a transaction is at risk of being in default.

1. Requisitions

One of the most common areas where problems arise is with respect to requisitions. Accordingly, it is important to know

- what constitutes a valid requisition;
- how and within what times it must be made;
- how and within what times it must be answered;
- what procedures are available to resolve disagreements as to the validity of a requisition or the sufficiency of the answer given;
- what other procedures are available for clarification or correction of title problems; and
- what are the rights of a party to terminate the agreement if a sufficient answer cannot be given.

1.1 Application under the Vendors and Purchasers Act

Subsection 3(1) of the *Vendors and Purchasers Act* provides that an application may be made:

> in respect of any requisition or objection or any claim for compensation or any other question arising out of or connected with the contract, except a question affecting the existence or validity of the contract ....

Courts have held that the phrase "or any other question arising out of or connected with the contract" is limited by the *ejusdem generis* rule of statutory interpretation to matters relating to requisitions, objections, or claims for compensation. Accordingly, such an application is not appropriate for dealing with controversial disputes that are more properly the subject of an action, and specifically the courts have held that the following are not appropriate matters for a *Vendors and Purchasers Act* application:

- disputed claim for possessory title;
- disputes respecting a purchaser's right to assign an agreement of purchase and sale;
- request for an order of conveyance of land where such application does not arise in the context of an answer to a requisition; and
- disputes respecting the answering of a requisition relating to a zoning by-law on the grounds that these do not constitute requisitions on title.

It is essential that requisitions be clearly thought through and clearly worded both when being made and when being answered. On an application under the *Vendors and Purchasers Act*, the court is to determine first, not whether the abstract of title and registered instruments disclose facts that would give rise to a valid requisition, but whether a valid requisition was in fact made, and second, not whether there is a sufficient answer that could be given to a valid requisition made, but whether the vendor made such a sufficient answer.

Orders made on applications under the *Vendors and Purchasers Act* are *in personam* and not *in rem* and, as a result, are binding only upon the parties to the application. As a result, the same set of facts disclosed by an abstract of title could, in a series of transactions, give rise to the same requisition and the same answer and could give rise to a series of applications under the *Act* on which different findings could be made. Remember that if in order to properly deal with the matter requisitioned, someone who is not a party to the transaction is to be affected, that person will have to be before the court in order to be subject to the order made on the motion (*Rules of Civil Procedure*, r. 38.06).

Note that you are not entitled to any extension of the closing date in order to bring an application under the *Vendors and Purchasers Act*.

1.2 Other applications

Some matters relating to the title to the property can be dealt with on an application under r. 14.05(3), which provides as follows:

> **14.05(3)** A proceeding may be brought by application where these rules authorize the commencement of a proceeding by application or where the relief claimed is,
>
> ...
>
> (d) the determination of rights that depend on the interpretation of a deed, will, contract or other instrument, or on the interpretation of a statute, order in council, regulation or municipal by-law or resolution;
>
> (e) the declaration of an interest in or charge on land, including the nature and extent of the interest or charge or the boundaries of the land, or the settling of the priority of interests or charges;
>
> ...

(h) in respect of any matter where it is unlikely that there will be any material facts in dispute.

2. Conditions

Agreements of purchase and sale often contain conditions affecting the rights and obligations of the parties to the agreement. A condition can generally be stated to be a provision that makes the existence of a right dependent upon the happening of an event.

Certain conditions are conditions precedent. Conditions precedent exist, according to the judgment in *Turney et al. v. Zhilka*, where:

> [t]he obligations under the contract, on both sides, depend upon a future uncertain event, the happening of which depends entirely on the will of a third party.

A true condition precedent cannot be unilaterally waived.

The obligation of a party with respect to the satisfaction of a condition is, at the very least, to make a genuine effort to obtain what was necessary to carry out the contract. Therefore, a party to an agreement cannot avoid the agreement entirely due to the non-satisfaction of a condition if that party has made no effort at all to satisfy it. In addition, a party to the contract whose assistance is required in order that a condition be satisfied must provide reasonable co-operation to the party whose obligation it is to satisfy the condition.

Where the satisfaction of a condition would require application to a court, the party whose obligation it is to attempt to cause fulfillment of the condition may not be required to make such application.

There is also authority to the effect that a party cannot justify refusal to complete a transaction by relying on a matter of conveyancing that is within such party's power to correct, even if the cost is significant. Similarly, where the agreement of purchase and sale is silent as to which of the parties will assume the obligation relating to the satisfaction of the condition, the nature of the condition may cast the obligation on one party as opposed to another.

2.1 Right to waive

As mentioned above, a party cannot waive a condition precedent. However, if a condition was obviously inserted for the benefit of one party as opposed to another, the party for whose benefit it was inserted may waive it. For example, if a purchase is made conditional upon the buyer obtaining suitable financing, the buyer should be able to waive the condition.

2.2 Satisfaction of condition

Conditions can be worded to provide that notice of satisfaction must be given within a specified time, failing which the condition will be deemed to have not been satisfied and the agreement will be terminated. Conditions can also be worded to provide that unless written notice of non-satisfaction is given within a specified time, the condition will be deemed to be satisfied. Other conditions are worded without any requirement for notice as to satisfaction or non-satisfaction, and in the latter case, it will simply be a question of fact as to whether the condition is or is not satisfied.

2.3 Rights of termination — alternatives to conditions

As an alternative to using conditions in an agreement of purchase and sale, it may be preferable to instead utilize a right of termination that may be exercised by one or both of the parties under a stipulated set of circumstances. In this way, you can avoid the difficulties regarding whether a condition is a condition precedent, whether a party has a right to waive the condition, etc.

It will always be necessary to examine the wording of the termination provision and, if exercising the right, to adhere strictly to the contractual provision as to time limits, giving of notice, and any other such requirements, but at least the law of conditions and its uncertainty are avoided.

3. Repudiation

3.1 When does repudiation occur?

Repudiation of a contract occurs when one party to a contract acts in such a manner as to permit the other party or parties thereto to conclude that the first party no longer intends to honour or be bound by the provisions of the contract.

3.2 What is repudiation?

Not every breach of the terms of a contract will amount to a repudiation. To constitute repudiation, the threatened breach must be such as to deprive the injured party of a substantial part of the benefit to which he is entitled under the contract.

3.3 Response to repudiation

When faced with repudiatory conduct, an innocent party must be careful to clearly state his or her position. The innocent party may take the position that the breach of the contract by the repudiating party relieves the innocent party of any further obligations under the contract and permits the innocent party to bring an

action for damages flowing from the breach. Alternatively, if the innocent party wishes to uphold the contract and sue for specific performance, he or she must very clearly state that position and subsequently do nothing inconsistent with such position. If a vendor repudiates an agreement of purchase and sale, the purchaser cannot demand return of the deposit and sue for specific performance since those two positions are totally inconsistent. If the innocent party wishes to uphold the contract, he or she will have to await the day of closing, tender, and immediately commence an action for specific performance. If the repudiatory conduct amounts to anticipatory breach, the innocent party may immediately commence action for specific performance.

4. Rescission

"Rescission" has been used to mean a number of different things and is therefore often misunderstood. It would be better to avoid the use of the word and, by using other language, to articulate very clearly the position being taken by your client.

Rescission can be thought of as negating or unwinding an agreement that should never have been executed. It often relates to contracts entered into under inequitable circumstances such as duress, undue influence, illegality, fraud, misrepresentation, mistake, or frustration. When a contract is rescinded, the parties are not only released from their contractual obligations but are to be restored to their respective pre-contractual positions. For example, a purchaser's deposit would be returned. Note that after closing, a purchaser's right to rescission may be restricted by *caveat emptor* and the doctrine of merger.

5. Specific performance

5.1 What is specific performance?

Specific performance is an equitable remedy whereby the court orders a party to a contract to fulfill its contractual obligations. In the case of a purchaser, the rationale for allowing specific performance is based on the assumption that an estate in land possesses a particular value for the purchaser and that pecuniary damages would therefore be inadequate. This assumption is rebuttable and must be carefully examined following the declaration of the Supreme Court of Canada that specific performance will only be available if the property is truly "unique." The availability of specific performance as a remedy for a vendor is not quite as clear; however, it may be justified on the basis of mutuality, i.e., the reciprocity of remedies for a vendor and purchaser. It might also be justified on the basis that damages are inadequate in a transaction where the vendor does not obtain the full price on closing (e.g., vendor take-back charge) and, on an action for damages, would only be entitled to the difference between the sale price and the market value of the land.

5.2 Desirability of specific performance

There are many reasons why a party might seek specific performance rather than accept the repudiation by the other party and claim damages:

- There is no obligation on the innocent party to mitigate damages when seeking specific performance if the claim for specific performance is reasonably founded.
- A plaintiff may join a claim for specific performance with a claim for damages in the alternative and may elect his or her remedy up to the conclusion of the trial.
- If, at the conclusion of the trial, damages are awarded in lieu of specific performance, the plaintiff may claim that the damages be assessed as of the date of trial and not as of the date of the breach, which is the normal date of assessment.

5.3 Prerequisites to a purchaser seeking specific performance

As stated earlier, a purchaser is entitled to claim specific performance on the basis that he or she has a particular interest in the land that cannot be compensated by damages. Recent case law suggests that one may look behind the transaction in order to determine uniqueness before granting specific performance as of right. For example, if land is purchased as an investment, any loss of profits intended to flow from the transaction can easily be compensated for in damages. In these circumstances, the court might require mitigation of those damages. A vendor used to have the same entitlement as the purchaser to specific performance on the basis of mutuality of remedies. Though now a rare occurrence, a vendor may be granted specific performance if damages might not provide an appropriate remedy or if the vendor is unable to mitigate by finding a suitable purchaser.

5.4 Ready, willing, and able to close/tender

Before a party may successfully apply for a decree of specific performance, that party must show that on the date set for closing, he or she was ready, willing, and able to fulfill his or her obligations under the contract. This readiness, willingness, and ability to close must continue not only beyond the original closing date but right up to the time of the conclusion of the trial. Specific performance will not be granted in circumstances where, subsequent to the date set for closing (and upon which date the party was ready, willing, and able to close), that party ceases to be ready, willing, and able to close.

In most cases it will be advisable, if not absolutely necessary, to tender on the defaulting party. Great care

should be taken to ensure that the tender is complete and that tender is effected upon the defaulting party (unless the agreement of purchase and sale permits tendering upon the solicitor for the defaulting party). Any effective tender requires the tendering on the defaulting party of all things required to be produced by the innocent party at the closing of the transaction. A letter listing all of the deliveries would be useful evidence, as would a witness.

If the transaction is to close with the electronic registration of the transfer and any charge back to the vendor, the lawyer will tender all off-title documents and money, if appropriate, together with a copy of the DRA signed by the lawyer. The lawyer should ensure that he or she has in his or her possession an appropriate acknowledgement and direction authorizing both the closing and the tender. As well, if appropriate, the lawyer should set out in a letter accompanying the tender all conditions to which the tender is subject, such as satisfactory answers to requisitions.

Tender may be expressly waived by a defaulting party or may be unnecessary where the facts show that a tender would be absolutely useless. If in doubt as to whether a tender is necessary, the safest course of action is to effect a tender.

5.5 Bars to specific performance

Since the remedy of specific performance is an equitable remedy, it is within the discretion of the court to grant or deny such a remedy. Some matters that may be considered by the court in determining the exercise of its discretion are the following:

- whether there has been misrepresentation by a plaintiff claiming specific performance.
- the unfairness, if any, of the contract.
- hardship on the defendant.
- inadequacy of consideration.
- whether the plaintiff is in breach of the plaintiff's obligations under the contract.
- delay (*laches*). In order for delay to constitute a bar to the remedy of specific performance the defendant must show one of the following:
  - The delay of the plaintiff caused the defendant to change the defendant's position such that it would be inequitable to now require the defendant to carry out the contract.
  - The delay must be of such a character as to justify the inference that the plaintiff intended to abandon the plaintiff's rights under the contract.

5.6 Specific performance with abatement

Specific performance with an abatement in price is available to both purchaser and vendor, although the purchaser's rationale is stronger than the vendor's. Abatement, or reduction, of the purchase price is claimed as a result of the vendor not being able to convey all that the agreement of purchase and sale requires to be conveyed.

When sought by a purchaser, the rationale is that the purchaser is entitled to take whatever the vendor has to convey and to have an abatement of the price. This right is, of course, subject to any other provisions of the contract, including an annulment clause, which may permit the vendor to terminate the agreement if there are defects in title that the vendor is unable or unwilling to remedy.

When specific performance with an abatement is sought by the vendor, the circumstances under which the vendor will obtain the decree are generally limited to those where the vendor is able to substantially fulfill his or her obligations under the agreement and it would be inequitable to permit the purchaser to withdraw.

Abatement will not be allowed if it is found that the bargain between the plaintiff and the defendant was such that the plaintiff would take whatever the vendor had at a set price and that there could not be a deficiency in area under the terms of the agreement. Essentially, the court attempts to identify the expectations of the parties and to make an order that will further those expectations.

5.7 Specific performance plus damages for delay

When claiming specific performance, the plaintiff may also claim damages for delay in closing, if applicable, and may also include a claim for damages in the alternative.

5.8 Certificate of pending litigation

When an action for specific performance has been commenced by a purchaser, to prevent the vendor from disposing of the land to an innocent third party and thus defeating the goal of the action, a purchaser can obtain and register on title to the land a certificate of pending litigation. In order to obtain such a certificate, the plaintiff must assert a claim that would result in a judgment *in rem* or a judgment requiring the defendant to convey title to the plaintiff. Reference should be made to the *Courts of Justice Act*.

6. Damages

The innocent party may accept a repudiation as relieving the innocent party of having further obligations under the agreement and sue for damages resulting from such

breach. This claim for damages may be made as an alternative to a claim for specific performance and may be claimed in the same statement of claim. If a claim for specific performance is made but not pursued to judgment, the action may then proceed as an action for damages.

6.1 Measure of damages

A plaintiff who has suffered damages is to be restored to the position the plaintiff would have been in had the contract been performed subject to the rule of remoteness and so far as money can do so.

There is authority that damages may be assessed on a date subsequent to the breach, usually the date of trial. This is consistent with the underlying rule in awarding damages, namely, that the innocent party is to be put into the position he or she would have been in had the contract not been wrongfully repudiated.

The measure of damages that may be awarded for breach of an agreement for the purchase and sale of land is usually the difference between the contract price and the market price of the land at the time damages are assessed. It should be noted that many agreements of purchase and sale effectively limit the purchaser's rights to a refund of the deposit if there is a defect in title that prevents the closing of the transaction.

7. Deposits

Almost all agreements of purchase and sale provide for a deposit to be paid to the vendor or to the vendor's solicitor or agent to be held in trust pending closing or termination of the agreement and to be credited against the purchase price on closing.

A true deposit is a guarantee of performance by the purchaser. If the agreement is not clear, the parties will need to examine the circumstances in order to determine whether any payment made by the purchaser to the vendor, whether upon delivery of the offer to purchase or at some other time prior to closing, is a deposit or a part-payment of the purchase price. Such circumstances may be looked at to determine the intention of the parties as to the character of the payment.

The agreement will usually state the nature of the payment (i.e., that it is a deposit), what is to happen to it upon the closing or termination of the agreement, and in some cases, what is to happen to it in the event of default. A deposit made against the purchase price will generally be forfeited to the vendor on the default of the purchaser. This result can only occur if the vendor does not intend to sue for specific performance. If the vendor intends to sue for specific performance, the vendor is not in a position to claim forfeiture of the deposit.

Conversely, if the vendor is in breach and the purchaser intends to sue for specific performance, the purchaser should not demand return of the deposit since that is inconsistent with the maintenance of the agreement and an action for specific performance. Generally, if the payment was a true deposit and the transaction fails to close because

- the vendor failed to close when the purchaser was ready, willing, and able to do so; or
- the purchaser, having used reasonable efforts to satisfy conditions to the agreement, was unable to do so and withdrew from the agreement as permitted by it,

the purchaser will be entitled to a return of the deposit.

It is a general rule that a purchaser of land, when entitled to a return of the deposit, is entitled to a lien against the land to protect the payment of the deposit money and any other moneys paid on account of the purchase price, as well as interest and costs. This lien is in the nature of an equitable interest. The lien may be claimed in an action, and a certificate of pending litigation may be registered. The effect of the lien is to bind the land and any subsequent purchaser, except a subsequent purchaser for value without notice of the lien, and thus is afforded the protection of the *Land Titles Act* and the *Registry Act*.

7.1 Relief against forfeiture

Section 98 of the *Courts of Justice Act* provides as follows:

> **98.**— A court may grant relief against penalties and forfeitures, on such terms as to compensation or otherwise as are considered just.

According to case law, two criteria must be met before an order granting relief under this section will be obtained:

- The amount of the deposit must be out of all proportion to the damages suffered.
- It must be unconscionable for the vendor to retain the deposit in full.

8. Representations and collateral agreements/exclusionary clauses

A representation is a statement of fact made by one party to the contract to the other which, while not forming a term of the contract, may induce the other to enter into the contract.

A purchaser may rescind an agreement of purchase and sale prior to closing because of material misrepresentations made by the vendor or the vendor's agent that induced the purchaser to enter into the agreement. Rescission may be possible in such cases

whether the misrepresentations were innocent, fraudulent, or negligent.

A collateral agreement is a contract that is made collateral or prior to the main contract, in return for which a party is induced to enter into the main contract. A collateral contract may entitle the purchaser to repudiate the main contract. Most agreements of purchase and sale contain an exclusionary clause stating that there are no representations, warranties, or collateral agreements affecting the subject matter of the agreement except those contained in the agreement itself. If there was a representation or collateral agreement that induced the entering into of the agreement of purchase and sale and the representation was inaccurate or there was breach by the vendor of the collateral agreement, the exclusionary clause may not be of assistance. In addition, if there is fraud, the exclusionary clause will not protect the party guilty of the fraud.

9. Merger

Following closing, the basic rule is that any unfulfilled obligations will merge in the conveyance. Reasoning in support of the doctrine of merger is that there being a need for finality in commercial transactions, the parties are considered to have accepted the consideration flowing on closing as full satisfaction of the contractual obligations.

However, if the contract expressly provides for the survival of contractual obligations, or if the court finds, from the surrounding circumstances, that the parties' intention was that a particular obligation would survive, then the doctrine of merger will not apply.

If the agreement is not clear and it is desired that certain contractual obligations survive, then appropriate covenants, undertakings, or agreements should be entered into at closing to achieve that result.

10. What to do

10.1 When acting for a purchaser

- Make an application under the *Vendors and Purchasers Act* to determine the validity of requisitions and/or the sufficiency of answers given. Remember that if there is a dispute as to the validity of a requisition, the purchaser refuses to close, an action is commenced by the vendor for damages, and the requisition is determined at trial not to have been a valid requisition, then the purchaser will be in breach of the agreement and liable to the vendor.
- To prevent the vendor from improperly disposing of the land, register notice of the agreement of purchase and sale (or in the case of an option to purchase, the option agreement) on title or, in the land titles system, register a caution. You should note that land transfer tax will be payable upon the registration of the notice of agreement of purchase and sale.
- If the purchaser was induced to enter into the agreement of purchase and sale by representations or collateral agreements that have either proven to be untrue or are not being fulfilled, notify the vendor, set out the right of the purchaser to be no longer bound by the agreement, and claim a refund of the deposit and other damages. The grounds for withdrawing must be clearly understood.
- Allow the agreement to terminate for non-satisfaction of conditions, provided reasonable efforts have been made to satisfy such conditions, and have the deposit refunded. If reasonable efforts have not been made to satisfy conditions, consider treating the conduct of the vendor as an anticipatory breach and commencing an action for specific performance.
- Exercise a contractual right of termination under appropriate circumstances, and have the deposit refunded. If the right of termination lies with the vendor and the right is not being exercised capriciously, then permit the termination, and require a refund of the deposit. If there is a capricious exercise of such right, consider treating the vendor's conduct as an anticipatory breach and commencing an action for specific performance.
- Sue for damages resulting from a breach of the agreement by the vendor, and require a refund of the deposit. To secure a refund of the deposit, consider claiming a lien for the deposit and registering a certificate of pending litigation.
- Tender upon the vendor, and thereafter sue for specific performance (with damages resulting from the delay in closing), if available, and for damages for breach of contract in the alternative. Register a certificate of pending litigation. Consider an obligation to mitigate damages.
- If the purchaser is in default, consider whether it is appropriate to apply for relief from forfeiture of the deposit.
- Clearly understand and state the position you are taking and the grounds for taking it.

10.2 When acting for the vendor

- Make an application under the *Vendors and Purchasers Act* to determine the validity of requisitions and/or the sufficiency of answers given. Remember that if there is disagreement as to the sufficiency of an answer given, the purchaser refuses to close, an action is commenced, and at trial the answer given is found not to be sufficient, then the vendor will be in breach of the agreement.
- Allow the agreement to terminate for non-satisfaction of conditions, provided reasonable efforts have been made to satisfy such conditions,

and refund the deposit. If reasonable efforts have not been made by the purchaser when responsible for satisfying conditions, consider treating the conduct of the purchaser as an anticipatory breach and commencing an action for specific performance.

- Exercise a contractual right of termination under appropriate circumstances, and refund the deposit. If the right of termination lies with the purchaser and the right is not being exercised capriciously, then permit the termination, and refund the deposit. If there is a capricious exercise of such right, consider treating the purchaser's conduct as an anticipatory breach and commencing an action for specific performance.
- Sue for damages resulting from a breach of the agreement by the purchaser and forfeit the deposit.
- Tender upon the purchaser, and thereafter sue for specific performance of the agreement (with damages resulting from the delay in closing), if available, and for damages for breach of contract in the alternative. Consider an obligation to mitigate damages.
- Clearly understand and state the position you are taking and the grounds for taking it.

10.3 Summary

Each case necessarily depends upon its own facts. When a party wishes to withdraw from the transaction or the transaction appears to be falling apart, a clear consideration of the particular facts and particular agreement is necessary.

If the vendor is in breach of the agreement, does the purchaser wish to preserve the right to bring an action for specific performance? If so, then the purchaser must be in a position to make a valid tender upon the vendor on the date set for closing and must thereafter immediately commence an action for specific performance. The purchaser can then claim damages for breach of the agreement in the alternative and can register a certificate of pending litigation. Under these circumstances, the purchaser must not demand a return of the deposit, must make it clear that the purchaser is upholding the agreement, and must at all times (provided the purchaser does not wish to abandon the claim for specific performance) remain ready, willing, and able to close the transaction, up to the time of judgment in the action.

If the purchaser does not wish specific performance but wishes instead to accept the vendor's breach of agreement as relieving the purchaser of any further obligation, then the purchaser should notify the vendor, in clear language, that the vendor has breached the agreement, that the purchaser is no longer bound by the agreement, and that the purchaser will be looking to the vendor for all damages suffered as a result of the breach. The purchaser will also demand and, if necessary, commence an action for return of the deposit, claim a lien against the land, and register a certificate of pending litigation. The purchaser will have an obligation to mitigate damages under these circumstances.

If the purchaser is in breach of the agreement, does the vendor wish to preserve the right to bring an action for specific performance? If so, then the vendor must be in a position to make a valid tender upon the purchaser on the date set for closing and must thereafter immediately commence an action for specific performance. The vendor can claim damages for breach of the agreement in the alternative. The vendor must not under these circumstances claim forfeiture of the deposit but must make it clear that the vendor is upholding the agreement and must at all times up to the time of judgment in the action (provided the vendor does not wish to abandon the claim for specific performance) remain ready, willing, and able to close the transaction.

If the vendor does not wish specific performance but wishes instead to accept the purchaser's breach of the agreement as relieving the vendor of any further obligation, then the vendor should notify the purchaser in clear language that the purchaser has breached the agreement and that the vendor is no longer bound by the agreement and will be looking to the purchaser for all damages suffered as a result of the breach. The vendor will claim that the deposit is forfeit and will have to apply it against the damages suffered as a result of the purchaser's breach. The vendor will have an obligation to mitigate damages under these circumstances.

Unfortunately, there is often uncertainty as to whether one party or the other is entitled to rescind an agreement of purchase and sale, whether one party has acted reasonably in attempting to satisfy conditions, whether the vendor has acted reasonably in attempting to answer requisitions, etc. Care should be taken to make it clear to the other party exactly what course of action is being taken and the basis upon which it is taken. Thereafter, ensure that all actions taken are consistent with the rights or remedies claimed.

Chapter 57

The purchase and sale of a condominium unit

1. Introduction

The term "condominium" generally describes a system of ownership for a multi-unit building whereby each unit is owned separately by the individual who purchases it, while the common elements (lobby, walkways, elevators, etc.) are owned in common by all the unit owners. Each unit owner has an undivided interest in the common elements, which is in a fixed proportion—usually the proportion that the size of the unit bears to all the units in the project.

New types of condominium corporations can be created under the *Condominium Act, 1998* (*Act*). The *Act* permits "common elements condominium corporations," "phased condominium corporations," "vacant land condominium corporations," and "leasehold condominium corporations." As well, condominium corporations can amalgamate with one another.

2. Key condominium documents

In addition to the *Act*, the following documents form part of a condominium's "constitution":

- the "description" and "declaration";
- the various "by-laws" of the condominium corporation (there usually are several); and
- the "rules" of the condominium corporation.

2.1 The description

Under the *Act*, the registration of a declaration and description in the land titles office (or in any remaining areas of Ontario where no land titles system exists, in the registry office) creates a condominium plan upon the lands described in those documents. Upon registration of the declaration and description, the lands are divided into the various units and common elements constituting the condominium, and a condominium corporation without share capital is created, whose members are the unit owners from time to time.

Briefly, a description is prepared by the declarant's surveyor and comprises a pictorial depiction of the boundaries of the units, the common elements, and the exclusive-use common elements appurtenant to the units. (The "declarant" is the owner of the lands upon which the condominium is to be registered.)

The surveyor's plans are registered and retained in the land titles office. A buyer's solicitor should review the surveyor's plans filed in the land titles office in order to confirm with the client the location of the residential unit, the parking, and locker spaces.

The solicitor should also review with the buyer the vertical and horizontal boundaries of the unit(s) to be sure that they conform to what the buyer is buying. There have been instances in condominium townhouse developments where an owner has extended the unit vertically into the "attic" of the building by adding a third floor, or horizontally by adding a new room at the back of the building, without obtaining the consent of the condominium corporation. Since the "addition" in these situations is typically part of the common elements, the extension of the unit into the common elements will contravene the condominium's declaration and almost certainly will be removed at the owner's expense when discovered.

2.2 The declaration

The declaration is the most important of the various documents registered on title. The *Act* requires the declaration to contain seven mandatory provisions (as well as any other material required by *General*, O. Reg. 48/01, made under the *Act*), which are set out in s. 7(2) of the *Act*, and makes provision for the addition of five permitted matters, which are set out in s. 7(4). Under s. 107 of the *Act*, declarations can be amended either by a vote of 80% or 90% of unit owners. Alternatively, a judge of the Superior Court of Justice may amend the declaration upon application under s. 109 of the *Act*.

2.2.1 Exclusive-use areas

One of the mandatory inclusions in the declaration is a specification of any exclusive-use areas of the common elements that are set aside for the use of one or more designated unit owners rather than for all the owners. Balconies, front yards, backyards, patios, parking spaces, and locker spaces are the typical types of exclusive-use areas. This specification is usually described and allocated in a schedule to the declaration and pictorially depicted on a separate sheet of the description plan. It is important for a solicitor to examine the declaration and description and advise the buyer what areas are allocated for his or her exclusive use. The buyer should examine those areas on site and ensure that they conform to his or

her understanding of the representations made by the buyer as to what he or she was purchasing.

2.2.2 Parking and locker spaces

When discussing parking and locker spaces, it is important to understand that these spaces can be treated in several ways in a condominium's declaration and description. A parking or locker space may be created as

- a separate unit;
- a part of the principal unit being purchased (e.g., the parking space may constitute part of the townhouse unit that is being purchased);
- part of the general common element areas of the condominium, with the board of directors of the corporation allocating from time to time the various parking and locker spaces among the unit owners; or
- an exclusive-use common element area, which is for the use only of that unit so designated in a schedule to the declaration.

Some condominium declarations prohibit the transferring or mortgaging of a parking or locker unit independently from the dwelling unit to which it has been allocated. Some allow transfers of parking or locker units to other unit owners but prohibit transfers to non-owners. A buyer's solicitor should ensure that such requirements are complied with. Even if there is no such requirement in the declaration, it is important for the buyer's solicitor to ensure that separately registered parking and/or locker units having their own legal descriptions are conveyed to the buyer at the same time that the residential unit is conveyed so that the buyer becomes the registered owner of everything that he or she has purchased.

A solicitor should be aware of situations prevalent in residential and industrial condominiums created in the 1970s where, although each residential or industrial unit was to enjoy the exclusive use of one parking and/or locker space under the declaration, the choice of the actual space was left up to the board of directors of the condominium corporation and was to be allocated and re-allocated by it from time to time. This means that an owner (and prospective buyers from an owner) would have no certainty that any particular parking space would be permanently enjoyed by that unit owner.

2.3 By-laws

The general by-law of the corporation, By-Law No. 1, regulates the governing and internal functioning of the condominium corporation. Other by-laws may have been passed by the condominium and registered on title authorizing or regulating various matters.

The provisions in By-Law No. 1 and in most by-laws are standard and may be found in the *Act*, but a cursory review should be made of them in any event. The provisions allowed to form part of a by-law are restricted to those matters described in s. 56(1) of the *Act*. By-laws must be registered on title in order to be effective.

2.4 Rules

Rules may be passed by the board of directors of a condominium corporation under s. 58 of the *Act*. Notice of the proposed rules must be given to each owner in accordance with s. 58(6) of the *Act*. Under s. 58(7), if the board is not in receipt of a requisition in writing made by owners owning together at least 15% of the units within 30 days of the giving of the notice, the rules are effective at the expiry of the 30-day period. If a requisition is received during the 30-day period, the rule will not be effective unless it is approved at a unit owners' meeting. Unlike by-laws, rules are not registered on title.

The rules may only deal with the use of common elements and units. Section 58 states that the rules must be intended to "promote the safety, security or welfare of the owners and of the property and assets of the corporation" or to "prevent unreasonable interference with the use and enjoyment of the common elements, the units or the assets of the corporation."

2.5 The oppression remedy

A unit owner, a condominium corporation, a declarant, or a mortgagee of a unit is entitled under the *Act* to make an application to court for an order that the conduct of a unit owner, the condominium corporation, a declarant, or a mortgagee is or threatens to be "oppressive or unfairly prejudicial" to the party bringing the application or "unfairly disregards the interests" of the person bringing the application. This remedy is known as an "oppression remedy."

3. Searching title in the land registry office

The material below summarizes some of the searches and investigations that are pertinent to the purchase of a condominium unit, in addition to the standard searches and investigations otherwise required.

3.1 Where the Land Registration Reform Act has not been implemented

A solicitor searching title to a condominium unit must search each of the following four registers at the land registry office:

- The **Property Parcel Register** (called the "Property Abstract Index" in the registry system) shows the state of title of the condominium property at the time the condominium was registered. It is

the register where any blanket mortgage in existence at the time of condominium registration can be found, as well as all other instruments that are in existence at that time, such as easements, development agreements, and restrictive covenants.

- The **Constitution Index** records the declaration and description and all of the by-laws of the condominium corporation.
- The **Common Elements and General Index** records any documents or instruments affecting all of the units in the condominium (and therefore all the common elements of the corporation that are appurtenant to those units), which would be the documents recorded on the Property Parcel Register plus any documents or instruments created after the condominium's declaration has been registered. In this index will be recorded any new blanket mortgages given by the developer over all of the units after condominium registration, as well as construction liens that are registered after condominium registration.
- The **Unit Register** records any instruments affecting title to individual units, such as unit mortgages, transfers, common expense liens, and individual partial discharges of the blanket mortgages registered on either the Property Parcel or Common Elements and General Index Registers described above. Take note that a single residential condominium transaction may involve multiple units—a dwelling unit, a parking unit, and a locker unit. In such cases, all unit registers must be searched.

3.2 Where the Land Registration Reform Act has been implemented

For most registry or land titles offices or parts thereof, Part II of the *Land Registration Reform Act* has been implemented (POLARIS system), so there is only one index for each unit in the condominium. All of the instruments recorded in the four indexes described above are now recorded in each unit's own parcel register.

The legal description of a condominium is no longer simply the unit and level designation; what actually governs is the property identification number (PIN). Ensure the PIN, the unit, and the level are correct and pay attention to changes (resulting from sales between unit owners) to parking and locker units. Make sure that the PINs are updated if these units are changed.

3.3 Additional execution search

In addition to searching executions against the seller, executions should be searched against the condominium corporation. Under s. 23(6) of the *Act*, a judgment for the payment of money against the corporation is also a judgment against each unit owner at the time of the judgment. The unit holders are liable for a portion of the judgment determined by the proportions specified in the declaration for sharing the common interests. If a judgment is issued against the corporation, this usually results in a special assessment being made against all the current owners of the condominium corporation.

3.4 Liens for common expenses

Under and subject to ss. 85–86 of the *Act*, condominium liens for unpaid common expenses have priority over other lien claimants and mortgagees. Until 1998, this priority applied only to residential condominiums, but that restriction has been removed, and the priority now applies to all condominiums.

3.5 Registration of unit leases

Where a tenant (usually a commercial tenant) leases a condominium unit for a term of less than three years and the tenant is in actual possession of the unit, the tenant's rights under its lease will prevail against third parties such as mortgagees, and a notice of the lease need not be registered. However, a notice of a lease having a term of three years or more must be registered under s. 44(1) of the *Land Titles Act* in order for the lease to have priority over subsequently registered encumbrances.

4. Statutory protections for buyers of new condominium units

4.1 Disclosure statement

4.1.1 Requirement

The *Act* provides in s. 72(1) that the declarant is obligated to deliver to a buyer a copy of the "current disclosure statement" described in ss. 72(3)–(6). This applies to new residential, commercial, industrial, and retail condominiums. Under s. 72(2) of the *Act*, a purchase agreement for a new condominium unit is not binding on a buyer until the current disclosure statement is delivered to the buyer. A buyer of a new condominium unit who never receives a current disclosure statement can treat the agreement of purchase and sale as not being binding right up until final closing, when the buyer gets title to the unit.

A second protection for buyers of new condominium units is the statutory rescission right under s. 73. A buyer can rescind the agreement within 10 days of receipt of a disclosure statement without any obligation to provide any reason for so doing and is entitled to a refund of all moneys paid to the developer. The *Act* states in s. 73(2) that the 10-day time period commences on the later of the date of receipt by the buyer of a proper disclosure statement and the date the agreement of purchase and sale is fully executed.

4.1.2 Contents

Subsection 72(3) of the *Act* sets out what the disclosure statement must contain. Some of the mandatory contents are as follows:

- table of contents that complies with s. 72(4);
- name and municipal address of the declarant and the mailing address of the property;
- general description of the property, including types and numbers of units, building and recreational and other amenities, together with all conditions applying to the provision of such amenities;
- statement indicating whether the property, or part of it, is or may be subject to the *Ontario New Home Warranties Plan Act (ONHWPA)*;
- portion of the units which the declarant intends to market in blocks of units to investors;
- statement of the portion of units (to the nearest anticipated 25%) that the declarant intends to lease;
- if construction of the amenities is not completed, a schedule of the proposed commencement and completion dates;
- copy of the proposed declaration, by-laws, rules, and insurance trust agreement;
- brief description of the significant features of any agreements described in ss. 111–114 of the *Act* and all agreements or proposed agreements between the condominium corporation and any other corporation; and
- budget statement for the one-year period immediately following the registration of the condominium plan.

Under s. 72(6) of the *Act*, the following additional information is required to be inserted in the budget statement referred to in s. 72(3):

- common expenses of the condominium corporation;
- proposed amount of each expense of the corporation, including the cost of the reserve fund study required for the year and the cost of a performance audit of the common elements under s. 44 of the *Act*;
- particulars of the type, frequency, and level of the services to be provided;
- statement of the projected monthly common expense contribution for each type of unit;
- portion of common expenses to be paid into a reserve fund;
- status of any pending lawsuits material to the property of which the declarant has actual knowledge;
- amounts of all current or expected fees, charges, rents, or other revenue to be paid to or by the corporation or by any of the owners for the use of the common elements or other facilities related to the property;
- services not included in the budget but which the declarant provides, expenses that the declarant pays that might reasonably be expected to become a common expense, and the projected common expense contribution attributable to each of those services or expenses for each type of unit;
- projected amounts in all reserve funds at the end of the current fiscal year; and
- summary of the most recent reserve fund study, if any.

Case law has developed around the issue of what constitutes full and accurate disclosure under the *Act*. If buyers can establish to the satisfaction of a judge that material information is missing or misstated in the disclosure statement and that they would likely not have gone ahead with the transaction but would have rescinded the agreement within the 10-day time period had the correct information been provided, they may be entitled to treat the contract as non-binding. The onus is on the buyer to establish in court that the missing or misstated information is "material."

There is also a right of the buyer in s. 74(6) to rescind an agreement of purchase and sale within 10 days of receipt of a revised disclosure statement or notice where there has been a material change Subsection 74(2) of the *Act* sets out the definition of a material change. A buyer may, after receiving a revised disclosure statement or a notice, make an application under s. 74(5) for a determination as to whether a change or a series of changes in the disclosure statement or notice constitute a "material change."

A declarant has a corresponding right under s. 74(8) to make an application to court, within 10 days of receiving a notice of rescission under s. 74(6), for a determination as to whether the change or the series of changes on which the buyer's rescission is based constitutes a "material change," if the buyer has not himself or herself already made an application for such a determination under s. 74(5).

4.2 The two-stage closing

Most sale agreements for new residential condominium units in Ontario require a two-stage closing procedure.

In the first stage, the buyer is required to take possession of the purchased units on the "interim" closing date. On the interim closing, the buyer will pay to the seller the balance of the "down payment" portion of the purchase price (that is, the purchase price minus the buyer's intended mortgage amount and less the deposit moneys the buyer has paid). Some closing documents are usually

exchanged between the buyer and seller at this time, such as an "interim occupancy agreement," an interim statement of adjustments, and post-dated cheques for the monthly occupancy payments. Keys are released at this stage, but title cannot yet be transferred.

The period of time between the interim closing date and the final closing date is usually called the "interim occupancy period." It can be anywhere from two to 18 months in duration. The rights and obligations of the parties to an interim occupancy agreement are regulated by s. 80 of the *Act*.

The second stage of the closing occurs after the condominium has been registered in the land titles office. At this "final closing," payment to the seller is completed, title is transferred to the buyer, and further documents, including a status certificate, will be exchanged between the parties. The occupancy agreement from the interim closing terminates when the final closing is completed.

Why is the two-stage closing procedure required? As discussed previously, every condominium plan begins with the registration of the condominium's declaration and description in the land titles office. The approval and registration of the proposed declaration and description by the local land registrar cannot commence until all the units in the proposed building have reached a degree of construction (set forth in the regulations) that will render them ready for occupancy. Therefore, the trigger for the interim closing date will occur when the building is ready for occupancy. The trigger for the final closing date will subsequently occur when the declaration and description have been approved and registered. The delay between the two stages takes place while the declaration and description pass through the approval process and the units are prepared for electronic registration.

4.3 Statutory protections during the interim occupancy period

Under s. 81(1) of the *Act*, moneys paid by the buyer of a new condominium unit (a "proposed unit") to the declarant as part of the purchase price must be held in trust by a trustee of a prescribed class or by the declarant's solicitor. Deposits paid on account of upgrades for fixtures now constitute trust moneys, provided those upgrades were sold by the declarant. The declarant must provide each buyer with notice of receipt of each and every deposit, specifying the bank address and account number where the moneys are held. This must be provided to the buyer within 10 days of each deposit cheque being cashed.

These moneys are to be held in trust until they can be disbursed under s. 81(7) to the declarant after the buyer has acquired title or to whichever party is entitled to these moneys in the event the transaction is not completed. Prescribed security, being a deposit receipt under the *ONHWPA* for the first $20,000 of the purchase price or an insurance policy, can be obtained pursuant to s. 81(7), in which case the moneys may be disbursed from trust.

Under s. 82 of the *Act*, buyers will receive interest at the prescribed rate on purchase moneys paid to the declarant from the date that the moneys are paid until the date of the interim occupancy closing.

Under s. 80(4) of the *Act*, the declarant is entitled to charge the buyer of a new unit a monthly occupancy fee commencing on the date of interim occupancy, which is not to be greater than the total of

- where applicable, interest at the prescribed rate calculated on a monthly basis on the unpaid balance of the purchase price;
- an amount reasonably estimated on a monthly basis for the municipal taxes attributable to the unit being purchased; and
- the projected monthly common expense contribution for the unit.

Under s. 80(3), notwithstanding any provision to the contrary in an agreement of purchase and sale, the buyer may, during the 10-day cooling off period provided for under s. 73(2), elect to pay in full on the date of interim occupancy closing the balance of the purchase price remaining, after deducting the amounts paid by the buyer under the agreement of purchase and sale prior to taking occupancy. In this way, buyers can, if they wish and if they have the financial ability to do so, reduce or eliminate the first component of the monthly interim occupancy fee that the declarant can charge to the buyer.

4.4 Industrial, office, and retail condominium transactions

The disclosure requirements, trust provisions, buyers' entitlement to interest on purchase moneys up until interim occupancy closing, and ceiling on interim occupancy charges apply not only to new residential unit purchases but also to non-residential new unit purchases.

5. Resale residential transactions

The OREA form of agreement of purchase and sale for resale residential condominium transactions (Appendix A) includes a number of clauses dealing with condominium-specific issues.

One of the most important differences in a resale residential transaction is that the protections afforded to buyers of new units under ss. 72–75 and 80–82 do not apply to resale transactions. Since the condominium project has already been registered, there is in a resale

transaction only one closing and no interim occupancy period.

It is important for the solicitor acting for the buyer to understand how a resale condominium transaction operates so that the buyer's solicitor can take the proper steps to protect the client. A solicitor for a prospective buyer can help the buyer by reviewing the agreement of purchase and sale prior to its execution and by reviewing a status certificate at the outset.

5.1 The status certificate

Among a resale buyer's greatest concerns will be the financial status of the condominium corporation. If a condominium corporation has a poor financial outlook, a buyer can expect significant future increases in common expenses, the possibility of a special assessment against all unit owners, and perhaps a declining market value due to deteriorating physical conditions. A poor financial status may be a sign of poor management or of major structural issues with the building.

Under s. 76 of the *Act*, the condominium corporation is obligated to provide a status certificate to a person who requests one. Subsection 76(1) sets out in clauses (a)–(s) the information to be contained in the status certificate. In resale transactions, the status certificate serves as an important substitute for the statutory disclosure requirements provided to new unit buyers.

Effective September 1, 2011, the statutory forms of status certificate and of most other forms made under the *Act* and the *Regulations* are being published on the Ontario Government website and will no longer be set out in the *Regulations*.

5.1.1 Making the transaction conditional

The status certificate is a comprehensive form of disclosure and therefore an excellent source of reliable financial information for the buyer. Without the statutory protections afforded to new unit buyers in ss. 72–74, a resale unit buyer must rely on a detailed review of a status certificate by the buyer's solicitor as an alternative means of protecting the buyer's interests.

It is important for buyers' and mortgagees' lawyers to review these status certificates with their clients prior to closing, so that the client is aware of the contents of the status certificate and agrees to close the transaction with knowledge of its contents.

A solicitor consulted by a resale condominium buyer before the buyer submits an offer to purchase a unit should verify in most circumstances that a condition precedent has been added to the agreement, by which the agreement is conditional for, typically, 12 business days upon the buyer receiving a status certificate from the condominium corporation and upon the buyer's solicitor being satisfied with the contents thereof. It has become commonplace for real estate agents to include such a condition precedent in the agreements they prepare.

The status certificate can then be reviewed with the client before the transaction becomes binding. The certificate will contain information that may confirm or contradict representations made by the seller in paras. 13 and 15 of the resale condominium agreement of purchase and sale, as well as show legal and financial information not disclosed previously. Such information may be sufficient to deter the buyer from proceeding with the transaction. In appropriate circumstances, conditional transactions can in this way be terminated for cause at their outset.

5.1.2 Reserve fund status

Under s. 94 of the *Act* and Part IV of O. Reg. 48/01, condominium corporations must at regular intervals obtain reserve fund studies and act on them once received. These studies are typically performed by engineers. A reserve fund study examines in detail and attempts to predict the financial status of the condominium corporation over the ensuing several years, based in part on the physical condition of the building. Details of the most recent reserve fund study are included with the status certificate and should be reviewed with the client.

Boards of directors of condominium corporations are required within 120 days of receiving a reserve fund study to review it and to propose and send to unit owners a plan for the future funding of the reserve fund so as to ensure that the study will adequately serve the purpose for which it was done. These plans must also be disclosed in the status certificate and reviewed with the client.

A status certificate must state the amount in the reserve fund within the past 90 days (not just the figure appearing in the most recent financial statements, which may be a year or more out of date).

5.1.3 Other financial disclosure

In addition to containing information about the reserve fund, the status certificate includes information such as

- whether there are arrears of common expenses for the unit in question;
- whether the board of directors has increased the common expenses for the unit since the date of the budget for the corporation for the current fiscal year and the reason for such increase;
- whether the board of directors has levied any special assessments against units in the project to increase

the contribution to the reserve fund and the reason for the special assessment; and

- whether there are any legal actions to which the condominium corporation is a party, the amounts involved, and their status;
- whether there are any judgments against the condominium corporation.

Where a legal action based in tort is disclosed, it is imperative to ascertain whether the condominium corporation is insured for the claim, since such claims potentially involve substantial liability.

The condominium corporation is also obligated to provide

- a copy of the budget of the condominium corporation for the current fiscal year;
- the last annual audited financial statements for the condominium corporation;
- the auditor's report on the financial statements;
- copies of the current declaration, by-laws, and rules; and
- a copy of a certificate or memorandum of insurance for each of the current insurance policies held by the condominium corporation.

APPENDIX A
Agreement of Purchase and Sale — Condominium Resale

OREA Ontario Real Estate Association

Agreement of Purchase and Sale
Condominium Resale

Form 101
for use in the Province of Ontario

This Agreement of Purchase and Sale dated this..... day of ..... 20.....

BUYER,.....(Full legal names of all Buyers)....., agrees to purchase from

SELLER,.....(Full legal names of all Sellers)....., the following

PROPERTY:

a unit in the condominium property located at.....

in the.....being

Unit No. ..... Level No. ..... Condominium Plan No. .....

Building No. ..... known as .....(Apartment/Townhouse/Suite/Unit)..... No. ..... together with ownership

or exclusive use of Parking Space(s) .....(Number(s), Level(s))....., together with ownership or exclusive use of

Locker(s) .....(Number(s), Level(s))....., together with Seller's proportionate undivided tenancy-in-common interest in the common elements appurtenant to the Unit as described in the Declaration and Description including the exclusive right to use such other parts of the common elements appurtenant to the Unit as may be specified in the Declaration and Description: the Unit, the proportionate interest in the common elements appurtenant thereto, and the exclusive use portions of the common elements, being herein called the "Property".

PURCHASE PRICE: Dollars (CDN$).....

.....Dollars

DEPOSIT: Buyer submits .....(Herewith/Upon Acceptance/as otherwise described in this Agreement)

..... Dollars (CDN$).....

by negotiable cheque payable to..... "Deposit Holder" to be held in trust pending completion or other termination of this Agreement and to be credited toward the Purchase Price on completion. For the purposes of this Agreement, "Upon Acceptance" shall mean that the Buyer is required to deliver the deposit to the Deposit Holder within 24 hours of the acceptance of this Agreement. The parties to this Agreement hereby acknowledge that, unless otherwise provided for in this Agreement, the Deposit Holder shall place the deposit in trust in the Deposit Holder's non-interest bearing Real Estate Trust Account and no interest shall be earned, received or paid on the deposit.

Buyer agrees to pay the balance as more particularly set out in Schedule A attached.

SCHEDULE(S) A.....**attached hereto form(s) part of this Agreement.**

1. **IRREVOCABILITY:** This Offer shall be irrevocable by .....(Seller/Buyer)..... until ..... a.m./p.m. on the ..... day of ..... 20....., after which time, if not accepted, this Offer shall be null and void and the deposit shall be returned to the Buyer in full without interest.

2. **COMPLETION DATE:** This Agreement shall be completed by no later than 6:00 p.m. on the ..... day of ....., 20..... . Upon completion, vacant possession of the Property shall be given to the Buyer unless otherwise provided for in this Agreement.

INITIALS OF BUYER(S): ( ) **INITIALS OF SELLER(S):** ( )

3. **NOTICES:** The Seller hereby appoints the Listing Brokerage as agent for the Seller for the purpose of giving and receiving notices pursuant to this Agreement. Where a Brokerage (Buyer's Brokerage) has entered into a representation agreement with the Buyer, the Buyer hereby appoints the Buyer's Brokerage as agent for the purpose of giving and receiving notices pursuant to this Agreement. **Where a Brokerage represents both the Seller and the Buyer (multiple representation), the Brokerage shall not be appointed or authorized to be agent for either the Buyer or the Seller for the purpose of giving and receiving notices.** Any notice relating hereto or provided for herein shall be in writing. In addition to any provision contained herein and in any Schedule hereto, this offer, any counter-offer, notice of acceptance thereof or any notice to be given or received pursuant to this Agreement or any Schedule hereto (any of them, "Document") shall be deemed given and received when delivered personally or hand delivered to the Address for Service provided in the Acknowledgement below, or where a facsimile number or email address is provided herein, when transmitted electronically to that facsimile number or email address, respectively, in which case, the signature(s) of the party (parties) shall be deemed to be original.

FAX No.: ..... (For delivery of Documents to Seller) FAX No.: ..... (For delivery of Documents to Buyer)

Email Address: ..... (For delivery of Documents to Seller) Email Address: ..... (For delivery of Documents to Buyer)

4. **CHATTELS INCLUDED:**.....
.....
.....
.....
.....
.....

Unless otherwise stated in this Agreement or any Schedule hereto, Seller agrees to convey all fixtures and chattels included in the Purchase Price free from all liens, encumbrances or claims affecting the said fixtures and chattels.

5. **FIXTURES EXCLUDED:**.....
.....
.....
.....
.....
.....

6. **RENTAL ITEMS:** The following equipment is rented and **not** included in the Purchase Price. The Buyer agrees to assume the rental contract(s), if assumable: .....
.....

7. **COMMON EXPENSES:** Seller warrants to Buyer that the common expenses presently payable to the Condominium Corporation in respect of the Property are approximately $.....per month, which amount includes the following:.....
.....

8. **PARKING AND LOCKERS:** Parking and Lockers are as described above or assigned as follows:.....
..... at an additional cost of:.....

9. **HST:** If the sale of the Property (Real Property as described above) is subject to Harmonized Sales Tax (HST), then such tax shall be ..... (included in/in addition to) the Purchase Price. If the sale of the Property is not subject to HST, Seller agrees to certify on or before closing, that the sale of the Property is not subject to HST. Any HST on chattels, if applicable, is not included in the purchase price.

INITIALS OF BUYER(S): **INITIALS OF SELLER(S):**

10. **TITLE SEARCH:** Buyer shall be allowed until 6:00 p.m. on the ..... day of....., 20....., (Requisition Date) to examine the title to the Property at Buyer's own expense and until the earlier of: (i) thirty days from the later of the Requisition Date or the date on which the conditions in this Agreement are fulfilled or otherwise waived or; (ii) five days prior to completion, to satisfy Buyer that there are no outstanding work orders or deficiency notices affecting the Property, and that its present use (.....) may be lawfully continued. If within that time any valid objection to title or to any outstanding work order or deficiency notice, or to the fact the said present use may not lawfully be continued, is made in writing to Seller and which Seller is unable or unwilling to remove, remedy or satisfy or obtain insurance save and except against risk of fire (Title Insurance) in favour of the Buyer and any mortgagee, (with all related costs at the expense of the Seller), and which Buyer will not waive, this Agreement notwithstanding any intermediate acts or negotiations in respect of such objections, shall be at an end and all monies paid shall be returned without interest or deduction and Seller, Listing Brokerage and Co-operating Brokerage shall not be liable for any costs or damages. Save as to any valid objection so made by such day and except for any objection going to the root of the title, Buyer shall be conclusively deemed to have accepted Seller's title to the Property. Seller hereby consents to the municipality or other governmental agencies releasing to Buyer details of all outstanding work orders and deficiency notices affecting the Property, and Seller agrees to execute and deliver such further authorizations in this regard as Buyer may reasonably require.

11. **TITLE:** Buyer agrees to accept title to the Property subject to all rights and easements registered against title for the supply and installation of telephone services, electricity, gas, sewers, water, television cable facilities and other related services; provided that title to the Property is otherwise good and free from all encumbrances except: (a) as herein expressly provided; (b) any registered restrictions, conditions or covenants that run with the land provided such have been complied with; (c) the provisions of the Condominium Act and its Regulations and the terms, conditions and provisions of the Declaration, Description and By-laws, Occupancy Standards By-laws, including the Common Element Rules and other Rules and Regulations; and (d) any existing municipal agreements, zoning by-laws and/or regulations and utilities or service contracts.

12. **CLOSING ARRANGEMENTS:** Where each of the Seller and Buyer retain a lawyer to complete the Agreement of Purchase and Sale of the Property, and where the transaction will be completed by electronic registration pursuant to Part III of the Land Registration Reform Act, R.S.O. 1990, Chapter L4 and the Electronic Registration Act, S.O. 1991, Chapter 44, and any amendments thereto, the Seller and Buyer acknowledge and agree that the exchange of closing funds, non-registrable documents and other items (the "Requisite Deliveries") and the release thereof to the Seller and Buyer will (a) not occur at the same time as the registration of the transfer/deed (and any other documents intended to be registered in connection with the completion of this transaction) and (b) be subject to conditions whereby the lawyer(s) receiving any of the Requisite Deliveries will be required to hold same in trust and not release same except in accordance with the terms of a document registration agreement between the said lawyers. The Seller and Buyer irrevocably instruct the said lawyers to be bound by the document registration agreement which is recommended from time to time by the Law Society of Upper Canada. Unless otherwise agreed to by the lawyers, such exchange of the Requisite Deliveries will occur in the applicable Land Titles Office or such other location agreeable to both lawyers.

13. **STATUS CERTIFICATE AND MANAGEMENT OF CONDOMINIUM:** Seller represents and warrants to Buyer that there are no special assessments contemplated by the Condominium Corporation, and there are no legal actions pending by or against or contemplated by the Condominium Corporation. The Seller consents to a request by the Buyer or the Buyer's authorized representative for a Status Certificate from the Condominium Corporation. Buyer acknowledges that the Condominium Corporation may have entered into a Management Agreement for the management of the condominium property.

14. **DOCUMENTS AND DISCHARGE:** Buyer shall not call for the production of any title deed, abstract, survey or other evidence of title to the Property except such as are in the possession or control of Seller. Seller agrees to deliver to Buyer, if it is possible without incurring any costs in so doing, copies of all current condominium documentation of the Condominium Corporation, including the Declaration, Description, By-laws, Common Element Rules and Regulations and the most recent financial statements of the Condominium Corporation. If a discharge of any Charge/Mortgage held by a corporation incorporated pursuant to the Trust And Loan Companies Act (Canada), Chartered Bank, Trust Company, Credit Union, Caisse Populaire or Insurance Company and which is not to be assumed by Buyer on completion, is not available in registrable form on completion, Buyer agrees to accept Seller's lawyer's personal undertaking to obtain, out of the closing funds, a discharge in registrable form and to register same, or cause same to be registered, on title within a reasonable period of time after completion, provided that on or before completion Seller shall provide to Buyer a mortgage statement prepared by the mortgagee setting out the balance required to obtain the discharge, and, where a real-time electronic cleared funds transfer system is not being used, a direction executed by Seller directing payment to the mortgagee of the amount required to obtain the discharge out of the balance due on completion.

15. **MEETINGS:** Seller represents and warrants to Buyer that at the time of the acceptance of this Offer the Seller has not received a notice convening a special or general meeting of the Condominium Corporation respecting; (a) the termination of the government of the condominium property; (b) any substantial alteration in or substantial addition to the common elements or the renovation thereof; OR (c) any substantial change in the assets or liabilities of the Condominium Corporation; and Seller covenants that if Seller receives any such notice prior to the date of completion Seller shall forthwith notify Buyer in writing and Buyer may thereupon at Buyer's option declare this Agreement to be null and void and all monies paid by Buyer shall be refunded without interest or deduction.

INITIALS OF BUYER(S): ( ) **INITIALS OF SELLER(S):** ( )

16. **INSPECTION:** Buyer acknowledges having had the opportunity to inspect the Property and understands that upon acceptance of this offer there shall be a binding agreement of purchase and sale between Buyer and Seller. **The Buyer acknowledges having the opportunity to include a requirement for a property inspection report in this Agreement and agrees that except as may be specifically provided for in this Agreement, the Buyer will not be obtaining a property inspection or property inspection report regarding the Property.**

17. **APPROVAL OF THE AGREEMENT:** In the event that consent to this sale is required to be given by the Condominium Corporation or the Board of Directors, the Seller will apply forthwith for the requisite consent, and if such consent is refused, then this Agreement shall be null and void and the deposit monies paid hereunder shall be refunded without interest or other penalty to the Buyer.

18. **INSURANCE:** The Unit and all other things being purchased shall be and remain at the risk of the Seller until completion. In the event of substantial damage to the Property Buyer may at Buyer's option either permit the proceeds of insurance to be used for repair of such damage in accordance with the provisions of the Insurance Trust Agreement, or terminate this Agreement and all deposit monies paid by Buyer hereunder shall be refunded without interest or deduction. If Seller is taking back a Charge/Mortgage, or Buyer is assuming a Charge/Mortgage, Buyer shall supply Seller with reasonable evidence of adequate insurance to protect Seller's or other mortgagee's interest on completion.

19. **DOCUMENT PREPARATION:** The Transfer/Deed shall, save for the Land Transfer Tax Affidavit, be prepared in registrable form at the expense of Seller, and any Charge/Mortgage to be given back by the Buyer to Seller at the expense of the Buyer.

20. **RESIDENCY:** Buyer shall be credited towards the Purchase Price with the amount, if any, necessary for Buyer to pay to the Minister of National Revenue to satisfy Buyer's liability in respect of tax payable by Seller under the non-residency provisions of the Income Tax Act by reason of this sale. Buyer shall not claim such credit if Seller delivers on completion the prescribed certificate or a statutory declaration that Seller is not then a non-resident of Canada.

21. **ADJUSTMENTS:** Common Expenses; realty taxes, including local improvement rates; mortgage interest; rentals; unmetered public or private utilities and fuel where billed to the Unit and not the Condominium Corporation; are to be apportioned and allowed to the day of completion, the day of completion itself to be apportioned to the Buyer. There shall be no adjustment for the Seller's share of any assets or liabilities of the Condominium Corporation including any reserve or contingency fund to which Seller may have contributed prior to the date of completion.

22. **PROPERTY ASSESSMENT:** The Buyer and Seller hereby acknowledge that the Province of Ontario has implemented current value assessment and properties may be re-assessed on an annual basis. The Buyer and Seller agree that no claim will be made against the Buyer or Seller, or any Brokerage, Broker or Salesperson, for any changes in property tax as a result of a re-assessment of the Property, save and except any property taxes that accrued prior to the completion of this transaction.

23. **TIME LIMITS:** Time shall in all respects be of the essence hereof provided that the time for doing or completing of any matter provided for herein may be extended or abridged by an agreement in writing signed by Seller and Buyer or by their respective lawyers who may be specifically authorized in that regard.

24. **TENDER:** Any tender of documents or money hereunder may be made upon Seller or Buyer or their respective lawyers on the day set for completion. Money may be tendered with funds drawn on a lawyer's trust account in the form of a bank draft, certified cheque or wire transfer using the Large Value Transfer System.

25. **FAMILY LAW ACT:** Seller warrants that spousal consent is not necessary to this transaction under the provisions of the Family Law Act, R.S.O. 1990 unless Seller's spouse has executed the consent hereinafter provided.

26. **UFFI**: Seller represents and warrants to Buyer that during the time Seller has owned the Property, Seller has not caused any building on the Property to be insulated with insulation containing ureaformaldehyde, and that to the best of Seller's knowledge no building on the Property contains or has ever contained insulation that contains ureaformaldehyde. This warranty shall survive and not merge on the completion of this transaction, and if the building is part of a multiple unit building, this warranty shall only apply to that part of the building which is the subject of this transaction.

27. **LEGAL, ACCOUNTING AND ENVIRONMENTAL ADVICE:** The parties acknowledge that any information provided by the brokerage is not legal, tax or environmental advice.

28. **CONSUMER REPORTS: The Buyer is hereby notified that a consumer report containing credit and/or personal information may be referred to in connection with this transaction.**

29. **AGREEMENT IN WRITING:** If there is conflict or discrepancy between any provision added to this Agreement (including any Schedule attached hereto) and any provision in the standard pre-set portion hereof, the added provision shall supersede the standard pre-set provision to the extent of such conflict or discrepancy. This Agreement including any Schedule attached hereto, shall constitute the entire Agreement between Buyer and Seller. There is no representation, warranty, collateral agreement or condition, which affects this Agreement other than as expressed herein. For the purposes of this Agreement, Seller means vendor and Buyer means purchaser. This Agreement shall be read with all changes of gender or number required by the context.

30. **TIME AND DATE:** Any reference to a time and date in this Agreement shall mean the time and date where the Property is located.

INITIALS OF BUYER(S): ( ) **INITIALS OF SELLER(S):** ( )

31. **SUCCESSORS AND ASSIGNS:** The heirs, executors, administrators, successors and assigns of the undersigned are bound by the terms herein.

SIGNED, SEALED AND DELIVERED in the presence of: IN WITNESS whereof I have hereunto set my hand and seal:

.....
(Witness) (Buyer) (Seal) DATE.....

.....
(Witness) (Buyer) (Seal) DATE.....

I, the Undersigned Seller, agree to the above Offer. I hereby irrevocably instruct my lawyer to pay directly to the brokerage(s) with whom I have agreed to pay commission, the unpaid balance of the commission together with applicable Harmonized Sales Tax (and any other taxes as may hereafter be applicable), from the proceeds of the sale prior to any payment to the undersigned on completion, as advised by the brokerage(s) to my lawyer.

SIGNED, SEALED AND DELIVERED in the presence of: IN WITNESS whereof I have hereunto set my hand and seal:

.....
(Witness) (Seller) (Seal) DATE.....

.....
(Witness) (Seller) (Seal) DATE.....

SPOUSAL CONSENT: The Undersigned Spouse of the Seller hereby consents to the disposition evidenced herein pursuant to the provisions of the Family Law Act, R.S.O.1990, and hereby agrees with the Buyer that he/she will execute all necessary or incidental documents to give full force and effect to the sale evidenced herein.

.....
(Witness) (Spouse) (Seal) DATE.....

CONFIRMATION OF ACCEPTANCE: Notwithstanding anything contained herein to the contrary, I confirm this Agreement with all changes both typed and written was finally accepted by all parties at.....a.m./p.m. this.....day of....., 20..... . .....
(Signature of Seller or Buyer)

INFORMATION ON BROKERAGE(S)

Listing Brokerage..... Tel.No.(.....).....
.....

Co-op/Buyer Brokerage..... Tel.No.(.....).....
.....

ACKNOWLEDGEMENT

I acknowledge receipt of my signed copy of this accepted Agreement of Purchase and Sale and I authorize the Brokerage to forward a copy to my lawyer.

..... DATE.....
(Seller)

..... DATE.....
(Seller)

Address for Service.....
.....Tel.No.(.....).....
Seller's Lawyer.....
Address.....
(.....)..... (.....).....
Tel.No. FAX No.

I acknowledge receipt of my signed copy of this accepted Agreement of Purchase and Sale and I authorize the Brokerage to forward a copy to my lawyer.

..... DATE.....
(Buyer)

..... DATE.....
(Buyer)

Address for Service.....
.....Tel.No.(.....).....
Buyer's Lawyer.....
Address.....
(.....)..... (.....).....
Tel.No. FAX No.

Property Manager:.....
(Name) (Address) (Tel No.,FAX No.)

FOR OFFICE USE ONLY

COMMISSION TRUST AGREEMENT

To: Co-operating Brokerage shown on the foregoing Agreement of Purchase and Sale:
In consideration for the Co-operating Brokerage procuring the foregoing Agreement of Purchase and Sale, I hereby declare that all moneys received or receivable by me in connection with the Transaction as contemplated in the MLS® Rules and Regulations of my Real Estate Board shall be receivable and held in trust. This agreement shall constitute a Commission Trust Agreement as defined in the MLS® Rules and shall be subject to and governed by the MLS® Rules pertaining to Commission Trust.

DATED as of the date and time of the acceptance of the foregoing Agreement of Purchase and Sale. Acknowledged by:

.....
(Authorized to bind the Listing Brokerage)

.....
(Authorized to bind the Co-operating Brokerage)

This Schedule is attached to and forms part of the Agreement of Purchase and Sale between:

BUYER,....., and

SELLER,.....

for the purchase and sale of .....

..... dated the ..... day of ....., 20..... .

Buyer agrees to pay the balance as follows:

This form must be initialed by all parties to the Agreement of Purchase and Sale.

INITIALS OF BUYER(S): ( ) **INITIALS OF SELLER(S):** ( )

Chapter 58
Estate conveyancing

When an owner of real property dies, there are numerous special conveyancing problems that may arise. These are dealt with in this chapter.

1. Preliminary concerns

1.1 Proof of death

Prior to dealing with lands of a person who is now deceased, proof of death is required. The best proof of death is a death certificate issued by the Office of the Registrar General under the *Vital Statistics Act*. The certificate issued by the funeral home that handled the funeral arrangements is also generally accepted as proof of death.

If the death is recited in a document that is more than 20 years old and there is no issue as to its veracity, the recital could also be used as proof of death (*Vendors and Purchasers Act*, s. 1). Production of a certificate of appointment of estate trustee with a will or without a will (formerly called a grant of probate) is also is evidence of proof of death.

1.2 Proof of ownership

A subsearch of the registered title will confirm the identity of the owners and the nature of the ownership immediately prior to the death.

1.3 Spousal rights

1.3.1 Dower

If a married man died prior to March 31, 1978, the widow may have been entitled to a dower right in the lands where the deceased husband, during marriage, owned the legal estate. Dower rights used to be an important matter in estate conveyancing.

The *Family Law Reform Act, 1978* abolished the widow's common-law right of dower but did not abolish any dower rights that had vested prior to March 31, 1978.

1.3.2 Family Law Reform Act, 1978

Under the *Family Law Reform Act, 1978*, the rights under Part III (matrimonial home) are for the benefit of a spouse. However, a spouse ceased to be a spouse on the death of the other spouse. This would make the provisions of Part III inapplicable because the widow or the widower would no longer be considered a "spouse" within the meaning of the *Family Law Reform Act, 1978*. This applies to deceased spouses who died from and including March 31, 1978, to but not including March 1, 1986.

1.3.3 Family Law Act

Where the deceased died on or after March 1, 1986, and the lands that form part of the transaction constitute a matrimonial home, the provisions of the *Family Law Act* (*FLA*) must be considered. "Matrimonial home" is defined in s. 18. In most cases, a matrimonial home is a property in which a person has an interest and that is ordinarily occupied by the person and his or her spouse as their family residence.

In the context of estate conveyancing, the *FLA* is only of concern if the deceased at the time of his or her death was a spouse and if the lands constituted a matrimonial home. If the *FLA* applies, the transaction may be affected in one or more of the following three circumstances:

(a) Deemed severance of a joint tenancy

The effect of s. 26(1) of the *FLA* is that immediately before the time of death, a joint tenancy is severed and becomes a tenancy in common that would devolve as either a testacy or intestacy unless one of the following statements can be made:

- The deceased and one of the surviving joint tenants were spouses of each other when the deceased died.
- The deceased was not a spouse at the time the deceased died.
- The property was not a matrimonial home of the deceased within the meaning of Part II of the *FLA* at the time the deceased died.

(b) Right to occupy matrimonial home

Subsection 26(2) of the *FLA* allows a surviving spouse to live in the matrimonial home rent-free for 60 days after the deceased spouse's death. If the closing of a sale by the deceased before the date of death is within 60 days following the date of death of the deceased, the property may be subject to this right of possession.

(c) Surviving spousal right of election

Section 6 of the *FLA* provides for extensive rights on the part of the surviving spouse to make certain elections. Until the provisions dealing with the spousal right of election have been dealt with, no distribution of the deceased's estate may be made (*FLA*, ss. 6(14)–(15) and

(19)). The prohibition against distribution in s. 6 does not prohibit the sale of the property of the deceased.

There are two instances where the sale of property may constitute a distribution. Pursuant to the provisions of s. 17 of the *Estates Administration Act* (*EAA*) the personal representative may sell for the purpose of distributing the proceeds among persons beneficially entitled or may sell for the purpose of distribution of the real property to or among persons beneficially entitled. In either of those situations, there would be a distribution, in which event the following considerations and requirements would apply:

- if the conveyance takes place within six months after death:
  - evidence that the deceased had no surviving spouse;
  - a court order authorizing such conveyance; or
  - the consent of the surviving spouse; and
- if the conveyance takes place six or more months after the time of death:
  - evidence that the deceased had no surviving spouse;
  - a court order issued authorizing the transaction;
  - satisfactory evidence that no election has been made and no application under Part I of the *FLA* has been received;
  - where an application has been made under said Part I, the consent of such applicant (presumably the surviving spouse); or
  - satisfactory evidence that an election has been filed, what that election is, and that there is no application under Part I of the *FLA* by the surviving spouse.

1.4 Proof of other rights affecting the property

1.4.1 Creditors' rights

If the deceased has been engaged in business, the personal representative should advertise for creditors of the deceased.

1.4.2 Rights of children born outside marriage — Estates Administration Act, s. 24

The appropriate inquiries and searches should be made to discover the identity of any such persons.

1.5 Land transfer tax on a conveyance to a beneficiary

Generally, there is no land transfer tax payable where the property is conveyed from the personal representative of a deceased person to a person beneficially entitled, provided no money or other consideration is paid by the beneficiary. This would not be the case in the event there is a sale to a third party who is not a person beneficially entitled (the sale is to a *bona fide* purchaser for value.) In those circumstances, land transfer tax would be payable on the full value of the consideration.

1.6 Electronic registration — the lawyer's duty to obtain and retain documents

Electronic Registration, O. Reg. 19/99, made under the *Land Registration Reform Act*, sets out both the general and specific requirements for electronic registration. While compliance with law statements made by solicitors via electronic registration replace many of the affidavits, certificates, and other supporting evidence that were registered before electronic registration came into being, this does not mean that such affidavits, certificates, or other supporting documents are no longer required as part of a transaction. It is fundamental that solicitors continue to ensure that all required affidavits, certificates, and other supporting documentary evidence are completed prior to a solicitor making any compliance with law statements and that they retain all such documents in the solicitor's file in the event that any compliance with law statements are questioned or challenged in the future.

1.7 Forms

There are now effectively two sets of land registration forms, consisting of electronic forms within the meaning of s. 17 of the *Land Registration Reform Act* and non-electronic forms under *Procedures and Records*, R.R.O. 1990, Reg. 690. For most purposes, the substance of the electronic forms and of the corresponding non-electronic (paper) forms are the same. In this chapter, the legal requirements of the various estate conveyancing procedures will not distinguish between the two sets of forms.

As of September 1, 2011, all forms under Reg. 690 have been transferred to the Ontario Government website pursuant to O. Reg. 430/11.

2. Joint tenancy

When a joint tenant dies, the real property vests automatically in the surviving joint tenant(s) by operation of law, subject to the requirements of s. 123 of the *Land Titles Act* and s. 26(1) of the *FLA*.

Under the electronic registration system, in addition to the information to be provided in the other sections of O. Reg. 19/99, s. 13 of that *Regulation* also requires that a survivorship application contain the following:

- the name of the deceased joint tenant;
- proof of death of the deceased satisfactory to the land registrar; and
- a statement by the applicant that the land affected by the application is not subject to any spousal right under the *FLA* with respect to the deceased.

Note also that under s. 62(3) of the *Land Titles Act*, where title is registered in the names of two or more trustees and one of them dies, the trustees are deemed to have held title as joint tenants unless specifically stated otherwise in the transfer to them.

2.1 Registry system

Under the *Registry Act*, satisfactory evidence of death of the deceased joint tenant would be required. Any affidavits or declarations as to death or death certificates must be deposited on title by attaching them to a Form 4 (Document General) and by reciting the registration number thereof in a recital included in a schedule attached to a Form 1 (Transfer/Deed of Land).

Where there is actual notice that a joint tenancy has been severed (for example, only one joint tenant mortgaging his or her undivided interest in the property), the foregoing would not apply. In such circumstances, the real property of the deceased tenant in common will devolve as a testacy or intestacy, as the case may be. In addition, please note the requirements of s. 26(1) of the *FLA*. This section applies equally to lands under the registry and land titles systems.

3. Testacy

This section deals with the conveyancing of land (except for land held as a joint tenant and not subject to s. 26(1) of the *FLA*) where a deceased person leaves a will. The land may be the subject of a specific bequest included in the will: "To deliver to my spouse all of my right, title, and interest in the lands and premises known as 9876 Main Street, Midtown, Ontario." Or the land may be included in the distribution of the residue of the estate: "To transfer and deliver the residue of my estate to my issue alive at the date of my death in equal shares per stirpes."

A will may be drafted

- as a "trust will," in which the testator devises the entire estate to the estate trustee in trust upon certain defined trusts; or
- without trusts, in which cases all bequests and other dispositions are made directly to the persons beneficially entitled.

This distinction becomes important when examining the following: first, the extent to which the powers of the estate trustee are subject to statutory provisions of the *EAA*, and second, the situations in which the consent of a beneficiary to a conveyance by the estate trustee under an express or implied power of sale is required.

3.1 Transmission applications (*Land Titles Act* only)

Whenever a deceased person has left a will dealing with the disposition of land owned by the deceased and before any transfer or sale of the land can take place, land under the *Land Titles Act* must first be transferred from the name of the deceased either

- in the case of a "trust will," to the name of the estate trustee; or
- where the will does not devise the entire estate to the estate trustee in trust and the land is bequeathed to a specific beneficiary who wishes to take title to the land or sell the land, to the beneficiary.

The applicable legislation is contained in ss. 120–122 and 124 of the *Land Titles Act*. This initial transfer is made using a transmission application. When this step is completed, the estate trustee or beneficiary will be in a position to sell or transfer the land to a third party.

It should be noted here that transmission applications are not subject to land transfer tax under the *Land Transfer Tax Act*.

3.1.1 Transmission application by an estate trustee

In addition to the statements required by other sections of O. Reg. 19/99, s. 14 of that *Regulation* also requires that a transmission application contain the following:

- the name and date of death of the owner;
- one of the following:
  - the certificate of appointment or order confirming the appointment of the applicant as estate trustee, executor, or administrator, as the case may be;
  - the date and court file number of the certificate or order; or
  - proof satisfactory to the Director of Titles that the value of the estate is less than $50,000; and
- evidence of spousal rights under the *FLA*, the sex of the deceased, the debts of the estate, the heirs of the deceased, and whatever else the Director of Titles may specify or all of the following:
  - a statement that the land affected by the application is not subject to the debts of the deceased, if that is the case; and
  - a statement that the applicant as estate trustee, executor, or administrator, as the case may be, is entitled by law to be registered as owner.

The statements to be used will depend upon the individual circumstances of each application. The solicitor acting for the estate must obtain all documentation required, including consents, certificates, and affidavits, as applicable, to support the foregoing statements and must retain them for future reference.

3.1.2 Transmission application by beneficiary

In addition to the statements required by other sections of O. Reg. 19/99, s. 15 of that *Regulation* also requires that a transmission application made by a beneficiary contain the following:

- the name and proof of death of the owner satisfactory to the land registrar; and
- evidence of spousal rights under the *FLA*, the sex of the deceased, the debts of the estate, the heirs of the deceased, and whatever else the Director of Titles may specify or all of the following:
  - a statement by the applicant that the land is not subject to any spousal right under the *FLA* with respect to the deceased;
  - a statement that the land is not subject to debts of the deceased, if that is the case; and
  - a statement that the land has vested in the applicant.

There is currently a one-time waiver of the requirement of a certificate of appointment of estate trustee if the conveyance is the first dealing with real property of any value (thus more than $50,000) after its conversion by the Ministry from the registry to the land titles system.

At this time, this is important as a possible way to save estate administration tax on the value of real property that is the only asset dealt with in a will, as well as legal fees that would otherwise be incurred in applying for a certificate of appointment of estate trustee.

The statements to be used will depend upon the individual circumstances of each application. The solicitor acting for the estate must obtain all documentation required, including consents, certificates, and affidavits, as applicable, to support the foregoing statements and must retain them for future reference.

3.2 What rights does an estate trustee have to sell the real property of the deceased?

After the land has been placed in the name of an estate trustee using a transmission application, one must examine the authority of the estate trustee acting under the will to sell the land.

3.2.1 Preliminary consideration

If the lands are under the registry system, either a certified or notarial copy of the certificate of appointment of estate trustee with a will of the deceased or the original or notarial copy of the will, together with the prescribed statements and other documents required pursuant to s. 53(1) of the *Registry Act*, will have to be registered before the land can be conveyed.

For lands under the land titles system, unless the value of the estate does not exceed $50,000 and except for the one-time waiver described above, a certified or notarial copy of the certificate of appointment of estate trustee with a will is required before the land can be conveyed. Instead of registering a copy of the actual document, the court file number on the certificate of appointment will be required in the electronic documentation.

Where the deceased dies leaving a valid will and assuming the deceased's interest in land is not as a joint tenant, the provisions of the will are paramount for conveyancing purposes.

3.2.2 Basic principles

An estate trustee may only sell real property belonging to the deceased if the estate trustee is authorized to do so.

Such authorization takes the form of a "power of sale." A power of sale must consist of one of the following:

- an express power of sale;
- an implied power of sale; or
- the statutory power of sale in s. 17 of the *EAA*.

The original principle at work was that if a person dies owning a parcel of land, the land should *prima facie* remain the property of the beneficiaries of the deceased, i.e., not be sold, unless

- the deceased in a valid will authorized the sale of the land by the estate trustee; or
- there is some other good reason for which the land should be sold.

Authorization by the deceased consists of an express or implied power of sale contained in the will of the deceased. "Express or implied power of sale" refers, generally, to language in the will that, explicitly or by implication, authorizes an estate trustee to sell the real property of the deceased.

If a will does not contain an express or implied power of sale, then the estate trustee must rely on the statutory power of sale and therefore can only sell for the purposes set out in s. 17 of the *EAA*.

Finally, consider also the situation in which automatic vesting of the land in the beneficiaries (so that the estate

trustee can no longer deal with it) occurs due to the passing of time.

For conveyancing purposes, in order to determine the authority, if any, for the estate trustee to sell the land, the following questions first need to be considered:

- Does the will contain an express power to sell?
- Alternatively, does the will contain an implied power to sell?
- Does the will devise the property of the deceased to the estate trustees upon trust (in other words, is it a "trust will"), or alternatively, was it devised directly to the beneficiaries?
- Does the will contain any specific bequests involving the land?

3.2.3 Will contains an express power of sale

Where there is an express power of sale in a will and there are no specific bequests involving the land being dealt with, the estate trustee may sell the land without the consent of any beneficiary, and a purchaser acting in good faith for value without notice will take the property free from debts.

Where there is an express power of sale in a will and the will contains a specific bequest of the land, the release of the person to whom the specific bequest was made must be obtained and registered on title. The estate trustee may then sell to a third-party purchaser as above.

3.2.4 Will contains an implied power of sale

Where there is no express power of sale contained in the will, it will be necessary to determine whether a power of sale can be implied. The two requirements set out in s. 44 of the *Trustee Act* are that the land be devised to the estate trustee (that is, the will is a "trust will") and that the land be charged with payment. When a will charges land with a payment, the implication is that the land must be sold to raise the money for the payment. In these circumstances, a power of sale will normally be implied.

If there is an implied power of sale in a will and the will also contains a specific bequest of the land, the release of the person to whom the specific bequest was made must be obtained before the estate trustee can sell. Charging land with a payment and simultaneously bequeathing it to a beneficiary seems inconsistent. The implication here is that either the beneficiary must agree to make the "payment" in return for a conveyance of the land or, alternatively, the estate trustee must first mortgage the land to raise the payment and then convey to the beneficiary subject to such mortgage.

3.2.5 Will contains no power of sale — the statutory power of sale

Many estate trustees assume incorrectly that simply by virtue of their office, they have the right to sell the property of the deceased. This is not correct. Where there is no express or implied power of sale, the estate trustee has limited rights to sell the property. Those rights consist of the statutory powers provided by s. 17(1) of the *EAA*.

These statutory powers also apply to an intestacy, since by definition there exists no express or implied power to sell in an intestacy.

The application of the statutory powers in both of these situations is discussed below under the subject of intestacy.

3.2.6 Will contains no power of sale and no devise to the estate trustee — automatic statutory vesting

When the will contains (1) no power of sale, and (2) no devise to the estate trustee (the will is not a "trust will"), the real property will vest in the persons beneficially entitled three years after the death of the deceased, unless in the interim the estate trustee has conveyed the land in compliance with the will and s. 17(1) of the *EAA*, or unless a caution is registered against the real property (*EAA*, s. 9(1)). The result of this "automatic" statutory vesting is that once it takes place, the estate (and therefore the estate trustee) no longer owns the land and can no longer convey it. When the real property has so vested, only the beneficiaries can convey it.

The automatic vesting provisions of s. 9(1) of the *EAA* apply to both testacies and intestacies as long as the two criteria stated above both apply. However, s. 9 of the *EAA* must be read in conjunction with s. 10. Case law has held that where a will provides for an express or an implied power of sale or where there has been a conveyance to the estate trustee upon trust, vesting will not occur pursuant to s. 9 since it would interfere with the estate trustee's rights under the will.

3.3 Preparation of the conveyance

3.3.1 The parties to the conveyance

When there is a power of sale or a devise to an estate trustee upon trusts (a "trust will") but no specific bequest of the land, the conveyance must be from the estate trustee and not from the beneficiary. In such a case, as seen above, there is no "automatic vesting" under s. 9(1) of the *EAA*.

If the land was specifically bequeathed to a beneficiary in the will, the release of that beneficiary must be obtained

and registered if the estate trustee wishes to convey the land to any other party.

3.3.2 Documentation for a transfer by an estate trustee

After having determined the necessary parties to the conveyance, the following should be prepared:

- certified or notarial copy of the certificate of appointment of estate trustee with a will for retention in the solicitor's file where electronic registration is in force or for registration on title where electronic registration is not in force;
- Transfer/Deed including appropriate recitals as to the following:
  - the date of death of the deceased and the interest of the deceased in the real property being conveyed;
  - the registration particulars of the certificate of appointment of estate trustee with a will; and
  - where the death occurred on or after March 1, 1986, the spousal status of the deceased at death.

Again, the solicitor acting for the estate must, when registering electronically, obtain all documentation required, including consents, certificates, and affidavits, as applicable, to support the foregoing statements, and must retain them for future reference.

4. Intestacy

When the deceased dies and does not leave a valid will, the powers of the estate trustee are found in several sections of the *EAA*, including in particular s. 17. The authority under which an estate trustee may sell land in an intestacy is otherwise similar to the testacy situation in which a deceased leaves a valid will not containing an express or implied power of sale. In both cases, there exists no power of sale other than the statutory powers. Close attention must be paid to those statutory powers to assure that a conveyance is valid. Also, as is the case with a will that does not contain a devise to an estate trustee upon trusts, automatic vesting after three years may occur (see above).

In an intestacy, for the estate trustee to exercise any of the statutory powers under the *EAA*, a certificate of appointment of estate trustee without a will from an Ontario court must be obtained. Because the powers of sale are limited by statute and depend on the purpose of the sale, it is then necessary in each case to ascertain the purpose of such sale (*EAA*, s. 17(1)).

4.1 Statutory powers: sale for the purpose of paying debts

When the estate trustee is selling for the purpose of paying debts, he or she has the right to sell within three years after the death of the deceased (or longer if a caution has been registered) without the concurrence of any beneficiaries, whether or not any of the beneficiaries are minors or mentally incapable. Under these circumstances, a purchaser for value without notice will take title free of the debts of the deceased.

The Transfer/Deed from the estate trustee will include statements that the sale is for the purpose of paying debts and as to the spousal status of the deceased. A surviving spouse will need to consent to the sale if the property is a matrimonial home. In the case of electronic registration, the solicitor for the estate must obtain all documentation required, including consents, certificates, and affidavits, as applicable, to support the foregoing statements and must retain them for future reference.

4.2 Statutory powers: sale for the purpose of distributing the proceeds among persons beneficially entitled

When the purpose of the sale occurring within three years after death (or longer if a caution has been registered) is to distribute the proceeds of sale among persons beneficially entitled, the concurrence of a majority of those beneficially entitled representing together not less than one-half of all the interests in the estate is required together with the approval of the Children's Lawyer on behalf of any minors, and the Public Guardian and Trustee acting on behalf of a mentally incapable person who has no guardian or no attorney for property pursuant to a continuing power of attorney for property under the *Substitute Decisions Act*.

If the only persons interested in the real property being sold are minors, then the proper procedure is for an application to be made under the *Children's Law Reform Act*.

When the estate has not yet been fully administered, then if some or all of the beneficiaries are minors, the Children's Lawyer may concur on their behalf under s. 17(2) of the *EAA*.

Under s. 17(2), if a beneficiary is

- a mentally incapable person who has no guardian or attorney for property;
- an adult whose consent cannot be obtained because his or her place of residence is unknown;
- an adult of whom it would be "inconvenient" to require concurrence; or

- a patient in a psychiatric facility under the *Mental Health Act* and the Public Guardian and Trustee is his or her guardian of property (under s. 17(4)),

then the Public Guardian and Trustee may concur on behalf of such person.

As a matter of practice, the Children's Lawyer or the Public Guardian and Trustee, as the case may be, must be convinced that all efforts to locate beneficiaries have been made before approving on behalf of unfound beneficiaries. With respect to mentally incapable persons, they will only approve if the consent of that mentally incapable person is required to complete the majority of the beneficiaries. With respect to those beneficiaries whose consent it would be inconvenient to obtain, as a matter of practice, they will generally only consent when a court has determined that it would in fact be inconvenient to obtain their consent.

Unless the required approvals are obtained, a purchaser will take title subject to the claims of the remaining beneficiaries as well as the debts of the deceased. It should be noted that where any of the beneficiaries are minors, mentally incapable persons, or persons under any other mental disability, different limitation periods apply depending on the circumstances. Please refer to ss. 36–39 of the *Real Property Limitations Act*. Where the required consents of the beneficiaries have been obtained, a purchaser for value without notice would get good title free of the debts of the deceased, save and except those of which the purchaser has actual notice.

Although a beneficiaries' majority and the consent of the Children's Lawyer or Public Guardian and Trustee will protect a purchaser for value without notice, the personal representative may still be liable to those beneficiaries who did not consent. For this reason, it would be advisable from the point of view of the personal representative to obtain the concurrence of all beneficiaries and, if that is not possible, to obtain a court order dispensing with the consent of those beneficiaries who for one reason or another will not consent. While the foregoing may not be of particular concern to a purchaser, it is, of course, of concern when acting for the personal representative.

4.3 Statutory powers: sales or conveyances for the purpose of distribution of the real property to or among persons beneficially entitled

The personal representative may within three years after death (or longer if a caution has been registered) convey the property directly to those beneficially entitled either with or without a court order.

4.3.1 Without a court order

When the conveyance is made without a court order, the concurrence of all persons beneficially entitled thereto together with the approvals of the Children's Lawyer on behalf of minors and the Public Guardian and Trustee on behalf of mentally incapable persons are required. However, such a conveyance does not free the property from the debts of the deceased owner (*EAA*, s. 17(8)).

As a matter of policy, the Children's Lawyer and the Public Guardian and Trustee will not consent on behalf of anybody unless there is a court order.

4.3.2 With a court order

Under s. 17(5) of the *EAA*, the personal representative, before the expiration of three years from the death of the deceased, may apply for an order dividing or distributing the estate among the persons beneficially entitled. By operation of s. 21(1), a purchaser in good faith for value from a person so beneficially entitled receives the property free of any debts of the deceased owner (except as may be specifically charged thereon other than by will).

4.4 Statutory powers: sales by persons beneficially entitled

In addition to an estate trustee selling or conveying real property within three years from the death of the deceased (or longer if a caution has been registered), pursuant to the provisions of the *EAA*, the beneficiaries may convey the property to third parties provided there are no minors involved where either

- the real property has been conveyed to them by the administrator; or
- the real property has vested in them pursuant to s. 9.

When the real property has been conveyed to the beneficiaries within the three-year period following the death of the deceased without a court order and the beneficiaries in turn have conveyed the real property to a purchaser in good faith and for value, that purchaser takes the property subject to the debts of the deceased (*EAA*, s. 17(8)(a)). The liability of the purchaser ends after the three-year period has expired unless proceedings have been instituted and a certificate of pending litigation or a caution has been registered against the real property. If a purchaser is required to pay debts, that purchaser has the right to claim relief over against the beneficiaries and in certain circumstances also against the personal representative.

If the conveyance to the beneficiaries was made pursuant to a court order, a purchaser obtaining a conveyance

from such beneficiaries takes the property free from the debts of the deceased (*EAA*, s. 21(1)).

When real property vests in the beneficiaries pursuant to s. 9(1) of the *EAA*, the real property continues to be charged with the debts of the deceased owner so long as it remains vested in such person or in any person claiming under him or her not being a purchaser in good faith and for valuable consideration. A purchaser from a person beneficially entitled in whom real property has vested pursuant to s. 9(1) would be protected by s. 23.

4.5 The conveyance by electronic registration

4.5.1 Transfer by estate trustee

In addition to the statements required by other sections of O. Reg. 19/99, s. 16 of that *Regulation* also requires that this transfer contain the following:

- a statement that the transferor is entitled to transfer the land affected by the document under the terms of the will, if any, the *EAA*, and the *Succession Law Reform Act*;
- a statement by the transferor that the land affected by the application is not subject to any spousal right under the *FLA* with respect to the deceased;
- a statement that the transferor has obtained the consent of all required parties or that no consents are required; and
- a statement that the land affected by the transfer is not subject to debts of the deceased, if that is the case.

The solicitor acting for the estate must obtain all documentation required, including consents, certificates, and affidavits, as applicable, to substantiate these statements and must retain them for future reference.

4.5.2 Transfer by beneficiary

In addition to the statements required by other sections of O. Reg. 19/99, s. 17 of that *Regulation* also requires that this transfer contain a statement that the transferee is not aware of any specific debts of the deceased (if that is the case).

4.6 The conveyance under the registry system

Subsection 5(1) of the *Land Registration Reform Act*, sets out the implied covenants of a personal representative. These implied covenants would apply to transfers made under the *Registry Act* unless they are expressly amended. In this regard, it is suggested that the first implied covenant be amended by adding the words "except as the records of the land registry office disclose" so that the first implied covenant would read as follows:

> That the transferor has not done, omitted, or permitted anything whereby the land is or may be encumbered or whereby the transferor is hindered from giving the transfer except as the records of the land registry office disclose.

Where the conveyance is by the persons beneficially entitled, the foregoing implied covenants would not apply. In their place, the usual covenants, also set out in s. 5(1) of the *Land Registration Reform Act*, would apply. After having determined the necessary parties to the conveyance and prepared the Form 1 (Transfer/Deed of Land) there should be included as a schedule all necessary recitals dealing, where applicable, with each of the following points:

- the date of death of the deceased and the interest of the deceased in the real property being conveyed;
- the registration particulars of the certificate of appointment of estate trustee with or without a will;
- the registration particulars of the certificate for registration;
- the registration particulars of the caution (if any) pursuant to s. 9 of the *EAA*;
- the spousal status of the deceased at death; and
- the purpose of the sale.

If the sale is for the purpose of paying debts, no further recital should normally be required.

If the purpose of the sale is to distribute the proceeds of sale among persons beneficially entitled, the following additional recitals should be included:

- the listing of all surviving heirs-at-law and next of kin, their relationship to the deceased, and specification as to any minors or mentally incapable persons;
- the consent and approval of the Children's Lawyer on behalf of specified minors and the Public Guardian and Trustee on behalf of mentally incapable persons;
- a statement that all debts have been paid; and
- where there is a surviving spouse, the appropriate recitals.

Where the purpose of the sale is to distribute the real property to those persons beneficially entitled, all of the foregoing recitals may be applicable and the following additional one:

- the registration particulars of the court order authorizing the distribution.

Where the sale is by the persons beneficially entitled, all of the foregoing recitals may be applicable.

From a conveyancing point of view, it is advisable to have the recitals attested to by the personal representative or by one of the beneficiaries. Accordingly, it is suggested

that a declaration or an affidavit by the person giving the conveyance be prepared and deposited and that the registration particulars of that deposit be recited in the schedule to the Transfer/Deed of Land.

5. Use of power of attorney by estate trustees

Although, generally, an estate trustee cannot appoint an attorney by power of attorney to deal with the estate of a deceased, it is possible for the estate trustee to do so in very limited circumstances. For example, if the estate trustee has negotiated and signed the agreement of purchase and sale for real property but will not be available to sign the closing documents, the estate trustee may appoint an attorney by a power of attorney to sign documents related to the sale of real property, as long as that attorney is not exercising any discretionary powers or performing any fiduciary duties on behalf of the estate trustee and is simply signing documents in an administrative capacity that requires no decision-making on the attorney's part.

The power of attorney will have to be registered on title before closing in an application containing statements to substantiate the foregoing facts.

Chapter 59
Cottage conveyancing

1. Introduction

Over the past several decades, property values in cottage areas have increased to the point where they equal or exceed values in urban areas. The characteristics of a cottage lot, from a solicitor's perspective, are however quite different from the characteristics of a fully serviced lot in an urban residential subdivision.

This chapter will highlight the major differences and describe the underlying legal issues. The matters considered in this chapter are

- Crown patent reservations and exceptions;
- survey matters;
- public highways;
- access including water access;
- navigable waterways;
- shoreline ownership;
- water systems;
- sewage systems;
- unregistered hydro easements;
- zoning issues;
- co-ownership agreements; and
- miscellaneous issues.

2. The Crown patent

Our property system assumes that land is originally owned by the Crown, after being acquired by conquest, treaty, discovery, or other recognized means. The Crown subsequently transfers the land into private ownership by letters patent.

In many instances, a cottage property is not on a registered plan of subdivision under the *Planning Act*; instead, the property's legal description still consists of part of a lot on a concession as laid out and surveyed for the purpose of the original Crown patent. Alternatively, the cottage property may be part of a registered plan of subdivision that is subject to limitations originally attached to the Crown patent.

Many early Crown patents contained few limitations. By the second quarter of the 19th century, the Crown had a considerable interest in protecting existing Crown privileges (i.e., protecting public highways, reserving profitable resources, and disposing of the remainder as farmland). In order to advise a client as to what is being purchased, it is advisable to look at the exceptions and reservations in the Crown patent.

If the Crown patent has been registered, the title searcher should review it. If not, the searcher should at least confirm the date of issuance of the Crown patent and the name of the patentee, since the absence of a patent may mean no title.

While s. 3 of the *Real Property Limitations Act* permits adverse possession against the Crown on proving 60 years' occupation, it does not, by s. 16, apply to vacant Crown land. A second drawback is that proof of adverse possession sufficient to establish a fee simple title in the name of the owner may require a court application.

A copy of the Crown patent can be obtained from the Crown if not registered.

2.1 Exceptions and reservations

A Crown patent may exclude from a patent a specific parcel of land retained by the Crown. In addition, the Crown patent may contain a reservation, which is a privilege retained by the Crown in land transferred by patent.

The most common exclusions are for public or colonization roads crossing the land at the date of the Crown patent. A "colonization road" is a highway laid out by the Crown surveyors to provide access to an area being opened up for settlement. In some cases, the Crown also excluded a strip of land along the edge of a waterway; this should not be confused with an original shore road allowance shown on an original Crown survey, which is outside the lot and concession to which the Crown patent refers.

The most common reservations are the free use of navigable waters; the right of access to the shore for all vessels, boats, and persons; mines and minerals; timber and trees; the right to use 66 feet from the water's edge for fishery purposes; the right to float saw logs and build dams and similar works; and the right to take a percentage (usually 5% to 10%) of the property for a road without compensation, plus materials for road construction. Many of these reservations obviously relate to the main commercial activities of the 19th century.

2.2 Mining and forests

The underlying purpose of the *Mining Act* is to regulate and encourage extraction of minerals, not to protect

landowners. The *Act* allows prospectors to stake claims on any land in Ontario where the Crown holds mineral rights. A prospector can enter onto such land without permission and stake claims, which can easily encompass entire parcels of land containing cottages. The prospector is required to notify the landowner before taking physical steps to explore the claim and can then immediately bring equipment onto the land and begin working. Thousands of new claims are staked every year in Ontario. There is much more to know about the process, but suffice it to say that it is fundamental that the solicitor be aware of the consequences of the reservation of mining rights by the Crown and advise the client accordingly in appropriate situations.

Generally, unless the Crown patent was issued under the *Mining Act* or the mining rights were disposed of beforehand, the reservation of mines and minerals in a patent issued before May 6th, 1913, is void by statute.

There are many properties for which Crown patents were issued under the *Mining Act*. Some of these conveyed the surface rights only, reserving the mining rights to the Crown. Others included the sub-surface rights, subject to forfeiture to the Crown if the annual mining tax is not paid.

As to other Crown rights, most reservations of trees are now void by statute. The right to take land without compensation can be very significant, if five percent of a 100-acre lot includes the client's entire two-acre parcel. Some of these reservations can be released on application to the Crown.

3. Survey matters

Just as the Crown patent should be examined, so should the available survey information, and in the case of an entire township lot, this is the original Crown survey held by the Surveyor General's Office, with copies available in some registry offices. The limits of the land to be conveyed are often defined by original road allowances between lots and concessions and original shore road allowances along waterways. These are original allowances only if shown on the original Crown surveys. Crown surveys often show colonization roads and portages (the public right to which is protected by s. 65(4) of the *Public Lands Act*).

More recent plans of survey sometimes commence at different township lot corners and result in overlaps or gaps when they meet. Natural boundaries, monuments, and lines of occupation, such as fences, are more important in determining the correct legal boundary of a property than the measurements and bearings in a land description. The improvement of surveying techniques over rough terrain frequently results in a different set of bearings and distances from one point to another, but if the points are the same, then the boundary is the same.

4. Public highways

The public highways of the province came into existence by statute and common law. Those that existed before January 1, 2003, include all original road allowances, all colonization roads, all roads dedicated on subdivision plans, all lands expropriated for highway purposes, and all lands dedicated by transfer or acquiescence of the owner to public use and accepted by municipal or public action. Those created after that date are established by by-law, made by Crown surveyors, or shown on a registered plan of subdivision. The Crown owns the highways in unorganized (unincorporated) townships.

At common law, the public has a paramount right of passage along every public highway. This right cannot be interfered with except by the clearest legislation unequivocally expressed. By s. 35 of the *Municipal Act, 2001*, municipalities may pass by-laws to remove or restrict this right. The general rule is therefore "once a highway always a highway," until it is properly closed or such a by-law is enacted. The case law indicates that it requires clear action to create a highway and even clearer action to close one. Unused highways do not lose their status by abandonment. They are also not subject to adverse possession, unless one can prove 60 years' possession prior to 1913.

There is a difference between the status of a piece of land as a highway and the obligation of a public body to maintain the surface. Until a municipality has assumed responsibility for maintaining the surface, it has no obligation to maintain any of the many highways that it owns. Subsections 31(4)–(5) of the *Municipal Act, 2001* make this clear.

Contractors build cottages that produce the best views and install wells and sewage systems where the soil is best suited. It is, therefore, common to find that part of a residence or a sewage system is actually on an original road allowance that has never been improved for travel. That road allowance is owned by the municipality; it can require the structure to be removed, and the general public has every right to travel along the road allowance. A mortgagee may refuse to advance funds where the main building encroaches onto the road allowance.

A solicitor must discuss with the client the survey information, the location of road allowances if there is an encroachment, the advisability of further survey work, and the availability of title insurance. Always bear in mind that title insurance compensates for monetary loss but may not resolve an actual legal problem. The client's input from inspection of the property is as important as

the solicitor's input. It should be clear from this alone that the purchase of cottage property without a recent survey is inadvisable.

Many municipalities are prepared to close and sell road allowances or at least lease or license the area of the encroachment to the neighbouring owner. By ss. 66–67 of the *Municipal Act, 2001*, a private property owner may terminate the paramount public right of passage over an adjacent unopened original road allowance on meeting specific criteria, and those criteria are strictly interpreted by the courts. Note that portions of a highway that are under water, while they can be closed, cannot be transferred into private ownership without the approval of the Ministry of Natural Resources.

There are road allowances that are used for access to property but are not maintained by the municipality. Municipal permission is necessary before doing any work to improve the surface, and the improvement is available to the general public, not just the person who paid for it. Even if the surface is brought up to municipal standards, the municipality has no obligation to assume the responsibility for maintenance.

Where a municipality has assumed responsibility for maintenance, it cannot abandon that obligation. It is obliged to maintain the state of repair to an extent sufficient to serve the actual use made of the highway by the public—from year-round, high-quality maintenance to the spreading of a load of gravel every few years. Most municipalities will advise on request whether the subject property abuts a municipally maintained public highway and whether maintenance is seasonal (no snowplowing) or year-round. Some official plans or zoning by-laws do not permit further development unless the property abuts a year-round maintained highway. The purchaser's intentions, as expressed in the agreement of purchase and sale, should be checked against the highway access available.

There are a number of highways that have existed and have been publicly maintained for decades but that have not been recorded as municipally owned in the registry office. These "trespass roads" are nevertheless public highways, although there is often a question as to their actual width. Identifying the highway boundary is critical to a determination of whether the purchaser's property actually abuts the highway (a question of access) and whether the vendor will retain some land between the property sold and the highway edge (a potential contravention of the *Planning Act*). These problems are solved by quit claiming the full width of the trespass road to the municipality.

Every title is subject to any existing public highway, whether or not recorded on the title.

5. Access

The best way to determine access to a property is to examine plans of survey, the municipal zoning maps, Teranet maps, and the maps issued by various government ministries, including the Ontario Base Maps.

The best means of access to a property is by a maintained public highway. The fact that the highway abuts is not guaranteed access, as many levels of government require an entrance permit in order to physically access a highway. If a proposed entrance is in a location that might cause a traffic hazard, a permit may be refused.

The following are various means of gaining access to such properties.

5.1 Roads across Crown land

Part II of the *Public Lands Act* provides for certain public rights of passage over Crown land. If there is a parcel of Crown land between the subject property and the nearest municipal highway, there may be an existing developed road access across the Crown land. It is Crown policy that the road is available for use by the general public, including nearby property owners. Upon application, the Crown can issue a work permit that allows a person to make improvements to the surface at that person's own expense. The improvements then belong to the Crown and are available to the public.

5.2 Right of way

A right of way is a particular type of easement over one property for the purpose of access to another property. It may arise by express transfer, by implication, or by operation of law such as prescription. The right of way may expressly limit when or how it may be used. Care must be taken to ensure that the easement has not been overburdened, by either using it for a purpose not permitted by the transfer or extending it to serve a property to which it is not appurtenant.

Where the only access to a property is across a right of way, the existence of such right of way must be verified, preferably with an up-to-date survey and a careful examination of land registry office records. Purported access across apparently public property such as a beach may in fact not exist if the beach is privately owned, and in such a case, obtaining a right of way may be prohibitively expensive. Title insurance may protect the purchaser in respect of right of way access issues, but this must be verified with the title insurer and by reviewing the insurance policy.

There may be a right of way several kilometres in length from a series of lots around a lake to the nearest travelled public highway. The longer the right of way and the larger the number of users, the more likely that there is a cottage road association that collects money from users to improve, maintain, and repair the surface. Enquiries should be made of the vendor. If there is no such group, surface maintenance (including winter snow removal) can become a problem. In addition, purchasers of cottages located on roads not maintained by the municipality should be advised to obtain liability insurance. One possible source of such insurance is the Federation of Ontario Cottagers' Associations.

5.3 The Road Access Act

The *Road Access Act* defines an "access road" as a strip of land that has been used for the purpose of vehicular access to the property. It also defines a "common road" as an access road upon which public money has been spent. By definition, neither an access road nor a common road can be a public highway. The access road must have been established with the permission or acquiescence of the owner of the underlying property in the first place.

No person may obstruct an access road or a common road without a court order. The judge may grant the order if the closure is reasonably necessary to prevent substantial injury or damage to the owner's interests or if the person using the access or common road has no legal right to do so. A person having the use of an access road has not acquired any interest in the underlying land but is simply not a trespasser. There is, therefore, no interest that a vendor can convey to a purchaser. The privilege is also strictly limited to vehicular access and not pedestrian access or access on horseback.

The Ontario Court of Appeal in the recent case of *992275 Ontario Inc. v. Krawczyk* considered access roads and orders to close such roads. Among its many rulings, the court held that a finding that a road is an access road does not give persons whose properties are served by the road a legal right to use it within the meaning of s. 3(1)(b) of the *Road Access Act*.

5.4 Unopened road allowances and subdivision roads

The municipality may, on application, permit the improvement of the surface of an unopened road allowance so that it can serve as access to a property. Municipalities are reluctant to do this except over short distances with easy access onto a maintained highway. The improvement is available for use by any member of the public.

Occasionally, although a subdivision road is owned by a municipality pursuant to s. 57 of the *Surveys Act*, it is not maintained. The municipality again may permit the improvement of the surface; although if the subdivision road will serve a significant number of properties, the municipality may require upgrade to full municipal standards as a local improvement charged against all of the lots abutting the road.

5.5 Water access

All island properties and many shoreline properties with no adjacent right of way, access road, or highway gain access by water. Most larger lakes have marinas, which provide parking and boat launching facilities.

Some municipal planning regimes permit the establishment of a waterfront landing, basically a parking area and dock, on smaller parcels of land that are not suitable for other development and that abut highways. Others permit boat launching from original road allowances that lead to water. Several have policies that prohibit the use of public docks as water access facilities for private properties. Enquiries should be made from the vendor, the marina (if any), and the municipality to determine what is permitted locally and what is available.

6. Navigable waters

A navigable waterway is one that is capable of being traversed by small craft, whether for recreational or commercial purposes, or which is used to float logs, log rafts, and booms. Most lakes, rivers, and many streams are therefore navigable. The Crown owns the bed of every navigable waterway (with a few statutory exceptions). The public has a paramount public right of navigation over every such waterway that can only be interfered with by the clearest legislation. The federal government has jurisdiction over navigation under the Canadian Constitution.

The responsibility for determining whether a particular waterway is navigable is usually left to a surveyor. As navigability is a question of fact, in many cases there is no resolution without litigation.

The bed of a waterway is the land normally covered by water. Plans of survey often show the high water mark or the low water mark, but these terms were adapted from English law on tidal waters, and Ontario's waterways are not considered tidal. The surveyor's job is to determine, from the examination of the shoreline, the normal level of the water when the original Crown survey was prepared. The water's edge is the limit of the bed. The shore is the area between high and low water, so for non-tidal waterways, it is the line of the water's edge.

The water's edge is also the legal limit of the ownership of the adjacent dry land, whether it be in private ownership, an original shore road allowance, or a beach in public ownership. If the water's edge moves imperceptibly from year to year, adding dry land by way of accretion or removing it by way of erosion, then the legal boundary moves as well. A property owner on an eroding shoreline is losing property, because the other boundaries of that property do not move in concert with the water's edge.

If the water's edge moves suddenly, as a result of a heavy storm water flow, shoreline construction, or the raising of the water level by the installation of a dam on the waterway, this does not change the legal boundary of the bed of the waterway or of the adjacent dry land property. Where property in private ownership has been flooded in this fashion, although it remains in private ownership, it becomes subject to the paramount public right of navigation.

A water lot is a parcel of land in the bed of a waterway that the Crown has patented into private ownership. While the private owner has all the usual rights of ownership, those rights are subject to a number of other rights that take priority, including the paramount public right of navigation, riparian rights, and various statutory privileges.

Shoreline structures, such as boathouses and docks, are usually located mostly on the bed of the waterway and therefore on Crown land. The Crown has generally tolerated this, sometimes requiring that the adjacent land owner obtain a lease, licence, or land-use permit for the privilege. Where a shoreline structure has been in place for more than 60 years, an application can be made for quit claim letters patent of the footprint of the structure that sits on the bed.

The bed of a waterway that is not navigable is in private ownership. If a stream is a property boundary, then unless the land description indicates otherwise, the adjacent owners on either side own the land to the middle thread of the channel.

Before any construction can take place at the water's edge or on the bed of a waterway, it is necessary to obtain approvals from the Ministry of Natural Resources as owner, the Department of Fisheries and Oceans as to protection of fish habitat, the Coast Guard as to navigation hazards, and of course, the local municipality as to zoning and building requirements.

7. Shoreline ownership

Where a property owner's land extends to the water's edge, that owner has certain additional rights and privileges normally referred to as riparian rights. It is necessary that the ownership touch the water, so that if there is an unopened original shore road allowance or a Crown reserve of land between private property and the water's edge, the private property owner would not enjoy riparian rights.

An owner's riparian rights include

- the right of access to the water;
- the right of drainage into the water;
- the right to receive the flow undiminished from properties upstream and to use the flow to power equipment;
- the right not to have the water polluted;
- the right to use the water (without materially reducing the flow); and
- the right to accretion of land from silt washing downstream.

These rights are not often litigated, but droughts and pollution spills will bring them to the fore.

If there is an original shore road allowance that has not been closed, the municipality is the riparian owner. The adjacent private property owner has the right to cross the road allowance (using the paramount public right of passage) but not the right to erect shoreline structures nor the right to pipe water across the road allowance from the waterway without municipal permission. For these reasons, as well as for privacy, many cottage owners decide to apply to close and purchase the road allowance in front of their properties. If there is already public use of the road allowance in the form of a travelled road or a public beach, there is virtually no chance of closing the road allowance.

Where the water's edge recedes gradually from its original high water mark over many years, resulting in a growing parcel of land where the water used to be (a process known as "accretion"), the issue will also arise as to who owns the accreted land. The considerations in adjudicating the consequent conflicting claims were illustrated in a decision of the Alberta Court of Appeal in *Andriet v. County of Strathcona*.

Properties adjacent to rivers may also be subject to flood plain regulations. Engineers have determined the extent to which the river would flood in the worst storm that could be statistically predicted in a 100-year period. From this, the flood plain, which would be under water in such a storm and the flood fringe, which would be less seriously affected but nevertheless very wet, are determined. The results are incorporated in local municipal zoning by-laws and should therefore be discovered by the zoning search. Existing structures on the flood plain are usually permitted to continue but new

construction must take place above a certain elevation. A surveyor can establish where this elevation is on the property, prior to any construction.

The Crown and certain hydro electric companies have reserved flooding rights, up to a specified elevation, along some waterways. Since such flooding can take place without compensation, it should be determined whether the present water level is the flood level (most likely) or whether flooding to the permitted level might further affect the client's property. A surveyor's assistance is essential.

8. Water systems

Cottage properties are normally served by wells or by drawing water from a nearby waterway. If a well is installed by a professional, that person must be licensed by the Ministry of the Environment and must send to the Ministry a report showing the recovery rate (how quickly the well replenishes water). A copy may be obtained on enquiry. Private owners may also install their own wells, in which case there is no record at the Ministry.

The issues related to any water source are quantity and quality. Note that title insurance will generally not provide coverage for potability, capacity, or quality issues.

Water quantity is a function of the user's habits (showers, lawn watering, appliances, etc.). Quantity is usually not an issue if water is taken from a nearby waterway for private use only. However, quantity will be an issue if the water source is a well. In such cases, purchasers are advised to include before the agreement of purchase and sale becomes firm and binding an appropriate condition precedent in the agreement of purchase and sale so that a professional inspection of the well can be made to assure that there is sufficient water flow.

Water quality is a question of bacterial content and chemical content. One problem to watch for is cross-contamination between a septic system and a well on the same property. Purchasers should always include a condition precedent in the agreement of purchase and sale regarding the obtaining of a satisfactory water quality test from an authorized laboratory. Water samples can be submitted to the local public health laboratory for testing. Coliform bacteria are often found in wells, particularly if animals and birds leave faeces near the well. The well can be sanitized with bleach and then retested, but purchasers should be aware that this procedure may only conceal the quality issue temporarily.

The presence of toxic chemicals requires a test at a private laboratory. A distinct colour or residue in the water is often a chemical problem. A well located near a road may be contaminated by road salt and other chemicals. Lake water can also show bacteria and chemicals, although tests may vary as contaminants are moved by wind and currents.

9. Septic systems

9.1 Terminology

A septic system (also known as a septage system or a small sewage system) is a private, small (limited to a maximum of 10,000 litres per day), subsurface sewage disposal system, located entirely inside the boundaries of the single parcel of land that it serves. It generally services a single family residence such as a cottage that does not have access to a municipal sewer system.

The definition of "sewage system" in the *Building Code*, O. Reg. 350/06, made under the *Building Code Act, 1992*, is all-encompassing, including:

- a chemical toilet, an incinerating toilet, a recirculating toilet, a self-contained portable toilet, all forms of privy, and a composting toilet system;
- a *greywater* system;
- a cesspool;
- a *leaching bed* system; and
- a system that requires or uses a *holding tank* for the retention of *hauled sewage*.

Italicized words are further defined in the *Building Code*.

9.2 Jurisdiction

Jurisdiction over septic systems has varied. The Environmental Protection Act applied from 1974 to 1998. Enforcement has passed from public health units to the Ministry of the Environment and now back to municipalities or persons under contract to municipalities pursuant to the *Building Code Act, 1992*.

Information on approvals for small septic systems can be obtained from municipal building departments. In unorganized (unincorporated) areas of northern, central, and eastern Ontario, much of the land is Crown land, under the jurisdiction of the Ontario Ministry of Natural Resources (MNR) on behalf of the Crown. The MNR may sell or lease parcels in these areas and will be responsible for approvals and inspections. Other lands owned or managed by conservation authorities and other non-government organizations are also leased to cottagers under lease agreements containing specific requirements including provisions for septic systems and wells.

9.3 Licensing and inspections

Septic system contractors and subcontractors must be licensed under s. 3.3 of the *Building Code*.

Part 8 of the *Building Code* provides for mandatory maintenance inspection programs of private sewage (including septic) systems in defined areas of the province. The *Building Code* was amended by O. Reg. 315/10, made under the *Building Code Act, 1992*, to create such a mandatory program for certain areas bordering on Lake Simcoe and its watershed. It can be expected that similar mandatory requirements will in the future be imposed on other areas of the province where a threat to water quality exists. Where a cottage property is located in such an area, a compliance report should be obtained from the local municipality (often the health department) to confirm that no municipal orders or requirements are outstanding. Title insurance may also provide coverage.

9.4 Class 4 septic systems

Four classes of private sewage systems are defined in Part 8 of the *Building Code*. The most common septic systems affecting cottage and similar properties are a Class 1 pit privy and a Class 4 septic tank and tile bed.

A Class 4 system, the most common type, must be installed by a licensed installer. An initial inspection is done and a building permit is issued. The system is installed and left open for a final inspection and certification. A search should be made to ensure that a use permit or a final inspection letter was issued when the system was constructed. Records from 25 years ago and more were often filed under the installer's name, not the property description or the property owner's name, so a search may not be successful. Some records no longer exist.

The Class 4 system is said to have been designed to work for 20 to 30 years before it needs to be replaced. Many systems have successfully operated for much longer. The main issue for a purchaser is whether the system has malfunctioned in the past and whether it is presently working properly.

The tile bed part of the system is buried and can be inspected by a septic system installer using a specially designed camera. The tank can be pumped out and inspected by a licensed inspector. A visual inspection around the boundaries of the system, looking for pools of liquid and odd coloured vegetation, as well as the frequency of the necessity to pump out the septic tank may assist in determining its present operation. A tile bed over which motor vehicles, snow machines, or other heavy items have travelled or have been stored will often malfunction because the drainage tiles have been crushed.

Over time, the size of a Class 4 system has been determined by the number of bedrooms or the number of water fixtures or fixture equivalents. If a major addition was made to a small building, the adequacy of the sewage system should have been reviewed at that time and the system expanded or replaced if necessary. An addition to a dwelling does not automatically require an addition to the system, but this should be verified with the appropriate authority.

A warranty from the vendor is usually all that is available with respect to the past. A purchaser of a property containing a Class 4 system should therefore always include a condition precedent in the agreement of purchase and sale as to the completion to the buyer's sole satisfaction of an inspection and report on the system by a licensed inspector.

10. Unregistered hydro easements

Hydro One Inc., the owner and operator of the transmission lines providing electricity to many Ontario municipalities, has the right to acquire unregistered easements for its transmission lines across private property. This right is contained in s. 46 of the *Electricity Act, 1998*. Such easements normally require that no structures or major vegetation are to be installed within 15–33 feet from the centre line of the easement. In most cases, the installation of poles or wires across the property will be apparent; however, a written search should nonetheless be forwarded to the regional office of Hydro One Networks Inc. Alternatively, a search may now be performed online on the Hydro One website.

11. Zoning issues

A zoning search may reveal that the property is zoned for seasonal use. This provision is confirmation that the municipality does not supply services, including garbage collection and road maintenance, during at least part of the year. It also indicates that other services such as school bus and mail delivery are not available. While the municipality may not object if an owner decides to use a seasonally zoned property on a year-round basis, that person must be ready to find his or her own way to the nearest snowplowed road in winter. The municipality will not respond to appeals for year-round services.

As is apparent, the zoning of a property can be of critical importance to a purchaser. If an agreement of purchase and sale states that a property is zoned for all-year residential use when in fact it turns out to be seasonal, a purchaser's solicitor should immediately seek instructions from his or her client. When drafting such an agreement of purchase and sale, consider including a condition precedent requiring confirmation that the property is zoned for all-year residential use if that zoning is what the purchaser is expecting. For the foregoing reasons, when dealing with rural and cottage

properties, the use of title insurance does not obviate the need for a zoning search.

Many cottage buyers contemplate future additions or accessory structures, such as boathouses and docks. Clients should be made aware of any zoning restrictions and the impact on the existing septic system and well serving the property.

Most cottage areas have a strong aesthetic and environmental protection system in their official plans and zoning by-laws. Setbacks of 50 feet and more from the water's edge, requirements to preserve existing mature trees, and requirements of larger lot sizes for steeply sloped properties and narrow water bodies are common. Swampy areas and areas with significant fish habitat are zoned to prevent almost any construction except small docks. Conservation authorities impose regulations near significant conservation areas.

12. Co-ownership

An issue that frequently arises in connection with the estate of a deceased cottage owner is the inheritance of the family cottage by the children of the deceased. Typically the will of the deceased specifically instructs the executor to transfer the title to the cottage to the children of the deceased in equal shares, such that the children become the owners of the cottage as tenants in common, with each child owning an equal fractional interest.

This arrangement contains the seed of what might become a serious family quarrel involving issues such as the following:

- Rights of possession: Who has the right to use the cottage at any particular time, such as summer weekends?
- Carrying costs: Is each owner to pay his or her share of the property taxes, insurance premiums, utilities, maintenance, and repair costs? Who will decide what maintenance and repairs should be done? To what standard should these be done?
- Mortgages: Is an owner entitled to mortgage his or her fractional interest? If a majority of the owners wish to mortgage the cottage, should the minority be compelled to sign the mortgage as well?
- Liability: Will there be cross-indemnities among the owners in case the misfeasance of one owner exposes the others to third-party liability? Or will there be cross-indemnities in respect of carrying costs if one owner fails to pay a share of the costs?
- Death: If an owner dies, can he or she bequeath the fractional share to several beneficiaries, resulting in ever smaller multiple ownership fractions as the years pass? Will the surviving owners alternately have the right or the obligation to buy the fractional interest of the deceased?
- Events of default: What happens if one owner's fractional interest is seized by creditors or by a bankruptcy trustee? What happens if one owner's marriage ends bitterly and the spouse asserts rights of possession and ownership under the *Family Law Act*?
- Sale: If one owner wishes to sell their fractional interest, what are his or her rights? And what procedure is there for doing this?

The solution to these potential problems lies in the negotiation of a comprehensive co-ownership agreement among the owners, hopefully before the registered title of the cottage is transferred to them. Note that ideally each co-owner should have separate legal representation in the negotiation and drafting of the agreement. Such an agreement can anticipate the various issues and provide procedures by which the parties agree to resolve each such issue.

Note that these issues are not exclusive to cottage properties. Similar issues can and do arise when two or more persons together purchase investment properties and urban homes and in business associations of various kinds.

13. Miscellaneous

The following is a non-exhaustive list of additional issues that may arise:

- **Access across Aboriginal lands:** A cottage that is accessed by a road across a reserve may be the subject of an access permit issued by the Minister with a consent of the band. It does not give fishing and hunting rights on the reserve.
- **Grave sites and abandoned cemeteries:** The local municipality should be asked to accept and assume responsibility for these. Once the *Funeral, Burial and Cremation Services Act, 2002* is proclaimed (probably on July 1, 2012), a site disposition agreement will be required.
- **Old dump sites:** These must be dealt with in accordance with the *Environmental Protection Act*.
- **Old gasoline and oil tanks:** For gasoline tanks, reference should be made to the *Liquid Fuels Handling Code, 2007*. Domestic underground oil tanks must be inspected and approved pursuant to the *Fuel Oil Code*, which is referenced in O. Reg. 213/01, made under the *Technical Standards and Safety Act, 2000*. Depending on the age of the tank and whether it is in use, upgrading or removal is required. If there is any suspicion that contamination from an underground tank may exist on the property being purchased, a condition precedent requiring a satisfactory Phase 2 environmental site assessment under the *Environmental Protection Act* should be added to the agreement and the seller asked to pay part of the cost. The cost of a cleanup of such contamination

can be very expensive, and leakage onto adjacent land can result in liability claims.

- **Unorganized townships:** Although there is no municipality to collect municipal taxes, taxes are payable in any event under the *Local Roads Boards Act*, the *Education Act*, and the *Provincial Land Tax Act, 2006*.
- **Gas and oil pipelines:** The inter-provincial pipelines are regulated under the *National Energy Board Act*. No structure may be erected and no vehicle operated across a pipeline without the appropriate permission.
- **Livestock facilities:** The provincial policy statements issued under the *Planning Act* require livestock facilities, including animals and manure storage, to be protected. Residences must be more than the minimum prescribed distance from such facilities. See also the *Nutrient Management Act, 2002* and regulations.

Title insurance is often available to insure over title defects discovered; but always bear in mind that title insurance provides loss compensation, it does not necessarily resolve or repair the actual problem.

Chapter 60

Understanding a new home agreement of purchase and sale

1. Parties, property, and price

1.1 The vendor

The registered owner of the lands on which the new homes are being constructed may be the vendor itself, the subdivider of the subdivision encompassing the new housing project, or a company affiliated with the vendor or the subdivider. Where the subdivider is the registered owner but is not the vendor, the builder's agreement of purchase and sale may require the purchaser to execute an acknowledgement that the subdivider is not the vendor and will have no liability to the purchaser whatsoever with respect to the transaction.

At common law, a vendor is bound, at the very least, to prove that it is in a position to procure title to be vested in the purchaser on closing, failing which a claim for anticipatory breach of contract will arise.

Where the vendor is not the registered owner of the land, the production and delivery, on or before closing, of a good and valid Transfer/Deed of the property from the registered owner to and in favour of the vendor should be requisitioned, as well as a good and valid Transfer/Deed from the vendor to the purchaser. In the alternative, the purchaser's lawyer should ask for delivery of satisfactory evidence in the form of an acknowledgement by the registered owner that the vendor named in the agreement has the ability to procure a fee simple conveyance from the registered owner to the purchaser directly. Since most new homes are created on newly subdivided land that is registered in the land titles system, with the state of title effectively guaranteed by the Ontario government, the fact that the title covenants may flow from the registered owner as opposed to the vendor (if not one and the same party) pursuant to the *Land Registration Reform Act* does not affect the quality of title received by the purchaser.

TARION is a not-for-profit corporation established in 1976 by the Ontario government for the purpose of administering the *Ontario New Home Warranties Plan Act* (*ONHWPA*). Under the *ONHWPA*, no person shall act as a "vendor" and enter into agreements of purchase and sale and receive deposit moneys from purchasers unless the person is formally registered as such with TARION. Likewise, no person shall act as a "builder" unless such person is also formally registered with TARION on or before the issuance of a building permit in connection with the new home to be constructed. Furthermore, the proposed dwelling itself must be formally enrolled with TARION prior to the issuance of the building permit.

Accordingly, it is imperative that the purchaser's lawyer confirm that the vendor and the builder (if not one and the same party) are both registered with TARION and that the home is duly enrolled with TARION. This will ensure that the statutory safeguards afforded by the *ONHWPA* are available to the purchaser and will expedite the processing of any compensation claims subsequently made on behalf of the purchaser. This will also provide a reasonable level of comfort for purchasers in the marketplace, inasmuch as the vendor and builder will have had to pass TARION's screening process for business integrity, technical construction proficiency, competency, and financial solvency, which together should be sufficient to sustain compliance with the statutory warranties TARION automatically provides to consumers.

Homes custom built by or for an owner of land may not be eligible for enrolment under TARION, in which case no statutory warranty coverage will be provided. For example, if the owner of a vacant lot acts as its own general contractor, hires individual subcontractors to perform individual work (such as plumbing or wiring), and purports to live in the house for even a limited period of time, then there is no "builder" as defined under the *ONHWPA*, and no warranty coverage will apply. A purchaser buying such a home will have to rely on private contractual warranties that have been negotiated from the vendor in the agreement of purchase and sale.

1.2 Description of the property

Since the new home being acquired may not be erected at the time of entering into the agreement of purchase and sale, the purchaser's lawyer should ensure that both the legal description of the property being acquired and the type, size, model, and elevation of the home intended to be constructed on it are accurately reflected and identified in the agreement of purchase and sale.

The typical builder's agreement specifies the dwelling type, elevation, lot number, and civic address of the home (if available). The purchaser's lawyer should also consider confirming that the lot number set out in the agreement of purchase and sale coincides with the lot

depicted in the vendor's brochure or subdivision plan. The purchaser's lawyer should request that a sketch, survey, or copy of the proposed plan of subdivision (if not already registered) be attached to the agreement, with the specific lot highlighted and initialled by the purchaser and the vendor.

The addendum mandated by the *ONHWPA* obliges the vendor of a new home to disclose the current planning status of the land at the time the agreement is entered into. If the plan of subdivision encompassing the new home has not yet been registered but is in draft form awaiting finalization, then the purchaser or his or her lawyer may wish to make inquiries with the relevant government authorities as to the status of the draft plan of subdivision in an effort to determine whether the date scheduled for closing will realistically be met by the vendor. One should also keep in mind that s. 52(1) of the *Planning Act* prohibits the sale of land by reference to an unregistered plan of subdivision unless draft plan approval has been issued under s. 51.

1.3 Deposits

Unlike the Ontario Real Estate Association (OREA) standard form agreement of purchase and sale, the typical builder's agreement requires that all deposit moneys up to $40,000 in the case of a freehold property and $20,000 in the case of a condominium be made payable to the vendor and that all deposit moneys in excess of those figures be paid to the vendor's solicitor in trust (instead of the real estate agent in trust or the vendor's lawyer in trust) pending the completion or termination of the agreement.

The *ONHWPA* protects a purchaser's deposit on a new freehold home to a maximum of $40,000 per home. Accordingly, if the agreement provides for a deposit structure that exceeds this limit, then such excess deposit moneys will be at risk in the event the vendor fails to complete the contract and subsequently absconds with the money or becomes insolvent. Therefore, a purchaser's lawyer should amend the agreement for the purchase of a new freehold home to ensure that any deposit moneys in excess of $40,000 are payable to (and held by) the vendor's lawyer in trust, to be released only upon the final closing of the purchase and sale transaction. The vendor's registration with TARION should also be verified by the purchaser's solicitor to confirm that the first $40,000 of the deposit is insured.

The deposit protection by TARION afforded to a new condominium unit is set at a maximum of $20,000 per dwelling unit. Deposits above this amount are protected separately by the trust and excess deposit provisions of the *Condominium Act, 1998*. Specifically, pursuant to s. 81 of the *Condominium Act, 1998*, all deposit moneys paid on account of the purchase of a new condominium unit must be held in trust by a trustee of a prescribed class or by the declarant's lawyer, pending the final closing of the purchase and sale transaction or the provision of prescribed security for such deposit moneys. Further, the purchaser is entitled to any interest accruing on the deposit moneys at the rate prescribed by the *Condominium Act, 1998*.

On a final note, the aggregate of all deposits paid prior to closing should not be more than 30% of the purchase price (excluding money held in trust under s. 81 of the *Condominium Act, 1998*). Otherwise, the purchaser will cease to have the protections afforded to a "homebuyer" (as defined in s. 1(1) of the *Construction Lien Act*) and thereafter may be responsible for possible construction lien claims against the new home and be exposed to statutory holdback liabilities with respect to such claims.

1.4 Payment of the balance of the purchase price

1.4.1 "All-cash" transaction — purchaser finances without vendor's help

The typical builder's agreement provides the purchaser with the ability to pay the total purchase price by certified cheque. If the purchaser indicates an intention to pay the entire balance of the purchase price to the vendor on closing, then the purchaser's lawyer should, out of an abundance of caution, discuss with the purchaser whether the purchaser will be arranging a first mortgage loan with a lender (typically a bank or a trust company) of its own choice from which to borrow the requisite funds to close the deal with the vendor. If the purchaser has not been "pre-approved" for the amount of the mortgage, then the purchaser's lawyer should ensure that the offer to purchase is made conditional upon the purchaser successfully arranging the requisite first mortgage financing to close the purchase.

The purchaser's pre-approval by their own mortgagee is all the more important because the typical builder's agreement obliges the purchaser to deliver to the vendor a copy of a binding mortgage commitment for at least 75% of the purchase price of the home (or other reasonably satisfactory evidence of the purchaser's ability to finance 75% of the purchase price) within a specified number of days after the date of the agreement of purchase and sale, failing which the vendor may terminate the agreement of purchase and sale or, in some cases, require the purchaser to arrange alternate financing for any shortfall below the 75% threshold.

1.4.2 Mortgage assumption transaction — purchaser finances with vendor's help

The builder may have arranged a loan facility having attractive terms with an institutional lender and encompassing its entire project. Builders use such financing facilities as a marketing attraction. Purchasers who qualify will have the option of financing their purchase through this facility.

The financing may be completed at the closing in one of two ways:

- The purchaser assumes at closing an existing first mortgage already given by the builder to the lender.
- Alternatively, a new first mortgage signed by the purchaser is registered by the lender at closing.

Depending on the market, a vendor/builder can negotiate favourable mortgage terms and rates from a bank or other lender for such "take-out loans" or "take-out mortgages" to be given or assumed by its home purchasers, reflecting a bulk discount or saving resulting from reduced mortgage inspection, appraisal, and/or approval fees and related disbursements.

Because the lender is designated by the vendor, the vendor wants to maintain much more control over the mortgage approval process of the purchaser, since it has a vested interest in ensuring that the purchaser will have the money available to close the deal. For example, consider the following circumstances:

- The purchaser fails to secure mortgage approval from the lending institution designated by the vendor.
- The mortgagee cancels its initial approval of the purchaser because of a subsequent change in the purchaser's financial circumstances.

If a purchaser's mortgage application is declined by a financial institution, the purchaser might have second thoughts about completing the deal. While the typical builder's agreement only allows the vendor to terminate the agreement (or work out a mutually satisfactory arrangement), many builders' standard forms of offer allow the vendor to force the purchaser to complete the transaction and have the purchaser give a short-term (e.g., one year) vendor take-back mortgage to the vendor. This allows the vendor to close the deal and retain all of the deposit moneys and cash balance due on closing. If and when the purchaser, who is now the owner of the property, subsequently defaults on the vendor take-back mortgage, the vendor, as mortgagee under the vendor take-back mortgage, can sell the home under power of sale proceedings. The vendor should be able to collect all the money owed under the vendor take-back mortgage, which typically ranges between 75% and 90% of the sale price of the property, provided that housing prices don't drop significantly in the period between the date of closing and the date of the subsequent mortgage default.

One of the purchaser's primary concerns when contemplating the giving or assumption of a mortgage at closing will be the interest rate charged. The typical builder's agreement sets the interest rate on an assumed mortgage at a rate to be established by the mortgagee some time prior to closing (usually 30 days). The purchaser's lawyer should consider "capping" the mortgage interest rate to protect the purchaser from the uncertainty of rising rates, particularly in the new home scenario where the closing date is often many months away.

The typical builder's agreement attempts to discourage the purchaser from subsequently making its own financing arrangements once the purchaser has agreed to give or assume the vendor's arranged mortgage. This is accomplished by making the vendor's consent to any such arrangements a prerequisite and presumably by compelling the purchaser to pay and/or reimburse the vendor for its estimated administrative and legal costs associated with arranging such mortgage financing to facilitate the closing. To maintain the maximum financial flexibility in favour of the purchaser, such provisions should be revised accordingly or perhaps deleted in favour of the purchaser arranging its own financing.

1.4.3 The Harmonized Sales Tax new housing rebate

(a) Availability of new housing tax rebates

The Goods and Services Tax (GST) and Harmonized Sales Tax (HST) new housing rebates discussed in this section are available to the purchaser only in the case of new housing that will be the primary residence of the purchaser or of a relation of the purchaser. (A relation is an individual related by blood, marriage, common-law partnership, or adoption. Blood relation is limited to parents, children, other descendants, or siblings. Marriage relation includes a spouse or a person who is connected to the spouse by blood or adoption. For purposes of the GST/HST new housing rebate only, a relation can also be a former spouse or a former common-law partner.) Purchasers of investment properties and second homes (such as cottages) will not qualify for the rebates if the new home is not intended to be the primary place of residence of the purchaser or a close relative.

In addition, a residential landlord purchasing a newly constructed residential building for rental purposes may be eligible to claim the "new residential rental property (NRRP) rebate" for some of the *federal* part of the HST.

The CRA has published a guide (Guide RC4231, "GST/HST New Residential Rental Property Rebate"), which contains complete details as to the availability and limitations of this rebate.

(b) Goods and Services Tax up to June 30, 2010

Since the inception of the GST under the *Excise Tax Act* in 1991, the sale price of every new home in Ontario has been subject to GST.

As part of the original legislation, the federal government implemented a purchaser rebate program to reduce the GST payable under the *Excise Tax Act* on the purchase of new housing priced at less than $450,000.

(c) Harmonized Sales Tax after June 30, 2010

The Province of Ontario has implemented the HST, which consists of two separate components: the federal GST and the province's Retail Sales Tax (RST). The Ontario legislation creating the HST is found in the province's omnibus budget bill at S.O. 2009, c. 34. Because the HST actually has two components, there are now two different new housing rebates available.

As of July 1, 2010, subject to transitional rules, the sale price of every new home in Ontario is subject to HST of 13%. As with the GST, a purchaser rebate program has also been implemented to reduce the RST component payable on the purchase of new housing. For the purpose of understanding how the new tax regime functions, we need to examine its two components.

The first rebate is the existing federal GST New Housing Rebate of 36% of the GST payable (5%) on the first $350,000 of the purchase price, with the rebate declining between $350,000 and $450,000. The rebate is eliminated entirely when the price reaches $450,000. This rebate applies only to the GST component of the Ontario HST.

The second rebate is called the Ontario HST New Housing Rebate; however, despite its name, this rebate actually applies only to the Ontario RST component of the tax. This rebate consists of 75% of the 8% RST component of the HST—in other words, the rebate is 6% of the sale price of the new home. The Ontario HST rebate applies to the first $400,000 of the sale price, and therefore has a maximum amount of $24,000. In effect, then, the first $400,000 of the sale price will be subject to Ontario tax of 2%. Where the price of a new home exceeds $400,000, the Ontario rebate is a flat $24,000. Unlike the federal GST component, the RST component does not decline and then vanish after a fixed price point.

(d) The rebate process

There will be two separate rebate applications, one for each rebate, to be signed and delivered to the vendor by a qualified purchaser at closing. The closing procedures will be similar to the following:

1. The long-standing practice of the new home construction industry in Ontario has been to price new homes in their agreements of purchase and sale with the net GST included in the stated sale price. In other words, the price of the new home is stated to be net of the rebate. This practice will be retained for the RST component as well. For example, in the case of a new home priced at $300,000 before HST, the total HST applicable at 13% will be $39,000, made up of $15,000 GST (at 5%) and $24,000 RST (at 8%). The 36% GST rebate on the first $350,000 of the price reduces the net GST by $5,400 to the amount of $9,600. The 75% rebate of the RST component will reduce the net RST portion by $18,000 to a net amount of $6,000. Therefore the builder's agreement of purchase and sale will price the home at $315,600 ($300,000 plus the net taxes of $9,600 and $6,000) inclusive of HST. The agreement will state that if the purchaser does not qualify for the HST rebate, then the $315,600 sale price will be adjusted at closing by adding to it the $5,400 and $18,000 rebate amounts, resulting in a final price of $339,000.
2. The amount of consideration that will appear on the Transfer/Deed of the property from builder to purchaser will in every case be the net sale price before HST is added in. This is done because Ontario (and City of Toronto, where applicable) land transfer taxes payable on the purchase price are computed before the HST. Thus, in our example the sale price in the Transfer will be $300,000. The taxes will of course appear in the statement of adjustments and be paid at closing.
3. Builders' forms of agreement of purchase and sale typically require the purchaser to provide the following executed documents to the vendor at closing for each component of the HST:
   a. rebate application to the Canada Revenue Agency (CRA) for GST and to the Ontario Ministry of Revenue (OMR) for RST;
   b. an assignment of each rebate to the builder;
   c. a document which (1) confirms that the new home will be the purchaser's primary residence and (2) agrees to indemnify the vendor for the amounts of the rebates in case a rebate application is rejected by the CRA or OMR.

   On the basis of these documents, the purchaser pays only the net HST of $15,600 to the vendor at closing, and the vendor remits only that amount.
4. The vendor submits the signed rebate applications, assignments, and proofs of primary residence to the CRA and OMR after closing. In reliance on this, the

vendor remits only the net HST of $15,600, and the CRA does not have to issue rebate cheques.

(e) Transitional rules for HST

Harmonized Sales Tax Information Notice 4 published by the Ontario Ministry of Revenue contains seven pages of specialized and transitional rules that can be consulted when necessary, covering leased land, co-operative housing corporations, owner-built homes, and mobile and floating homes, as well as transitional tax adjustments and grandfathering aspects of the new legislation.

(f) The GST transitional rebate

The federal GST rate was reduced from 7% to 6% effective as of July 1, 2006, and further reduced to 5% effective as of January 1, 2008. Depending on (1) the amount of GST included in an agreement of purchase and sale dated before January 1, 2008, (2) the date of the agreement, and (3) the date of possession, the purchaser may qualify for a transitional GST rebate. The purchaser can apply immediately after closing for a GST transitional rebate using form GST193E available from the CRA. This of course has no application in Ontario to HST since the latter took effect only in 2010.

1.4.4 Limits on the purchaser's ability to assign the agreement

Unless the vendor is a custom-home builder constructing one house at a time, most vendors of new homes are generally involved in constructing multiple dwellings in a subdivision development project and will not want to face any competition in the marketplace for their unsold inventory of homes from an existing purchaser purporting to "flip" the purchased property to a third party prior to closing. Accordingly, restrictions on the purchaser's ability to sell its new home prior to closing (or to do so indirectly, by way of assigning the purchaser's rights and interests in the agreement of purchase and sale to a third party) invariably will be found in most builders' forms of agreement of purchase and sale. Therefore, if the purchaser has any intention of reselling the new home prior to closing, the purchaser's lawyer should attempt to have this restriction deleted or at the very least revised to permit any such assignment by the purchaser in limited circumstances.

2. New home warranties

2.1 Non-qualifying "new" homes

Certain new homes do not qualify for TARION warranty coverage. If your client is buying such a home, the purchaser should bargain for (and will have to rely on) private contractual warranties from the vendor. The following is a non-exclusive list of examples that do not qualify:

- Condominium conversions: This is an existing building which has been rebuilt into condominium units.
- Previously occupied homes: Statutory warranties do not apply to "new" dwellings that have been occupied by or rented out to tenants by the vendor/builder.
- Owner-built homes: An owner-built home is a home where the landowner owns the lot and the landowner rather than a contractor (1) exercises significant control over the construction of a new dwelling, and/or (2) is responsible for contributing one or more "essential elements" to it.
- Homes built on existing foundations: If part of the foundation (based on a fairly complex definition) of a home is pre-existing and that foundation exceeds 40% of the foundation footings as determined by linear measurements (footprint), the home will not have statutory warranty coverage.
- Modular homes: This is a complete home composed of finished sections usually built in a factory. Statutory warranty coverage applies to such a home if the assembled sections are placed on a permanent foundation that meets Part 9 of the *Building Code* and was installed by the same builder that sold the home to the purchaser.
- Mobile homes: This is a transportable, single or multi-section, self-contained home built off-site. Statutory warranty coverage applies if the mobile home is placed on a permanent foundation that meets Part 9 of the *Building Code* and was installed by the same builder that sold the home to the purchaser.
- Seasonal homes: This is a home that does not meet the requirements of Part 9 of the *Building Code* and is therefore not built for year-round occupancy.

2.2 The TARION addendum

The TARION addendum is a statutory series of clauses and disclosures that must be included in every new house and new condominium agreement of purchase and sale.

For agreements entered into before July 1, 2008, R.R.O. 1990, Reg. 894, made under the *ONHWPA*, requires all sellers of new freehold homes to attach (or incorporate) the addendum in all agreements of purchase and sale. The addendum serves to inform the purchaser of certain contractual rights and conditions that may alter its expectations regarding the completion of the transaction and provides for certain rights in the purchaser's favour that cannot be altered by private contract. This *Regulation* also provides the rules dealing with the registration of builders and other new home sellers.

The form and content of the TARION addendum was extensively modified by O. Reg. 165/08, made under the *ONHWPA*, which took effect on July 1, 2008, and applies to all agreements entered into on and after July 1, 2008.

2.3 Confirming enrolment in the program

All builders and vendors of newly built homes have to be registered with the TARION Program, and all new homes must be enrolled (see s. 6 of the *ONHWPA* and s. 8(1) of R.R.O. 1990, Reg. 892, made under the *ONHWPA*). Builders and vendors are not automatically registered under TARION, but must pass a risk assessment based on the applicant's ratings regarding such issues as financial solvency, building experience, and technical expertise. The typical builder's agreement also indicates the TARION enrolment number for the dwelling, as well as the registration number and telephone number of the vendor/builder.

It is illegal for a builder to enter into an agreement of purchase and sale or construction contract with a purchaser if the builder is not registered with TARION. It is also illegal to begin construction of a home or condominium without first enrolling it with TARION. It is not illegal for a registered builder to sell a house from plans and later enrol it prior to construction.

Unregistered builders and unenrolled homes have been an ongoing problem for the industry. Under s. 1.3.1. of Division C of the *Building Code*, municipalities must send to TARION prescribed information on most residential building permits issued after January 1, 2011. In recent years, TARION has prosecuted hundreds of unregistered builders annually. Not surprisingly, builders who fail to register with TARION or enrol their homes in the mandatory warranty program often do not inform purchasers of their right to statutory warranty coverage. Solicitors can verify that a new home builder is registered with TARION by contacting TARION. Solicitors can also review lists of prosecuted builders and revoked licences at TARION's website or by contacting TARION.

In the case of a new home that has not been enrolled with TARION, the purchasers, upon contacting TARION themselves before or after closing, will still be entitled to the TARION warranty. However, this is not a desirable outcome for new home purchasers because by the time they discover that they are entitled to the warranty coverage, part of the warranty period may have already expired. Therefore, if the registration and enrolment number cannot be confirmed, a purchaser's lawyer should include in the agreement a condition precedent requiring the builder to produce proof of its registration with TARION and of the corresponding enrolment of the new home to ensure that the purchaser can, at a future date, make warranty claims without concerns about a builder's non-compliance with the legislation.

In addition to receiving statutory warranties, coverage by TARION is a prerequisite for the purchaser of a new home to receive the benefit of the First Time Home Buyer Land Transfer Tax Rebate offered by the Ontario Ministry of Finance. This benefit allows a first time home buyer to receive a rebate of land transfer tax of up to $2,000 from the Ministry of Finance only if the home is eligible for the TARION new home warranty. A first time home buyer purchasing a new home that has not been enrolled with TARION will not be eligible for the rebate.

2.4 Providing disclosure to the purchaser

2.4.1 Agreements entered into before July 1, 2008

The typical builder's agreement essentially recites certain key provisions of the TARION addendum from before July 1, 2008. The addendum requires the vendor/builder to disclose whether the plan of subdivision encompassing the property on which the dwelling will be erected has been registered and whether a building permit for its construction is available for issuance by the municipality. The typical builder's agreement also makes purchasers specifically aware of the following:

- There are terms and conditions in the agreement that entitle the vendor to terminate the agreement, regardless of whether the purchaser is in default.
- It is a condition of closing that any purchaser assuming a mortgage be approved by the mortgage lender designated by the vendor.
- The interest rate payable on any mortgage being assumed or given on closing may be subject to increase.
- The vendor has the right to alter the plans and specifications of the dwelling or to substitute materials, without notice.
- The purchase price may be increased or augmented by certain additional costs or charges.
- The purchaser is specifically advised to consult a lawyer before executing the agreement.

Bear in mind that the only mandatory parts of this "model" disclosure are those required by the TARION addendum.

2.4.2 Agreements entered into on and after July 1, 2008

Under O. Reg. 165/08, agreements entered into on and after July 1, 2008, must disclose by way of a new form of addendum

- whether the property is within a plan or proposed plan of subdivision;

- whether any such plan of subdivision is registered;
- if not registered, whether draft plan approval has been given;
- whether the vendor has received government confirmation that there is sufficient water supply and sewage capacity to service the property;
- whether a building permit has been issued for the property;
- whether construction has begun and, if not, when it is expected to begin.

2.5 Extensions and termination

Closing extensions are among the most contentious issues that face builders, purchasers, and their respective lawyers. The complexity and physical challenge of building construction all but guarantee that original schedules and good intentions cannot assure a timely closing. For these reasons, lawyers acting for purchasers in particular must be aware of the complex and detailed rules for closing extensions so that they can properly advise clients of their rights.

Many changes to the delayed closing warranties for freehold homes and new delayed closing warranties for condominium homes took effect on July 1, 2008. All agreements for the purchase of new houses and condominiums entered into on or after July 1, 2008, must comply with the new rules. Four new statutory addendum forms are created by the new regulations, applying to houses and condominiums. The new rules, as well as the old, are contained in Reg. 165/08.

Agreements entered into before July 1, 2008, remain subject to the old rules.

In both cases, the extension and termination rules that apply to delayed closings are incorporated into the applicable statutory addendum.

2.5.1 Agreements entered into before July 1, 2008

The old addendum statutorily restricts unilateral rights of extension by the vendor/builder and imposes reasonable notice periods before an extension can be exercised or implemented.

In general, the vendor of a new home will automatically be entitled to unilaterally extend the closing date for a period of up to 120 days. For any extensions exceeding 120 days, the addendum prescribes that the purchase and sale transaction will automatically be

- terminated, if the purchaser delivers a notice of termination within the 10 days following the Initial Extension Period (the "10-Day Window");
- extended, for up to an additional 120 days if the purchaser has not delivered the termination notice within the 10-Day Window; and
- terminated, upon the expiry of the Second Extension Period, unless the parties agree otherwise.

Barring any exempted delays, the Second Extension Period will expire 240 days after the original closing date.

There are additional extensions allowed to the vendor in cases of an "Event" (which is defined in the addendum as a strike, fire, flood, act of God, or civil insurrection). Both vendors and purchasers have the option to extend the closing date of the new home transaction by the length of any delay caused as a result of an Event.

(a) How to exempt an "Event"

For vendors: The vendor must send both of the following notices to the purchaser for the 120/240-day "clock to stop" and to establish a new closing date:

- a written notice delivered no later than 20 days following the commencement of the Event, describing the nature of the Event and estimating the length of the delay in closing caused by the Event, if reasonably ascertainable; and
- a written notice delivered as soon as possible, but no later than 20 days after the conclusion of the Event, confirming the length of the consequential delay ("Delay Period") and thereby setting a new closing date.

Not only is the original closing date extended by the length of the Delay Period, but the Delay Period does not count towards the respective 120/240-day time periods.

For purchasers: To forestall the approach of the 240th day and the automatic termination of the transaction, in those circumstances where the vendor has not attempted to "stop the clock" and crystallize the Delay Period, the purchaser must make a formal request to both the vendor and to TARION to extend the closing date as a result of the Event. This request

- may be made either during the Event itself or no later than 40 days after the conclusion of the Event;
- must describe the Event; and
- must ask for a formal extension of the original closing date.

Since the purchaser is generally not able to assess or estimate the consequential delay in the closing date caused by an Event (which often exceeds the length of the Delay Period itself), TARION is responsible for setting a new and reasonable closing date in such circumstances.

The reason for creating a purchaser's option to extend the closing date was to prevent a builder, in a rising residential market (who could profit from reselling the

house at a higher price following the termination of the original agreement of purchase and sale consequent upon the expiry of the 240-day extension), from using the Event and its resulting delay of the closing date to the vendor's own advantage and to the corresponding detriment of the original purchaser.

The purchaser's lawyer should note that if the contract has been terminated in accordance with the mechanisms described above, the vendor may also be exposed to a claim in damages if both of the following occur:

- The home has not been completed by the end of the Initial Extension Period where the purchaser delivers a notice of termination within the 10-Day Window or the home is not completed by the end of the Second Extension Period.
- There is evidence that the vendor has not taken all reasonable steps to construct the dwelling without delay.

Accordingly, the vendor's obligations would likely be found to extend to all relevant aspects of the planning, development, and construction process and to the ultimate completion of the dwelling and its conveyance to the purchaser.

(b) Notice of delayed closing and compensation for delays

As part of the 120/240-day extension regime (and the right to exempt delays caused by an Event therefrom) prescribed by the addendum, any vendor of a new home requiring an extension of the closing date of 15 days or more must provide at least 65 days' written notice to the purchaser before the originally scheduled closing date in order to establish a new/extended closing date with impunity. In addition, any vendor of a new home seeking a minor extension of the closing date of not more than 15 days must provide the purchaser with at least 35 days' prior written notice.

If the new closing date is delayed more than five days beyond the date originally fixed for closing or more than five days beyond the extended closing date following the aforementioned notice periods required to be adhered to, the purchaser is entitled to obtain reimbursement from the vendor for its direct costs and out-of-pocket expenses up to certain maximum amounts. Claimable costs and expenses generally comprise all reasonable costs actually expended in connection with the moving and storage of the purchaser's household possessions and/or in having to vacate its previous residence and up to $100 per day for living expenses but subject to a maximum of $5,000 in the aggregate. In order to receive such compensation, the purchaser must close the purchase and sale transaction with the vendor. No compensation will be paid if the delay in closing is caused by reason of an Event.

A purchaser's election to exempt an Event (and thereby extend the closing date) does not prevent the purchaser from receiving delayed closing compensation prescribed under TARION. The vendor must ensure that its notices of any delays in the closing date (including notices advising the purchaser of an Event) are sent to the purchaser in a timely manner, failing which the purchaser will be entitled to seek the appropriate compensation for delayed closing costs after the transaction has been completed.

2.5.2 Agreements entered into on or after July 1, 2008

(a) Summary of O. Reg. 165/08

O. Reg. 165/08 provides the statutory basis for the Delayed Closing Warranty that is part of every new home agreement of purchase and sale signed after June 30, 2008. Its purpose is to protect new home purchasers from the consequences of the closing delays that are commonplace and often unavoidable in the new home construction industry.

In general, O. Reg. 165/08 does the following:

- requires that the closing date be stipulated as either tentative or firm;
- limits the builder's use of conditions that provide for early termination of the agreement of purchase and sale if the builder decides not to proceed with construction;
- requires the agreement to disclose the current status of development approvals and the status of construction;
- provides for adequate notice of delays to the purchasers;
- compensates purchasers for excessive delays; and
- sets an "outside closing date" after which the purchaser has the right to terminate and to compensation.

The new addendum

- must be attached to all new home purchase agreements signed on or after July 1, 2008;
- forms part of the mandatory disclosure requirements under Reg. 165/08; and
- contains a statement of critical dates, which requires home builders, inter alia, to provide a specific closing date and to state whether the date is firm or tentative.

The mandatory legal obligations of builders and the procedures required to be followed by them to obtain closing extensions are a modified and expanded version

of the old (before July 1, 2008) rules. The new rules are fully described in TARION Builder Bulletin 46 for freehold homes and TARION Builder Bulletin 47 for condominium homes. The new rules are complex. O. Reg. 165/08, the addenda, and the statements of critical dates contain much more material than is covered here. A lawyer advising clients about closing delays for new home purchases will need to be thoroughly familiar with the structure of the new scheme and the details.

All TARION builder bulletins as well as explanatory materials and relevant statutory extracts are available on the TARION website. Builder Bulletins 46 and 47, together with the applicable mandatory addendum and related forms for each transaction, contain all of the details about which purchasers will need advice where construction delays occur.

(b) The statutory addenda and forms

Two addenda: There are two different forms of addendum that are available, depending upon the particular circumstances of each transaction: the Freehold Delayed Closing Warranty and the Condominium Delayed Closing Warranty. One of these must be included by the builder in every new home agreement of purchase and sale entered into on and after July 1, 2008.

Four Statements of Critical Dates: The form of addendum must in turn attach one of four statements of critical dates. As a result, there are actually eight different form variants, which may be summarized as follows:

1. The **Freehold Delayed Closing Warranty** (TARION Builder Bulletin 46)
   - Freehold Firm Closing Date – Statement of Critical Dates and Addendum
   - Freehold Tentative Closing Date – Statement of Critical Dates and Addendum
   - Freehold Firm Closing Date – Statement of Critical Dates and Addendum – Economic Conditions
   - Freehold Tentative Closing Date – Statement of Critical Dates and Addendum – Economic Conditions
2. The **Condominium Delayed Closing Warranty** (TARION Builder Bulletin 47)
   - Condominium Firm Closing Date – Statement of Critical Dates and Addendum
   - Condominium Tentative Closing Date – Statement of Critical Dates and Addendum
   - Condominium Firm Closing Date – Statement of Critical Dates and Addendum – Economic Conditions
   - Condominium Tentative Closing Date – Statement of Critical Dates and Addendum – Economic Conditions

Firm closing date option: For both warranties, if the builder chooses a firm closing date option, the agreement must provide three dates:

- **Specific Firm Closing Date**;
- **Outside Closing Date:** 365 days after the first date; and
- **End of the Purchaser's Termination Period:** the end of the 30-day period that the purchaser has to terminate the agreement if the home is not ready by the outside closing date.

Tentative closing date option: For both warranties, if the builder chooses the tentative closing date option, the purchaser will know from the start that the closing date is subject to change. In that case, the agreement must provide six specific dates:

- **First Tentative Closing Date**: the date of the builder's original closing estimate.
- **Notice of Delay Beyond the First Tentative Closing Date**: 90 days before the First Tentative Closing Date. This is the last date by which notice of a further delay must be given.
- **Second Tentative Closing Date**: a date 120 days after the First Tentative Closing Date. The builder can unilaterally extend closing to this second date without penalty.
- **Firm Closing Date**: a date 120 days after the Second Tentative Closing Date. This is the maximum limitation on the builder's ability to extend without setting a "Delayed Closing Date" and paying compensation.
- **Outside Closing Date**: the date that is 365 days after the Second Tentative Closing Date or the Firm Closing Date, whichever is earlier. If the house is still not finished and final closing does not take place by this outside date, the purchasers may at their option terminate the agreement, receive a full refund, and claim delayed closing compensation.
- **End of the Purchaser's Termination Period**: the end of the 30-day period that the purchaser has to terminate the agreement if the home is not ready by the Outside Closing Date.

If construction of a house is not completed by the Outside Closing Date, the purchaser may at its option terminate the agreement within 30 days after the Outside Closing Date has passed. Purchaser will then receive a full refund of all money paid, plus delayed closing compensation of up to $150 a day after the firm closing date, up to a total of $7,500.

The same compensation is available if the purchaser chooses to proceed with the agreement after the Outside

Closing Date has passed so that closing takes place after the builder has used up all of its permitted extensions.

(c) Limits on conditions precedent entitling the builder to terminate before construction begins

Before July 1, 2008, builders included a variety of conditions precedent that entitled them to terminate new home agreements for various economic reasons, some of which were vaguely defined. The new addendum limits the grounds upon which the builder may terminate the agreement unilaterally to situations such as an inability to obtain a building permit, register the subdivision plan, or complete the installation of utility services to the site.

3. New home price adjustments at closing

3.1 Generally

In addition to the customary adjustments to the purchase price provided for in the OREA form, the typical builder's agreement expands the list of adjustable items (the purchaser's exposure to charges on closing) to include some or all of the following:

- where a builder's mortgage is being assumed, mortgage insurance fees, administration fees, and interest on the unadvanced portion of any mortgage being assumed;
- water, hydro, and gas service connection fees (as well as meter installation fees);
- the TARION enrolment fee;
- estimated annual realty taxes (even where taxes have not been formally assessed or fully paid) and a deposit on account of future taxes for any supplementary assessment following closing;
- the proportionate share attributable to the subject home of any increase in the applicable development charges (including education development charges) incurred between the date of the agreement of purchase and sale and the date of building permit issuance;
- a deposit to cover potential damages or alterations occasioned to any subdivision services, municipal installations, grading, and/or drainage patterns caused by the purchaser (or by those for whom the purchaser is at law responsible); and
- disbursements incurred by the builder's lawyer for discharging existing mortgages and for the Law Society real estate insurance levy.

3.2 Realty tax adjustments

3.2.1 Assessment as vacant land

A newly constructed home should be assessed as vacant land for tax purposes until it has been used. What does this statement mean, and what is the authority for it?

Municipal governments have their own tax rates, sometimes known as the mill rate. Each tier of municipal government (regional, local, and education for example) will have its own tax rate, and these rates typically vary from year to year, usually upward, of course, over time.

In real property taxation in Ontario, the taxable amount of a real property is its market value. (Compare this for instance to income tax, where one's income is the taxable amount, or sales tax, where price is the taxable amount). Market value is determined by periodic assessments of real properties made under the *Assessment Act*. The property taxes for a parcel of real property in any year can be determined by multiplying the assessed value of the property by the applicable tax (mill) rate.

Vacant land generally will have a much lower assessment than if there were a building or other form of development on it, since obviously its market value will be less when undeveloped than after development occurs.

The definition of "vacant land" in s. 1 of O. Reg. 282/98, made under the *Assessment Act*, encompasses the following:

1. Land that has no buildings or structures on it.
2. Land upon which a building or structure is being built.
3. Land upon which a building or structure has been built if no part of the building or structure has yet been used.
4. Land upon which a building or structure has been built if the building or structure is substantially unusable.

Thus, under paras. 2 and 3, a newly constructed home can be assessed as vacant land until it has been used. Under s. 1(2), "any occupation of a building or structure is a use for the purposes of paragraph 3 of subsection (1)."

Note that the reassessment of land on this basis is not automatic. It requires an application to the municipality. In the City of Toronto, the application is brought under s. 323 of the *City of Toronto Act, 2006*. Other municipalities will have similar procedures in place.

These rules lead to two important pieces of advice that a solicitor should give to clients:

- For the purpose of understanding how builders adjust for property taxes at closing, the property will be assessed as vacant land until the closing date in most instances.
- A small home builder who buys an old home for the purpose of complete or partial demolition and reconstruction should always take the necessary steps, pursuant to the definition of "vacant land," to have the assessment for that property changed to a

vacant land assessment until the new home is built and sold, in order to reduce the property taxes that the builder will have to pay during the construction.

3.2.2 Tax adjustments under the builder's agreement

The typical builder's agreement may allow for realty taxes to be adjusted on an estimated basis as if they had been paid in full by the vendor for the calendar year in which the closing date occurs and as if the dwelling had been fully completed and separately assessed, notwithstanding that this may not be the case (i.e., even if the property was assessed only on a vacant land basis as of closing).

Alternatively, the agreement may provide for adjustment of taxes on the basis that the builder has paid the realty taxes on a vacant land basis for the entire calendar year of the closing, in which case the builder will then apportion and adjust only these paid vacant land taxes among all of its homes under construction. After the closing, a tax reassessment will occur, which will retroactively assess the new home's market value as of the closing date, and the purchaser will receive a property tax bill (known as a supplementary or omitted tax bill) for the additional assessment.

From the purchaser's perspective, the possibility exists that the vendor may not have paid any of the realty taxes (including the taxes charged on a vacant land assessment basis) prior to closing. Accordingly, the purchaser's lawyer may wish to consider negotiating revisions to this clause to clarify (at least) that the purchaser will not be obliged to accept title to the property subject to existing arrears in realty taxes or, alternatively, to require that the vendor's lawyer will be required to give a personal undertaking to pay any such unpaid taxes. If this cannot be negotiated, as an alternative, title insurance may provide coverage.

3.3 Development charges

The governing statutes regarding development charges and education development charges are the *Development Charges Act, 1997* and Part IX, Division E of the *Education Act*, passed into law by the *Education Quality Improvement Act, 1997*. These Acts set out frameworks under which development charge by-laws and education development charge by-laws can be passed. More specifically, such by-laws allow local authorities to set specific charges for different types of building developments (e.g., townhouses, semi-detached houses, and apartments with two or more bedrooms).

Development charges can be reasonably estimated and may therefore be included by the vendor in the sale price. A typical adjustment clause attempts to pass on to the purchaser increases in such charges occurring after the date of the agreement of purchase and sale. A less common variant of this clause may attempt to pass on the full cost of any development charges or educational development charges relating to the new home. In either case, the vendor's approach is open-ended and thus poses a potentially very large extra expense for the purchaser.

While development charges are subject to revision by the local municipality from time to time, they become fixed (and must be paid) when a building permit is issued for the new home. Due to the potentially large amount of these adjustments, they are frequently capped or deleted at the request of the purchaser, and purchasers' solicitors should always view this as a negotiable item. The builder will more readily agree to this if the builder has already received its building permit for the property at the time of entering into the agreement of purchase and sale, since at that point the development charges will have been quantified and may already be fully included in the price of the new home.

To thwart the potential imposition of such charges onto the purchaser, the purchaser's lawyer might well consider negotiating a covenant from the vendor/builder to indemnify the purchaser in the event that any amount on account of development, education, or other charges or levies are subsequently assessed or taxable against the purchaser by reason of the vendor/builder's non-payment at the time the building permit is issued. Title insurance may cover this risk as well, but a close review of the policy will be needed to verify this.

4. Examining the builder's construction duties and obligations

4.1 Builder's right to modify plans

A vendor/builder reserves the right to modify the plans and specifications as a result of unforeseen (and sometimes even foreseeable) difficulties in completing the home in the manner or style as originally contemplated or to terminate the agreement entirely (but such termination is now subject to O. Reg. 165/08). If the plan of subdivision has not been registered by the time the agreement of purchase and sale has been entered into, the vendor will likely be more reluctant to allow any changes to the contract that would limit or restrict its ability to make alterations to the plans and specifications of the dwelling since the vendor/builder itself may be subject to modifications regarding on-site conditions that will only be crystallized upon the registration of the plan of subdivision. Depending upon the purchaser's relative bargaining power, frequently the only changes one can successfully negotiate are those that limit the degree of

modifications and/or require prior written notice of same before implementation.

For example, the typical builder's agreement purports to allow the vendor to make minor modifications to the plans and specifications as may be required by the subdivider, developer, and municipality to ensure the orderly completion of the development project and the new home's compatibility with it. Subdividers and municipalities frequently require the builder to obtain approval of building specifications by an architectural control committee in order to ensure an aesthetic quality or standard for exterior design, colour, and finishes that is uniform throughout the subdivision or phase of the subdivision. This, in turn, may allow less flexibility to the purchaser to make changes to the design or structure of the home.

Where the agreement of purchase and sale has been entered into following the registration of the plan of subdivision and the issuance of a building permit, few, if any, changes to the site will likely arise that would require significant changes to the plans and specifications of the dwelling. Moreover, such plans and specifications would, in such circumstances, have likely already received architectural approval from the relevant authorities (assuming such approval was required in the first place). Accordingly, in this scenario, the purchaser's lawyer should find less resistance in curtailing the vendor's unilateral right to alter the plans and specifications prior to closing.

The typical builder's agreement does specify an exact maximum level of variance that must be accepted by the purchaser in the event of an alteration affecting the dimensions of the dwelling, but the vendor has the right to alter the plans and specifications provided that doing so does not materially diminish the value of the property nor substantially alter the dwelling.

4.2 Substitutions of materials

The typical builder's agreement provides the vendor with the right to substitute other materials of at least equal quality to those originally specified in the contract or in the plans and specifications referred to in the contract, provided such substitution does not diminish the value of the property or substantially alter the dwelling. This provision is important to the vendor, particularly if there is a significant length of time between the date that the agreement is entered into and the closing date, because the vendor may have no assurance at the time of contract formation that certain building materials, finishes, or fixtures will be available or what their cost will be at the time of commencing construction of the dwelling.

As noted earlier, the statutory addendum discloses to the purchaser the possibility of the vendor substituting construction materials without notice. Where the purchaser is entitled to make construction or finishing selections in accordance with the terms of the agreement, s. 18(1) of Reg. 892 deems that the vendor warrants that no substitutions shall be made with respect to selections without the written consent of the purchaser, except for the following two cases:

- The purchaser, having been notified of the opportunity to make a selection of certain materials or finishes, does not make such selection within a specified time frame.
- Any item initially selected by the purchaser is not available, and the purchaser has not made a new selection within a further specified time frame.

If the purchaser fails to make the initial or substitute selection of materials or finishes, then the vendor will be entitled to make the selection on the purchaser's behalf, provided the selection is of equal or better quality than the original selection set out in the purchase agreement. Furthermore, with respect to an item that is not to be selected by the purchaser, s. 19 of Reg. 892 provides that the vendor warrants to the purchaser that where the vendor makes a substitution, the substitute item will be of equal or better quality than the item referred to in the purchase agreement.

Where the agreement of purchase and sale allows the purchaser to select items and substitutions are made without the purchaser's consent, the vendor must either change the items back to the original selection or offer the purchaser a cash settlement instead. The following are listed as examples of substitutions considered "minor" by TARION, thus entitling the purchaser to the foregoing monetary compensation:

- the colour of paint (interior and exterior), but excluding any shading differences. As set out in TARION Builder Bulletin 20, in all cases of changes to colour, the change must be a major change in colour and not merely a difference in shading.
- the design and colour of cabinets and countertops.
- the colour of roofing.
- the colour and type of kitchen and bathroom fixtures.
- the style of interior trim.
- the colour and type of floor.
- the type of windows.

4.3 The meaning of "completion" or "substantial completion"

In a typical builder's agreement, the stage at which the purchaser is required to close the transaction and take

possession will be defined in terms of "completion" or "substantial completion."

This raises the question, "At what point has substantial completion taken place?" The builder's agreement will define "completion" or "substantial completion" solely in terms of compliance with legislative standards. At first this sounds comforting; however, legislative standards are essentially minimum standards, and thus may be much less than what the purchaser expects.

There are four sources of legislative standards of "completion" to be considered:

- Subsection 13(1) of the *ONHWPA* states that the home be constructed in a workmanlike manner, free from defects in material, be fit for habitation, and constructed in accordance with the Ontario *Building Code Act, 1992*.
- Enforcement under the *Building Code Act, 1992* is achieved by prohibiting occupancy of a new building except as authorized by the *Building Code,* O. Reg. 350/06, made under the *Building Code Act, 1992*. Section 1.3.3 of Division C of the *Building Code* sets out the detailed requirements and procedures for authorizing occupancy. In general terms, the emphasis of these requirements is on competent completion of structural, mechanical, plumbing, and electrical systems and upon compliance with safety and health standards. The legislation does not concern itself with, for instance, whether all four bath tubs or the granite kitchen counter of a new home have been installed.
- Where the property is subject to a subdivision agreement with the municipality, certain conditions contained therein may also have to be satisfied before the home can be approved for occupancy.
- Municipal by-laws may provide for building and occupancy standards beyond those prescribed pursuant to the *Building Code Act, 1992*.

For agreements entered into before July 1, 2008, most builders' agreements will oblige the purchaser to complete the transaction if the home has been "substantially completed" by the scheduled closing date (or any agreed extension date) to a point that is sufficient to permit occupancy in accordance with the *Building Code Act, 1992*, the *Building Code*, and the local municipality's occupancy standards, even though there may be numerous outstanding unfinished items to be addressed (e.g., the installation of certain interior finishes and fixtures, exterior sodding, landscaping, painting, driveway paving, etc.). In some cases, builders' forms of agreement may purport to oblige the purchaser to complete the transaction and take possession of the dwelling even if a formal occupancy permit or certificate has not been issued by the municipality (or in those jurisdictions where no formal permit or certificate is customarily issued, even if no formal approval to occupy has been rendered by the building inspector or local building department).

For agreements entered into after June 30, 2008, O. Reg. 165/08 imposes the requirement that the builder deliver an occupancy permit (as defined in the regulation) at closing. This has the effect of modifying any definition of "completion" contained in the builder's agreement, since all new home closings for these agreements will require an occupancy permit to be delivered at closing. Again, however, occupancy permits are generally issued when the home meets the minimum requirements of the municipality's by-laws, the *Building Code Act, 1992*, and the *Building Code*. These requirements may be satisfied long before the home is completed for the purpose of the agreement. Final completion of the builder's work after possession may continue with several weeks of cosmetic and other work, and exterior work may not be completed for several months, depending on the season.

Any contractual provision that would oblige the purchaser to occupy the newly constructed premises contrary to s. 11 of the *Building Code Act, 1992* would be illegal and unenforceable and therefore should be deleted by the purchaser's lawyer. Beyond this, however, depending on the relative bargaining power of the purchaser and the type, size, and quality of the home being acquired, the purchaser's lawyer may wish to consider negotiating an amendment to the offer that contractually elevates the standard of quality construction and completion to reflect the purchaser's expectations (which would likely be related to the purchase price paid). The more expensive the home, the more likely it will be that a higher standard can be negotiated. The solicitor should explain to the purchaser what "substantial completion" means, so that expectations upon taking possession can be adjusted accordingly.

4.4 Statutory warranty coverage

Every new home in Ontario comes with warranty coverage provided by the builder and guaranteed by TARION. The maximum coverage for warranty protection for new homes and condominium units is $150,000 for purchasers who took possession of their homes before July 1, 2006. For purchasers who took possession on or after July 1, 2006, the maximum coverage is $300,000. The maximum coverage for condominium common elements is $50,000 times the number of units, to a maximum of $2.5 million. Coverage begins on the purchaser's date of possession and remains in effect even if the home is sold before the warranty expires.

Subsection 13(1) of *ONHWPA* and ss. 14–15 of Reg. 892 set out the warranties that every vendor of a new home is deemed to have given to the purchaser in connection with the sale and closing of the new home. These warranties will be enforced or honoured by TARION (in the event of the vendor's inability or unwillingness to do so) provided the purchaser formally reports the deficiencies in writing to TARION on the prescribed forms within the following time periods:

- **Within one year** after the date specified in the Certificate of Completion and Possession (CCP) (i.e., usually on or just before the date of closing): for all claims or deficiencies relating to the manner in which the home was constructed, its fitness for habitation, and breaches of the *Building Code* (s. 13(1) of *ONHWPA*).
- **Within two years** after the date specified in the CCP: for any claims relating to
  - water penetration through the basement or foundation of the home (Reg. 892, s. 14);
  - any defects in materials including windows, doors, and caulking that render the building envelope of the home susceptible to water penetration;
  - any defects in the electrical, plumbing, and heating delivery and distribution systems of the home;
  - any defects in the exterior cladding of the home, resulting in detachment, displacement, or physical deterioration; and
  - any violations of the *Building Code* affecting the health and safety of the occupants, including without limitation those violations pertaining to fire safety, insulation, air and vapour barriers, ventilation, and heating and structural adequacy (Reg. 892, ss. 15(2)–(3)).
- **Within seven years** after the date specified in the CCP: for major structural defects, which are defined in s. 1 of Reg. 892 to include any defect in work or materials that results in the failure of a load-bearing portion of any dwelling or that adversely affects its load-bearing function or that materially and adversely affects the use of such dwelling for the purpose for which it was intended, including significant damage due to soil movement, major cracks in basement walls, collapse or serious distortion of joints or roof structures (Reg. 892, s. 16).

Pursuant to s. 13(2) of *ONHWPA*, the following matters are specifically excluded from warranty coverage by TARION:

- defects in materials, design, and work supplied by the owner;
- secondary damage caused by defects, such as property damage and personal injury;
- normal wear and tear;
- normal shrinkage of materials caused by drying after construction;
- damage caused by dampness or condensation due to failure by the purchaser (owner) to maintain adequate ventilation;
- damage resulting from improper maintenance;
- alteration, deletion, or additions made by the purchaser (owner);
- subsidence of the land around the building or along utility lines, other than subsidence beneath the footings of the building;
- damage resulting from an act of God;
- damage caused by insects and rodents, except where construction is in contravention of the *Building Code*;
- damage caused by municipal services or other utilities; and
- surface defects in work and materials specified and accepted in writing by the owner as at the date of the CCP.

Finally, s. 13(6) of *ONHWPA* confirms that the statutory warranties apply, despite any agreement or waiver to the contrary.

4.5 Obtaining warranty service after closing

Before taking possession, the purchaser must

- execute a confirmation of receipt of a homeowner information package;
- complete a pre-delivery inspection (PDI); and
- at or immediately after the PDI complete and sign a CCP together with the vendor or its representative.

If the purchaser cannot personally attend at the PDI with the vendor, then the purchaser may appoint a designate by signing and delivering to the vendor before the PDI an "appointment of designate for pre-delivery inspection" or similar agency form. This form expressly authorizes the purchaser's designate to attend, conduct the PDI with the vendor's representative, and execute the three above-mentioned forms on the purchaser's behalf.

The purchaser's warranty coverage begins on the date of closing if possession is delivered at closing. In the case of new condominium units for which an interim closing takes place, the warranty coverage begins on the date of taking possession.

Solicitors should warn purchasers that TARION strictly enforces its time frames, so that late filing of warranty forms by a purchaser after possession can potentially result in complete loss of warranty coverage.

The purchaser must deliver a "30-day statutory warranty" form to TARION and the vendor within the first 30 days after the warranty coverage begins, listing all outstanding or incomplete items and known deficiencies. If this form is received by TARION more than 30 days after the warranty coverage begins, TARION will not act on it, which means that an unwilling vendor will not have to provide warranty service resulting from the 30-day form. The purchaser will then have to wait until the 11th month after possession to submit the "year-end warranty" form. Again, if that form is received late by TARION, TARION will not act on it, and the purchaser will in effect have lost its right to warranty service under the one year portion of the TARION warranty.

Any items listed on the pre-delivery inspection (PDI) form that have not yet been completed or rectified, as well as any newly discovered deficiencies, should be listed on the 30-day form. The builder will then have a maximum of 120 days after the 30-day form is received by TARION to repair or correct all listed warrantable deficiencies. The builder must be allowed reasonable access to the home in order to complete the requisite repairs. If the builder fails to complete its work by the end of that 120-day period, then the homeowner will have 30 days thereafter to contact TARION and formally request a conciliation. In that event, TARION will notify the builder in writing that an outstanding warrantable deficiency is being claimed by the purchaser, and the builder will be given 30 days to resolve the issue and avert the conciliation.

If the outstanding matter is not repaired or resolved to the homeowner's satisfaction within that time period, then TARION will conduct an on-site inspection and issue a warranty assessment report to both the homeowner and the builder within 10 days of the inspection. If TARION finds that even one item in the report is warranted, then the conciliation will be "chargeable" to the builder, and the builder will have one final opportunity to correct the outstanding items within 30 days from the date of issuance of the warranty assessment report. Failure to do so will result in TARION settling the matter directly with the homeowner (by TARION either repairing the outstanding matter on its own or making a cash settlement payment to the homeowner to cover the cost of the repairs).

After the initial 30-day period, the homeowner should take note of further outstanding deficiencies that appear and list these items on the year-end warranty form, which must be submitted during the last 30 days of the first year of possession. The reporting procedures and timeframes for builder repairs that applied to the 30-day deficiencies will be the same for the year-end deficiencies.

The homeowner information package also identifies certain exceptions to the foregoing time lines for repairing warrantable deficiencies (such as emergency situations or seasonal items), and in such instances, the stipulated time lines for effecting requisite repairs will change.

5. Title concerns

5.1 Permitted encumbrances

The lawyer for the vendor will want to ensure that the purchaser must accept title to the home subject to all existing or registered restrictions, easements, and agreements affecting title to the subject property in addition to any potential or future easements, restrictions, and agreements that might be entered into by the subdivider, developer, vendor, and/or builder with any government authorities, any public or private utility authorities, and any adjacent landowners, between the date that the agreement of purchase and sale has been entered into and the closing date. Thus, the "permitted encumbrances" clause typically found in builders' agreements is generally far more extensive and pervasive, both in degree and scope, than the title provisions found in the OREA form. In some instances, the agreement of purchase and sale may oblige the purchaser to grant and execute specific easements or covenants to or in favour of any of the aforementioned third parties.

5.2 Builder's rights of re-entry

In addition, builders' forms of agreement reserve rights of re-entry in favour of the vendor/builder so that the vendor can lawfully re-enter the property after closing to complete any remaining work to the satisfaction of the municipality. Since there must be dominant and servient tenements of land in order for an easement to be validly created in law, the builder, if it does not own neighbouring land, will endeavour to retain a right of re-entry in the nature of a licence in favour of the builder/vendor to re-enter the property, a copy of which will be attached to the Transfer/Deed of Land so as to be registered on title to the property. Remaining work may include

- completing any outstanding construction matters pertaining to the dwelling (including all exterior trim and finishes, exterior painting, landscaping, grading, and/or fencing obligations);
- rectifying any grading, drainage, or servicing problems; and
- fulfilling and complying with any outstanding obligations arising under any applicable subdivision

or other development agreement(s) with the government authorities.

When the municipality is satisfied that the vendor/builder has fulfilled its obligations under the relevant development or subdivision agreement, then all municipal works, services, and facilities installed by the subdivider/developer within the subdivision will be formally assumed by the municipality.

5.3 Restrictions on the use of the property

The vendor/builder will also often wish to impose certain restrictive covenants regarding the purchaser's use and enjoyment of the subject property, in order to maintain a uniformity of appearance throughout the housing project and to preserve any perceived "market value" of the remaining housing inventory retained by the vendor. For example, restrictions on the purchaser's ability (after closing) to place or store materials on portions of the property exterior to the dwelling, to erect fences exceeding a certain height restriction, or to install a satellite dish or television antenna are not uncommon in new subdivisions, and purchasers should be advised about them as soon as possible.

Most builders' forms of agreement will contractually restrict the purchaser's ability to make any changes whatsoever to the grading or drainage patterns of the property and to make any changes or installations to the dwelling that might affect the grading or drainage patterns while the builder/subdivider remains liable to ensure its satisfactory completion to the municipality. These are included because, among other reasons, the builder or subdivider will have extensive obligations to the municipality regarding proper drainage, and because changes to grading or drainage patterns could cause flooding of adjacent properties.

Similarly, it has become increasingly common for municipalities to require builders to include a list of warning clauses in their agreements of purchase and sale in order to place potential purchasers on notice as to the limitations or absence of a variety of municipal services, as to potential noise sources and other environmental issues that may disturb them, and so on. Purchasers should be advised about these warning clauses before the agreement of purchase and sale becomes firm.

Lawyers should advise purchasers to obtain from the builder or its lawyers (prior to making the agreement of purchase and sale firm) a draft copy of the restrictions the builder intends to register on closing and review them closely with the purchaser to ensure that the restrictions that will govern their use of the property after closing are understood and accepted.

The foregoing reservations, rights of re-entry, and restrictions will either be registered on title to the property on or before closing or will be incorporated in the Transfer/Deed of Title delivered on closing from the vendor (or the registered owner if not one and the same party) to the purchaser. In certain instances, purchasers may have objections to the nature and scope of these easements, restrictions, or restrictive covenants inasmuch as they may have a detrimental or prejudicial impact on the purchaser's intended use or enjoyment of the property. For example, a restriction without time limits on altering the grading of the property would certainly prohibit the purchaser from installing a backyard swimming pool.

Accordingly, the purchaser's lawyer should carefully review the scope of the restrictions and, in particular, the nature and extent of any pertinent easements intended to affect the property on closing to determine whether such restrictions or easements will impact negatively upon the purchaser; the lawyer should correspondingly endeavour to negotiate their deletion or restriction, if possible.

Chapter 61

Title insurance: an overview

1. Introduction

Home purchasers are making, in many cases, the largest purchases that they will make in their lifetimes. Because of the amounts of money involved, they generally understand at least implicitly the importance of confirming that they are getting, in legal terms, what they have bargained for: a good and marketable title to the home, free of encumbrances other than those that they agree to assume.

Home purchasers have three choices for assuring title:

- a lawyer's opinion on title;
- traditional title insurance; or
- TitlePLUS® (a combination of title insurance, regulatory compliance insurance, and legal services coverage).

Subrule 2.02(13) of the *Rules of Professional Conduct* requires a lawyer to disclose to a client the relationship between the legal profession, the Law Society of Upper Canada, and the Lawyers' Professional Indemnity Company (LAWPRO®).

It is the lawyer's duty to recommend the best choice to the client.

2. What is title insurance?

Title insurance is a contract to indemnify up to the face amount of the policy a purchaser and/or mortgagee in the event that loss arises from one or more specified causes. Title insurance allows purchasers and lenders to "insure over" selected problems, rather than insisting on a repair of the problem. It may reduce the legal bill of the purchaser or mortgagor, since certain searches may be waived by the title insurer.

Title policies contain many exceptions, which may involve standard-form exclusions, property-specific exceptions, or the printed stipulations of the policy itself. Because of the typical restrictions in the policies, many endorsements are available, especially for commercial properties.

Title policies vary depending on whether they are insurance policies for owners, lenders, or combined title insurance/legal service coverage policies with owner and lender coverage. Policies can vary from jurisdiction to jurisdiction, or insurer to insurer. The value of title insurance is completely dependent on the contractual terms of the policy.

Under a title insurance policy, a property owner has a direct claim against an insurance company if a specified title risk causes a loss, regardless of the source of the loss.

By contrast, where a purchaser receives a lawyer's opinion on title instead of title insurance, the purchaser only has a claim against the lawyer (and the lawyer's errors and omissions insurance policy will only insure the lawyer) if the purchaser can prove that the cause of the loss fell within the scope of the lawyer's retainer and that the lawyer acted negligently in respect of that issue.

A loss arising from an error on the part of any other party (such as a municipality responding to a search request) will therefore not generally be covered by the lawyer's errors and omissions insurance, but it will be covered by title insurance. The title insurer may absorb the loss or may take steps to recover the loss by way of subrogation.

Furthermore, a lawyer's opinion on title can only speak to the state of the property as of closing. Title insurance policies are increasingly offering protection for "post-policy date" events, such as a neighbour starting to encroach on the property or the fraudulent discharge of a mortgage that harms the interest of the lender.

Under r. 2.02(10) of the *Rules of Professional Conduct*, a lawyer is required to assess all reasonable options for assuring title when advising a client. While the lawyer must advise the client that title insurance is not mandatory and is not the only option available to protect the client's interests, it is clear that lawyers practising real estate cannot disregard the availability of title insurance.

The rule further provides that the lawyer must not receive any compensation from a title insurer for recommending a specific insurer (r. 2.02(11)) and that the lawyer must disclose to the client that no commission or fee is being furnished by the insurer (r. 2.02(12)).

3. Scope of coverage

Title insurers generally evaluate the degree of risk before agreeing to provide coverage for a specific property and will exclude any risks that they are not prepared to cover. Title insurers usually do not cover items that will not be revealed by public records, but any problem or defect disclosed in the public records may simply be listed in the property-specific exceptions (assuming that it is not already excluded by the standard-form exclusions, as is the case with Aboriginal land claims, for example).

It is open to the lawyer who has discovered the defect at the time of ordering the policy to ask the insurer to

"insure over" the problem, in whole or in part, for the purchaser and/or the lender. This means that it does not become an exception to coverage.

An owner's policy traditionally provides coverage for the following types of losses:

- title to the estate or interest insured (usually the fee simple estate in the subject property) being held (or vested) other than as shown in the policy;
- any defect in and charge, lien, or encumbrance on the title;
- unmarketability of title; and
- lack of a right of access to and from the land.

There are now homeowner and lender policies available in Ontario that provide much broader coverage, especially in terms of "off-title" risks such as work orders, zoning, and miscellaneous survey-related issues. The cost of defending a title is covered by most policies (assuming that the apparent ground of attack is a covered risk).

The property covered by the policy and the amount of insurance are set out on Schedule "A" to the policy. Schedule "A" will also contain the name of the insured (i.e., purchaser or lender), a description of the estate or interest in the land that is covered by the policy (e.g., fee simple for an owner), and a statement of who holds the title to that estate or interest in the land.

Schedule "B" may contain some printed exceptions, plus room to add property-specific exceptions to the policy. In addition, the pre-printed policy contains standard exclusions such as environmental claims, Aboriginal land claims, etc.

It is common for the following items not to be covered by the standard-form owner's policy for commercial properties:

- zoning;
- building and use restrictions;
- right of occupancy restrictions;
- rights to subdivide;
- expropriation rights (unless revealed by registered title);
- items created, permitted, assumed, or agreed to by the insured;
- items known to the insured but not shown in the public record;
- events occurring subsequent to the date of the policy;
- gifts;
- claims of those in possession not shown by public records;
- survey-related items (encroachments, overlaps, boundary disputes, unregistered easements, shortage in area);
- unrecorded construction liens;
- mineral rights;
- taxes or special assessments not shown as existing liens;
- reservations in Patent (Crown grant in Ontario);
- Aboriginal rights;
- environmental issues; and
- current mortgages.

There is no uniform policy currently in use in Ontario. Where there are "plain language" policies in Canada and the United States, they are often used for properties containing up to four residential units, and the coverage is generally broader than that described above. Even under "plain language" policies, coverage often narrows where the insured property is not on a plan of subdivision. Coverage differs because insurers appreciate the process for registering a plan of subdivision and the likelihood that certain risks are diminished by that process.

For lenders, standard policies have fewer exclusions. Lender policies are more likely to cover adverse possession, unrecorded construction liens, survey matters, and special assessments because these items rarely go to the heart of a property's value, and the lender is generally not exposed up to 100% of the value in any event. The title insurer is prepared to be generous with coverage because there is little risk.

4. Regulatory framework and the role of lawyer

Pursuant to *Title Insurance Licences*, O. Reg. 69/07, made under the *Insurance Act*, a title insurance policy cannot be issued without a concurrent title certificate provided by a lawyer not employed by the title insurer. It is necessary for the lawyer to understand which searches are or are not required as the basis of the title certificate. Each title insurer has its own specific search requirements. While a title insurer may not require that certain searches be conducted, such enquiries may nonetheless be relevant and important to the client or to the lawyer's retainer.

For instance, where title insurance is being utilized in the context of a residential purchase, it is often purchased as an alternative to an up-to-date survey of the property in order to facilitate mortgage financing. If the purchaser pays for a lenders-only policy to be issued in place of a survey, the purchaser has no protection whatsoever with respect to defects that would have been revealed by a survey. This situation has been compared to the case of a homeowner who buys a standard home insurance policy for fire and theft, then leaves the front door unlocked since the home is insured. In the case of title insurance, a survey will be of great assistance in detecting and resolving title issues before closing, rather than presenting the buyer with potentially far-reaching legal problems after closing. The purchaser's lawyer should advise his or her client about survey issues and the

differences and possible consequences of an owner's policy versus simply a mandated lender's policy.

Where title insurance is being obtained, the lawyer's role in a transaction may involve the following:

- determining which insurer to deal with, in terms of financial backing and experience.
- if one is not dealing with the insurer directly, confirming that the person one is dealing with has authority to bind the insurer to the coverage negotiated.
- negotiating the premium, if possible.
- reviewing the initial report or commitment, including the following:
  - is the "insured" named correctly?
  - is the legal description correct?
  - would it be preferable for the owner to have any specific problems resolved as opposed to "insured over"?
  - what coverage is excluded from the commitment/policy?
- advising whether the insured should obtain an up-to-date survey. This is closely related to the obligation to question the insured about the state of the property, since adverse rights apparent on a visual inspection may be excluded.
- advising whether the purchaser should have more than one policy. This becomes an issue if the policy is going to cover more than one site, in terms of how the coverage will be allocated under the policy.
- advising about the face amount of the policy (the amount of insurance being purchased).
- advising about possible endorsements. This may include preparing documentation in order for the insured
  - to be entitled to specific endorsements or affirmative insurance; or
  - to obtain waivers of standard exclusions.

  The following are examples of endorsements that may be appropriate, depending on the circumstances of the transaction:
  - an inflation endorsement (automatically increases the policy amount in accordance with a specified schedule);
  - a condominium endorsement (covers, *inter alia*, whether the condominium development was properly created under the relevant statute); or
  - a zoning endorsement (used to insure the zoning classification and the permitted uses for the property).
- questioning the insured as to whether he or she has any knowledge that would give rise to a "knowledge defence" and, in effect, limit the policy. If so, written disclosure must be made to the insurer. Any knowledge of the lawyer will likely be imputed to the client as well.
- advising about future conduct. What causes a lapse or termination of coverage? For example, advice should be given about a change of ownership, failure to notify the insurer regarding a claim, the risks of settling a claim without notifying the insurer, the need to be able to document any loss and so forth.
- reviewing the final policy once issued to ensure it complies with any re-certified or amended report/commitment issued following negotiations or the resolution of existing title problems.
- alternatively, advising whether there is a way to complete the existing transaction without an entirely new title insurance policy. This appears to be a particularly relevant consideration when there is a corporation on title.

In most cases, the companies that sell title insurance require the purchaser to sign an acknowledgment before closing, which typically covers the following:

- that the purchaser has received a copy of Schedule B and understands the exceptions listed therein;
- that the purchaser understands that the policy does not provide any coverage with respect to
  - future changes or additions to the structures located on the property or changes to the use of the property;
  - matters that the purchaser created, agreed to, or was aware of before closing without having disclosed them to the insurer;
  - defects disclosed in a home inspection report received by the purchaser;
  - government rights, including expropriation;
  - lack of compliance with fire retrofit or building code requirements; and
  - residential rent regulation.
- other matters, which may vary from policy to policy.

Subrule 5.01(5) of the *Rules of Professional Conduct* stresses the important role of the lawyer in respect of title insurance. It prohibits a lawyer from allowing a non-lawyer to give legal opinions regarding the insurance coverage obtained or to do any of the following without supervision:

- provide advice to the client about title insurance;
- present insurance options or information regarding premiums; or
- recommend one product over another.

Chapter 62

Commercial real estate transactions

1. Introduction

The same basic principles that apply to conveyancing and financing of residential properties also apply to commercial properties, although the dollar figures involved are usually larger and there may be additional considerations dictated by the nature of the property. Issues regarding closing dates, requisition dates, representations and warranties, damage prior to closing, treatment of chattels and fixtures, and the vendor's status under s. 116 of the *Income Tax Act* are still relevant. A purchaser must still be satisfied regarding the physical integrity of the building and soil, and a purchaser's lawyer still performs all the usual legal searches relating to title, executions, zoning and work orders, realty tax and water arrears, environmental searches, and reviews of the survey (unless title insurance is to be used). Even though the use of title insurance is becoming more common, it is no substitute for appropriate due diligence, and often both vendor's and purchaser's lawyers have to familiarize themselves with title so that they are in a position to negotiate appropriate agreements (such as any required assignment or assumption agreements, easements, or cost-sharing agreements) or obtain appropriate compliance letters. Closing takes place in much the same way as it does in a residential transaction. The statement of adjustments is calculated in the same way although there are usually additional adjustments relating to leases (e.g., deposits, common area maintenance costs, and rental payments), maintenance contracts, or additional deposits paid in stages as various purchaser's conditions are satisfied or waived.

Commercial transactions might involve industrial, office, or retail properties, apartment buildings, hotels, condominiums, daycare centres, recreational areas (such as golf courses or fishing lodges), farms, mines, or gravel pits. Commercial properties are not always urban, so it is not unusual to encounter issues relating to septic tanks, potable water supply, water drawing rights, conservation authority regulations, utility rights-of-way, separation of surface rights from mineral rights, or even heritage conservation or cemetery issues. A commercial property may be part of a larger development giving rise to cost sharing, easement, or traffic flow issues and specialized insurance and financing arrangements. Commercial transactions can include vacant land being acquired for development purposes or already constructed buildings. Physical integrity and zoning issues arise with both new and old buildings. A purchaser of an older building may be able to rely on non-conforming use principles to establish that the use and structure are permitted but has to accept that further changes to the structure or its use are limited. New construction has its own issues including construction liens; issues about who will repair damage resulting from the inevitable settling of the building and soil; and related guarantees of structural soundness, work orders, final inspections, and so on. Environmental conditions, soil compaction, and zoning are significant concerns when acquiring vacant land for future development.

Other considerations may be raised due to the nature of the legal interest being transferred. For example, if a leasehold interest (rather than ownership in fee simple) is being acquired, the purchaser's lawyer must review the lease and deal with the landlord and any limitations imposed by the lease, including the transferee's ability to finance the transaction. The vendor's lawyer should ensure that the proposed sale complies with the requirements of the lease. It is also common for very valuable properties to be owned by a number of co-owners. If the fee simple interest to be acquired in a transaction constitutes less than a 100% interest in a property, both the vendor's and the purchaser's lawyers need to be sure that no prior co-owner's rights (like a right of first refusal) interfere with the sale.

2. Agreement of purchase and sale

The principles regarding drafting and negotiating a residential agreement of purchase and sale apply to the drafting and negotiation of a commercial agreement of purchase and sale. The following are some additional considerations.

2.1 Price/value

The purchaser will need a reasonable period of time to investigate and confirm independently all the information that supports the value of a transaction. Most commercial transactions permit a purchaser to have a sensible period of time to access the property, inspect relevant books and records, and make inquiries at applicable regulatory agencies before committing to purchase. Some purchasers are prepared to incur the costs involved in a title search and related legal searches during this "due diligence" period. Others prefer to satisfy themselves about the financial and physical aspects of the property before incurring the expense of legal investigations. Sometimes a vendor will offer

representations, warranties, or guarantees regarding issues of importance to the purchaser. Some properties are sold on an "as is, where is" basis, requiring the purchaser to be satisfied, based solely on the purchaser's own independent investigations. Whether this happens depends on many factors, including bargaining power and sometimes the identity of the vendor. For example, a receiver or mortgagee in possession often does not know enough about the property to make reliable statements. Even if a vendor is prepared to give representations and warranties, a prudent purchaser will perform some due diligence rather than rely on the vendor. There may also be legal areas requiring specialized expertise, such as environmental contamination or realty taxes.

Once decisions are made about the areas to be investigated, it will be necessary to incorporate appropriate conditions into the agreement of purchase and sale. It is common for a purchaser to have the agreement conditional for a few days on the purchaser obtaining its board of directors' approval. Certain vendors also require board of director's approval, depending on their internal corporate structure, so the agreement may also contain a vendor's condition to this effect.

2.2 Harmonized Sales Tax (HST)

HST generally applies to most commercial real estate transactions, including the sale of property and commercial leasing. Some transactions are exempt from HST, or the land and building may be exempt while some of the other assets being transferred attract HST. The agreement of purchase and sale should expressly state whether HST is included in the purchase price or not. In some cases, provided the purchaser is an HST registrant, it may self-assess, claim input tax credits, and remit any tax directly. A vendor will want protection against the consequences of a self-assessing purchaser's failure to pay tax. If the purchaser's covenant is acceptable, many vendors will accept an indemnity. If the purchaser is to self-assess, the lawyer should confirm the purchaser's HST registration number with the Canada Revenue Agency before closing.

2.3 Income tax

Unlike a sale of a principal residence in Canada, the sale of other land has income tax implications that need to be addressed by both vendor and purchaser. Most purchasers and vendors want to agree on an allocation of the purchase price among depreciable assets and non-depreciable assets. Often the parties' accountants advise in this area. The purchaser generally wants to allocate more of the purchase price to depreciable assets so that there is more to depreciate in the future, but the vendor, who has already depreciated the same assets, wants to allocate a lower amount on depreciable assets so as to avoid recapture. Whatever the results of the negotiation, the allocation must be reasonable, and it can still be rejected by the taxing authority.

2.4 Adjustments

Although the same fundamentals of a statement of adjustments for a residential transaction (deposit, realty taxes, balance due on closing) apply in a commercial context, numerous additional considerations may also be applicable. For example, the value of land being acquired for development purposes is often determined by a certain price per acre or by a price per foot of frontage. Accordingly, the parties may include an estimated purchase price in the agreement of purchase and sale, but stipulate that the price is to be adjusted once the area or frontage is certified by a surveyor so that this will be an adjustment on closing. In the case of a rent-producing property, it will be necessary to adjust for rents and deposits. In the case of an apartment building, adjustments will include statutory interest accrued on the security deposits. In retail buildings where there are net leases, minimum rent, additional rent, security deposits, and sometimes, percentage rent, all will need to be adjusted. It is also common to address in the agreement of purchase and sale how rents ought to be adjusted where they are more or less current but not yet received or if there is a significant arrears issue that will not be resolved prior to closing.

Sometimes purchasers take control of collecting chronic arrears and later account to the vendor for the vendor's share. Alternatively, the vendor may want to continue the collection process on a long-standing arrears situation. Even if the purchaser is agreeable, it will want the vendor to agree not to interfere with the purchaser's landlord and tenant relationship. Assuming that there is a level of trust between the parties, either method could work.

To the extent that maintenance contracts are being assigned, adjust any prepaid fees. The parties should be encouraged to agree in the agreement of purchase and sale to deal with items for which an exact adjustment is not available on closing. Typical of these would be adjustments for common area maintenance costs payable under a net lease where the actual annual amount is not known until well after the end of the year. A reasonable deadline for readjustment should be set—January of the following year is too soon since the bills to the end of the previous year would not have been received or processed until a few months later.

If there is inventory to be counted, appropriate arrangements should be made and adjusted as soon as

the final numbers become available. The agreement of purchase and sale should contemplate disagreements over final numbers and include a mechanism or procedure to resolve them. If wages, benefits, or other items for employees of the vendor are being adjusted, advice should be obtained from an employment law specialist.

2.5 Conditions

Any conditions contained in a commercial agreement are subject to the same considerations as in the residential context. Since the stakes are higher, so should be the importance afforded to these terms. The lawyer should ensure that the party benefiting from the condition has sufficient time and access to the property to perform the required actions and that the related "waiver of condition" or termination provisions are clear and appropriate.

2.6 Timing issues

Commercial real estate transactions differ from their residential counterparts because with more aspects to investigate, due diligence and satisfaction of some conditions may take longer (for example, if the closing is conditional upon re-zoning). Sufficient time must also be allocated to negotiate the terms of the agreement of purchase and sale, as well as any other agreements, such as financing and mortgage documents and corporate documents that may be necessary for the parties—most of whom, in commercial transactions, are corporations—to authorize the transaction.

2.7 Bulk sales

Although many people do not consider the sale of real estate to be a "sale in bulk," the *Bulk Sales Act* applies to a "sale of stock in bulk out of the usual course of business or trade of the seller," and has been judicially determined to apply to the sale of a hotel business including the furniture, equipment, and furnishings. Other real estate transactions may also be affected. If this *Act* applies to the sale, the lawyer should provide for compliance in the agreement of purchase and sale.

2.8 Defects

When acting for a vendor, lawyers should familiarize themselves with the nature of the property and subsearch title before drafting or reviewing an agreement of purchase and sale. This will allow them to resolve or at least anticipate title or other defects and to craft the agreement of purchase and sale to take these or other peculiarities into account. If, for example, a vendor's lawyer knows that some encumbrance cannot be removed from title, then it can be designated as a "permitted encumbrance," and the purchaser can be required to assume the obligations under it. The purchaser's lawyer will want to review and assess all permitted encumbrances before the agreement of purchase and sale becomes binding.

2.9 Vendor take-back mortgages and corporate authority

Theoretically, vendor take-back mortgages are no different in a commercial context than they are in a residential context. The lawyer should still carefully consider what security can and should be granted by the purchaser in order to properly protect the vendor. Also, if the purchaser is arranging additional financing, the priority of the take-back security needs to be addressed.

While a vendor take-back mortgage might be perfectly adequate, a vendor's lawyer needs to consider whether the client will have a functional security package. The vendor may not want to repossess the property but only to attorn rents, in which case a general assignment of rents is required. If there are specific leases that are important, the vendor may want to take a specific assignment of those. If there is equipment without which the building cannot be operated or on which revenue depends (like refrigerators and stoves in an apartment building) or if the vendor could not operate or sell the property without access to the books and records of the purchaser/borrower (in order to see, for example, what the terms of a lease are), then a general security agreement (GSA) may be in order. A developer/purchaser might want to negotiate for partial discharges or a postponement to easements for utilities or to servicing financing (i.e., financing for installation of sewers, watermains, etc.). These should be provided for in the agreement of purchase and sale.

One should be able to rely on the impression of a corporate seal on a vendor take-back mortgage as evidence that it has been authorized, properly executed, and delivered, but many modern corporations do not have corporate seals. Although theoretically it should be possible to rely on the indoor management rule as evidence of authority and due execution, the practice when acting for a lender or, in this case, for a vendor who is financing the purchase by taking back a mortgage is to require a certified copy of the relevant corporate resolution, borrowing by-law, and an opinion of the purchaser/borrower's lawyer on the due authorization, execution, delivery, and sometimes even the enforceability of the security granted. These too should be provided for in the agreement of purchase and sale.

Unless there is some reason to suspect that a sale is not properly authorized, a transfer executed by the vendor

and capable of registration is usually adequate for a purchaser's lawyer. In the absence of vendor take-back security or some other significant obligation that will continue after closing, vendors' lawyers do not ask for evidence of the authority of a purchaser to purchase and are content just to receive the sale proceeds on closing.

In order to confirm that the entity granting the security actually exists and controls its assets, the lender's lawyer routinely obtains certificates of status and performs searches relating to insolvency and bankruptcy. If the security package includes an assignment of rents, leases, or a GSA, appropriate registrations need to be filed under the *Personal Property Security Act* (*PPSA*), including a copy of the registration provided to the purchaser and appropriate postponements or waivers obtained from other creditors of the same purchaser/borrower. A vendor's lawyer's *PPSA* search will indicate whether the vendor's *PPSA* registration is the only one registered against the purchaser/borrower. If it is not, the vendor's lawyer should make sure that the vendor's registration has priority over the assets in which the vendor is taking security.

Waivers or postponements from other secured lenders may be necessary since a secured lender can perfect more than one security interest in more than one asset by filing just one registration. Because it can do so before it acquires a security interest, it is possible for a security interest that does not initially compete with the client's security interest to later gain priority over that client's security interest.

2.10 Purchaser's right to assign

If the agreement of purchase and sale is silent on the right to assign the agreement, then like any contract, either party's "benefits" can be assigned without consent, but not their "burdens." If a vendor is taking back a mortgage or if the purchaser has given significant indemnities or covenants, the vendor would be concerned about the purchaser's identity and would want to limit or prohibit the purchaser's right to assign without vendor approval of the assignee. The purchaser on the other hand, wants flexibility to assign for a variety of reasons including tax planning, liability reasons, or compliance with the *Planning Act*. If the need to assign an interest in the agreement of purchase and sale is important, it should be included in the agreement of purchase and sale.

3. Due diligence

As mentioned, commercial transactions by their nature usually require detailed investigations or "due diligence" to ensure that the purchaser is acquiring the asset bargained for. This due diligence includes physical inspections of the property by the client, review of related leases, and other relevant contracts, title searches, and off-title inquiries.

3.1 Leases

Purchasers usually want to review current and historical income and expense statements relating to an income-producing property. On an acquisition that involves residential tenancies, historical reviews of rent are important, and competent rent control advice must be obtained. Prudent purchasers will not just rely on the rent roll and will review the leases themselves to verify whether rent was calculated and increased correctly and whether it matches the rent roll. In the case of net leases, purchasers will review the leases to ensure that they will be able to recover their operating and maintenance costs as completely as possible. Some leases will limit a landlord's recovery rights either expressly or unintentionally, and these aspects need to be analyzed. Recovery of realty taxes is complicated by recent amendments to Ontario's realty tax legislation, the effect of which is to subsume the former business tax into the realty tax base. The recent amendments not only cause realty tax assessments to rise and fall over time but also have caused many landlords to reallocate the tax burden among tenants. This has in turn resulted in significant litigation over a landlord's ability to recover certain realty tax increases.

A purchaser who relies on a rent roll and does not review the leases will not know about the existence of any unique clauses that may be in the leases being assigned on closing, such as a right to terminate, an option to purchase, a right of first refusal, the number of parking spaces that a tenant is entitled to use and whether they are exclusive-use parking spaces, or whether a tenant has been granted any "exclusive-use privileges." The property may satisfy zoning by-law parking ratios but still not have enough parking spaces to fulfill the owner's contractual obligations with tenants. Without a lease review and subsequent calculations, this deficiency would not be discovered until a tenant complained. A purchaser looking to redevelop part of a property will want to focus on clauses allowing the landlord to relocate tenants. Even if the rent roll tells the purchaser that a tenant has options to renew, it may not tell the purchaser about the formula by which renewal rental rates will be established. All lease amendments should be reviewed as should each tenant's file. The file should contain correspondence giving a more complete picture of the landlord and tenant relationship, any disputes or complaints with the potential to develop into a serious dispute or claim for set-off. It should also reveal whether space has been expanded or partially surrendered (and

whether the rent was adjusted accordingly) and so on. The rent roll usually shows security deposits or other prepaid items, but since the purchaser will ultimately be required to give the tenants credit for those items, purchasers should verify these amounts directly with the tenants by means of an estoppel certificate. Lease reviews are a matter of experience, common sense, and considering what information the owner/landlord needs to know.

3.2 Estoppel certificate

Since the level of rental income from a property influences its price, prudent purchasers can not only confirm rental information but also limit the potential for later disputes with a tenant who disputes the information the purchaser has uncovered during its inspections by obtaining estoppel certificates from the tenants prior to closing. Except possibly for apartment buildings where no one wants to disturb the tenant population and the amounts in question are less significant, purchasers require and vendors usually expect to obtain tenants' acknowledgments from as many tenants as possible. The purpose is, of course, to ensure that each tenant agrees with the purchaser's understanding of the lease terms. A tenant acknowledgment is simply a certificate executed by the tenant, confirming the material facts about a lease, which the tenant is asked to sign to signify consensus on those facts. Tenants' acknowledgments are often called "estoppel certificates" because, based on equitable principles of estoppel (especially where the tenant acknowledges that the purchaser and its lender are relying on the tenant's statement), the tenant will be estopped from later asserting a different understanding of the lease terms. Typically, tenants are asked to make statements about the existence of any amendments to the lease, the lease term, its expiry date, renewal rights, area, rent, additional rent, escalations in rent, whether rent is paid to date, the prepaid amounts, deposits, and defaults; that there are no disputes or rights of set off; or if there are, about the particulars.

Purchasers like to obtain estoppel certificates from as many tenants as possible in advance of, and also as reasonably close to, closing. In this way, they can be checked to confirm that the tenant's understanding conforms to the purchaser's understanding or, where there is a discrepancy, to deal with it in some way. Occasionally a tenant will disagree about some material lease provision or may disclose an unfulfilled obligation of the vendor as landlord (e.g., a repair or adjustment of rent issue). When negotiating an agreement of purchase and sale, it is important for both vendor and purchaser to assess and decide what the consequence(s) will be if the vendor is unable to produce a satisfactory number of estoppel certificates or should the tenants' versions of their lease terms vary too much and too materially from the vendor's version. In the absence of fraud, if after having exercised good faith and reasonable diligence, a vendor fails through no fault of its own to obtain sufficient and satisfactory estoppel certificates, then the parties might agree that the vendor will certify the information that would have been included in the missing estoppel certificates or they might negotiate a clause in the agreement of purchase and sale allowing an unwinding of the deal without either party being liable for damages or some other solution (such as an abatement in price or a temporary hold-back).

3.3 Off-title searches

The Appendix at the end of this chapter lists numerous off-title searches that a purchaser's or lender's lawyer may need to perform, depending on the nature of the property. While the Appendix includes relevant commentary, a few of the off-title concerns warrant more explanation:

- **Zoning and work orders:** As with a purchase of a house, a purchaser's lawyer checks to ensure that the use of a commercial property is permitted and that there are no outstanding work orders by obtaining a building and zoning compliance report from the relevant municipality. For commercial properties, there are often several different permitted uses because tenants may carry on a different business from that of their neighbours (e.g. a shopping centre can include retail, restaurant, theatre, office, medical or dentist office, and other uses). Consequently, greater care is required in the commercial context to ensure that the specific uses for which the property is actually being used are permitted and that each tenant's space complies with by-laws and applicable codes. Different municipalities regulate different matters, including setbacks, density, parking ratios, outside storage, siting of garbage containers, and so on. The part of the development that the vendor controls may comply with all of the by-laws and regulations, but a tenant's part may be in violation. If the tenant's lease requires the tenant to comply with such matters, the vendor may be able to require the tenant to rectify the problem. Be aware that other statutes can affect the use permitted. Incidentally, because up-to-date surveys are more often available for commercial real estate transactions, less reliance is placed on statutory declarations of possession (proving possession consistent with registered title) than is the case in residential transactions where up-to-date surveys are less common and where neighbours have more informal relationships with each other than is the case among commercial neighbours.
- **Environmental:** This is a specialty area, but most lawyers do at least basic searches with the Ministry

of the Environment and other government authorities. In most commercial transactions where environmental issues are a concern, at a minimum, a Phase 1 environmental site assessment should be conducted by a qualified environmental consultant. A record of site condition (RSC) may be filed on the Environmental Site Registry under O. Reg. 153/04, made under the *Environmental Protection Act*, to register the condition of the site as at the date of the RSC. A risk assessment is an option available to property owners when the site condition does not meet standards specified for an RSC filing under O. Reg. 153/04. On July 1, 2011, significant amendments to O. Reg. 153/04 came into force, imposing more stringent environmental assessment standards, including strengthened standards for measuring soil and groundwater site conditions, new Phase 1 and Phase 2 environmental site assessment standards, and a new risk-assessment process.

- **Fire and health departments:** One of the issues often negotiated is whether the purchaser should be entitled to cause inspections of the property by relevant authorities or whether it may only inquire of such authorities about matters already in their files. How the negotiation ends depends on the nature of the property and the needs of the parties. *Fire Code*, O. Reg. 213/07, made under the *Fire Protection and Prevention Act, 1997*, requires that older apartment buildings be retrofitted with fire safety equipment. If a purchaser intends to rely on legal non-conforming use principles to be comfortable that the use or physical structure is permitted, the retrofit legislation is paramount. The lawyer should determine if the Health Department has jurisdiction over the building; generally, it regulates food preparation and service areas.

4. Assignment of contracts

4.1 Third-party contracts and guarantees or warranties

Any obligation of the vendor to assign the benefit of guarantees or warranties to the purchaser should be set out in the agreement of purchase and sale. Many maintenance contracts relating to commercial properties are very informal. Formal written arrangements need to be reviewed to determine whether they can be assigned to the purchaser without the contractor's consent. Where the contractor's consent is required, someone needs to take responsibility for obtaining it. Even if there is no restriction on assigning, it is good practice to alert the contractor to the fact that the vendor will soon be dealing with the purchaser. Since many contracts require 30 (or more) days' notice of cancellation, it is useful if the purchaser can identify at an early date those contracts it wants to assume. The vendor's lawyer can draft this requirement into the agreement of purchase and sale so as to allow the vendor a reasonable time to terminate unwanted contracts without paying a penalty for cancelling on short notice. There may be circumstances where a vendor insists that the purchaser assume certain contracts (for example, a long-term contract might cost too much to terminate, or if the vendor is taking a vendor take-back mortgage, it may want the comfort of knowing that the purchaser has reliable contractors providing services that support rent and life and safety systems). Sometimes vendors expect their lawyers to arrange to cancel contracts or obtain contractors' consents to assignments. If this is the case, the lawyer should ask for pertinent information such as utility account numbers, details as to letters of credit that have been supplied, copies of contracts, and so on. Obviously, if the closing date of the transaction is extended or abridged, the contractor should be advised.

5. Closing

Closing is the culmination of all of the negotiations, inspections, and paperwork mentioned above. Commercial transactions are often closed at lawyers' offices rather than the registry office, and only the documents to be registered are taken to the registry office. In areas where electronic registration exists, many closings now take place by delivering to the opposing lawyer, in escrow, those documents that are not to be registered. A form of document registration agreement (such as the one that can be found on the Law Society of Upper Canada's website) is entered into regarding treatment of the documents that are to be registered, and these are "messaged" between the parties in the normal way. The following are items that one might typically find on a commercial real estate closing agenda:

- statement of adjustments (pre-closing) (same as residential).
- tenant estoppel certificate(s) (pre-closing).
- transfer with or without *Planning Act* boxes completed (purchaser to supply affidavit of land transfer tax and land transfer tax cheque) (same as residential).
- mortgage assumption agreement, if applicable, and related mortgage statement (same as residential).
- vendor take-back mortgage, collateral security, and supporting resolution and/or opinion, if applicable.
- general conveyance (for significant equipment and furnishings).
- assignment of guarantees.
- assignment of third-party contracts and related consents, if appropriate.
- assignment and assumption of leases. Theoretically, an assignment of leases from vendor to purchaser is not necessary. The new owner, as landlord, is entitled to collect rents from tenants. The practice is

that such a document is exchanged on closing. Purchasers find it useful to have a piece of paper to prove that the lease has been assigned, and vendors like to know that the purchaser is now responsible for all of the landlord's obligations. Such documents also often include mutual indemnities whereby the vendor indemnifies the purchaser from claims made by tenants respecting matters arising before closing, and vice versa.

- notice and direction to tenants. This is simply a piece of paper signed by the vendor notifying tenants of the sale and directing that future lease payments be made to the purchaser. Tenants react better to a seamless transition, so many purchasers deliver (along with the formal notice and direction) a welcoming letter identifying the new owner and the new property manager and giving telephone numbers and other means of contacting the new landlord.
- purchaser's insurance (if there is a vendor take-back mortgage or security package) showing the vendor as loss payee as its interest may appear.
- mutual undertakings to readjust.
- direction and redirection as to funds.
- purchaser's direction re: title (if the purchaser directs that the title be registered in someone else's name) and assumption by purchaser's assignee of significant covenants and indemnities, if any.
- vendor's certificate or statutory declaration pursuant to s. 116 of the *Income Tax Act* (same as residential).
- remaining tenant estoppel certificates or vendor's certificate/statutory declaration in lieu of missing estoppel certificate (if required by the agreement).
- purchaser's covenant to self-assess, pay HST, and indemnify vendor, if applicable.
- certified closing proceeds or wire transfer.
- keys (same as residential) and security passes and codes.
- original leases (and applicable extracts from tenant files), maintenance contracts, plans, surveys, and any other relevant contracts or documents.

6. Post-closing

Immediately after closing, the lawyers should call the clients and advise them that the deal has closed. The lawyer acting for the purchaser should deliver the keys. The vendor's solicitor should immediately disburse the closing funds.

The purchaser's solicitor should write to the tax department and utilities department to advise them of the change of ownership so that future bills will be sent to the purchaser.

It is very important for the solicitor to diarize the file in order to ensure completion of the following:

- receipt of confirmation of registration of all discharges, together with a copy of the registered discharge for his or her file;
- compliance with all undertakings; and
- reporting to the client and delivery of the statement of account.

If the lawyer has obtained moneys for his or her fees and disbursements, in trust, these fees and disbursements cannot be transferred to the general account until a report regarding the transaction is delivered to the client.

Lawyers should write the report on the transaction as soon as possible. The reporting letter will serve several important functions. First, when acting for the purchaser, it is the legal opinion to the client on the transaction. Second, it should be a good record of what took place:

- what the client's instructions were;
- what the lawyer did in response to the instructions; and
- other material matters with respect to the property.

It will form an excellent defensive tool, as well as a good starting point if the client decides to sell the property.

When reporting to a purchaser, the lawyer's report will include the following:

- the opinion on title. The opinion will usually say "that the purchasers have a good and marketable title in fee simple, subject to the following exceptions." Then recite all of the exceptions. Any qualifications to good title should be items that have been discussed with the client before closing and on which the client's instructions have been obtained. Any waivers by the client should be detailed—for example, instructions on not obtaining an up-to-date survey of the property, waiver of a condition, and any other material instructions.
- details regarding the statement of adjustments and how funds were dealt with on closing.
- full particulars of any mortgages. Be sure to let the purchaser know when mortgage instalments are payable and the manner of making such payments. It is wise to put this in a preliminary report so that if the report is delayed at all, the purchaser still has this information in a timely fashion.
- responses to search letters, including the status of zoning and building searches, tax account and utility status, and all other non-title searches.
- factual information such as the date of closing, how title was taken, and a short description of the various closing documentation.
- insurance arrangements.

- any unusual aspect of the transaction.

The report on a sale tends to be somewhat shorter. This letter is largely focused on the statement of adjustments and the disbursement of funds. If mortgages have been discharged, the details of the discharge should be set out. If there has been a mortgage back, the details of the mortgage back should be fully set out, as well as any waivers obtained from the client and instructions on any unusual matters. Helpful factual information, such as the date of closing, confirmation of payment of realty taxes and other payments, is useful. A short description of the closing documentation should also be included.

Keep a copy of the reporting letter with all documents together, either in a bound form or in one subfolder. This will avoid sifting through the file at a later date and will save a great deal of time and frustration if the file has to be recalled for any reason.

Appendix

Off-Title Searches for Commercial Transactions

Type of clearance	When applicable	Relevant legislation
1. Realty tax arrears	Always. Request a tax certificate from the relevant municipal authority.	*Municipal Act, 2001*, S.O. 2001, c. 25. s. 349(3) — taxes are a special lien on property in priority to every claim, privilege, lien, or encumbrance of every person except the Crown.
2. Local improvement charges	Always. In the request for the tax certificate above, an inquiry should be made as to whether there are any outstanding or pending local improvement charges.	*Local Improvement Charges – Priority Lien Status*, O. Reg. 586/06, made under the *Municipal Act, 2001*. s. 5(1) — a municipality that has the authority to undertake a work may pass a by-law to undertake the work as a local improvement for the purpose of raising all or any part of the cost of the work by imposing special charges on lots abutting the work or lots not abutting the work but that will be immediately benefited by the work or a combination of these abutting and non-abutting lots. s. 5(2) — a special charge imposed with respect to the work has priority lien status as described in s. 1 of the *Act*. *Municipal Act, 2001*, S.O. 2001, c. 25. ss. 1(2.1) and 398(2) — the municipality is allowed to add these charges to the tax roll. s. 1(3) — any amount added to the tax roll is a special lien on the property in the same manner as taxes under s. 349(3) and may be recovered from the assessed owner and any subsequent owner of the property.
3. Public utilities charges (a) Water and sewer charges (b) Artificial/natural gas (c) Steam or hot water	Always for any public utilities supplied by a local municipality. Most municipalities have a separate department that handles collection of water and sewer charges, and an inquiry letter should be addressed to such department.	*Fees and Charges — Priority Lien Status*, O. Reg. 581/06, made under the *Municipal Act, 2001*. s. 1 — fees and charges imposed by a municipality for the supply of water and the use of a sewage system that have been added to the tax roll under s. 398(2) of the *Act* have priority lien status as described in s. 1 of the *Act*. *Municipal Act, 2001*, S.O. 2001, c. 25. s. 1(3) — any amount added to the tax roll is a special lien on the property in the same manner as taxes under s. 349(3) and may be recovered from the assessed owner and any subsequent owner of the property.
4. Electrical Safety Authority — work orders	Always. Send a letter to the local Electrical Safety Authority requesting information on any outstanding work orders.	*Electricity Act, 1998*, S.O. 1998, c. 15, Sch. A. s. 113(11) — the authority may issue orders relating to work to be done in the installation, removal, alteration, repair, protection, connection, or disconnection of any of works or matters used or to be used in the generation, transmission, distribution, retail, or use of electricity as the Authority considers necessary or advisable for the safety of persons or the protection of property.

Type of clearance	When applicable	Relevant legislation
5. Building department (a) Zoning compliance (b) Municipal work orders (c) Occupancy permit	Always. A letter should be sent to the building department of the relevant municipality requesting, among other things, confirmation of the zoning; whether there are any planned amendments to the zoning; whether the building complies with all applicable by-laws; whether there are any outstanding permits, inspection files, or work orders; and whether an occupancy permit has been issued. Most municipalities will not give an opinion as to conformity with zoning, but they will advise as to the current zoning of the property.	(a) *Planning Act*, R.S.O. 1990, c. P.13. (b) *Building Code Act, 1992*, S.O. 1992, c. 23. Various sections of the *Act* give building inspectors the power to enter and inspect buildings and issue orders for the performance of remedial work within a specified time. If the required work is not completed within the specified time, the municipality can complete the work. The municipality has a lien on the property for the cost of the work, which has priority lien status under s. 1 of the *Municipal Act, 2001*.
6. Compliance with all municipal agreements registered on title	Always. Send an inquiry letter to the specific department of the municipality depending on the nature of the agreement.	*Planning Act*, R.S.O. 1990, c. P.13. s. 41(7) — as a condition to the approval of the development plans and drawings, a municipality may require the owner of the land to, among other things, enter into an agreement with the municipality dealing with and ensuring the provision of facilities or works. s. 41(10) — any such agreement may be registered and enforced against the owner and subsequent owners of the land. ss. 51(25)–(26) — similar provisions apply with respect to agreements that may be required as a condition to the approval of subdivision plans.
7. Unregistered hydro easements (a) Hydro One (formerly Ontario Hydro) (b) Municipal hydro corporation	Always. (a) Send an inquiry letter to Hydro One requesting information as to any unregistered easements it may have over the property pursuant to s. 46(1) of the *Electricity Act, 1998* and s. 48(2) of the *Power Corporation Act*. (b) Send an inquiry letter to the municipal hydro corporation requesting information as to any unregistered easements it may have over the property pursuant to s. 46(1) of the *Electricity Act, 1998* and s. 48(3) of the *Power Corporation Act*.	*Electricity Act, 1998*, S.O. 1998, c. 15, Sch. A. s. 46(1) — if, immediately before the repeal of s. 48 of the *Power Corporation Act*, land was subject to a right referred to in s. 48(2) or (3) of the *Power Corporation Act*, the land continues to be subject to the right until the right expires or until it is released by the holder of the right.

Type of clearance	When applicable	Relevant legislation
8. Corporate existence searches	Always. It is necessary to search all corporations that held title to the property to determine whether they existed during the period of their ownership of the property. There are varying opinions on whether this search should be done within the search period, back 40 years, or to the Crown Patent. If the property is a LTCQ title, it is only necessary to search corporations appearing in the chain of title subsequent to the conversion date.	*Business Corporations Act*, R.S.O. 1990, c. B.16. s. 244(1) — any property of a corporation that has not been disposed of at the date of its dissolution is immediately upon such dissolution forfeit to and vests in the Crown. s. 244(3) — a forfeiture of land is not effective against a purchaser for value of the land if the forfeiture occurred more than 20 years before the deed or transfer to the purchaser is registered. *Canada Business Corporations Act*, R.S.C. 1985, c. C-44. s. 228(1) — property of a body corporate that has not been disposed of at the date of its dissolution vests in Her Majesty the Queen in right of Canada.
9. Condominium status certificate	Always when dealing with a condominium property. Note: a status certificate may be obtained in addition to any disclosure statement required to be provided by the declarant under s. 72 of the *Condominium Act, 1998* in connection with the purchase of a new condominium unit.	*Condominium Act, 1998,* S.O. 1998, c. 19. s. 76 — the condominium corporation is required to give a status certificate in prescribed form to every person who requests such certificate and pays the prescribed fee.
10. Fire department — work orders	Always. A letter for a search of the records of the local fire department may require the property owner's consent. The Fire Marshal has discretionary power to inspect any premises notwithstanding that the inquiry letter only asks for a search of records. Send an inquiry letter to the Office of the Fire Marshall when dealing with nursing homes, retirement homes, or hotels.	*Fire Protection and Prevention Act, 1997*, S.O. 1997, c. 4. ss. 19(1)–(2) — a Fire Marshal, an assistant to a Fire Marshal, or a fire chief (collectively referred to as an "inspector") may, with or without a warrant, enter and inspect property for assessing fire safety at all reasonable times. s. 21 — an inspector who carries out such an inspection may order an owner or occupant to take any necessary measure to ensure fire safety on the property. ss. 33, 35 and 38(1) — if the person to whom an order is issued fails to comply, the inspector may apply to the Fire Safety Commission for an authorization to carry out the required work. The Fire Marshal, a fire chief, or an assistant to the Fire Marshal may issue an order to the property owner to pay the costs of such work and may instruct the municipality to recover such costs. Upon receiving such instruction, the municipality has a lien for the relevant amount against the property. Such lien has priority lien status as described in s. 1 of the *Municipal Act, 2001* and is added to the tax roll and collected like taxes.

Type of clearance	When applicable	Relevant legislation
11. Waste disposal	Always. Send an inquiry letter to the clerk of the municipality to determine whether the property was used as a waste disposal site and whether there is any record of sewer use violations, any spill events, or evidence of the operation of a landfill or sanitary dump site. The Ministry of Environment also maintains computer database inventories of waste disposal and PCB storage sites, waste manifest and generator information, and an Environmental Bill of Rights registry containing summaries of proposed and finalized certificates of approval, directions, and orders that can be searched.	*Environmental Protection Act*, R.S.O. 1990, c. E.19. s. 46 — no use shall be made of land or land covered by water that has been used for the disposal of waste within a period of 25 years from the year in which such land ceased to be so used unless the approval of the Minister has been given for the proposed use.
12. Conservation authority	Always. Send an inquiry letter to the relevant conservation authority requesting confirmation of whether the property is within its jurisdiction, the restrictions that apply, and details of any outstanding orders or violations.	*Conservation Authorities Act*, R.S.O. 1990, c. C.27. s. 28 — an authority can make regulations to, among other things, restrict and regulate the use of water from streams, rivers, etc.; require the permission of the authority for interfering with the channel of any waterway or wetlands; and require the permission of the authority for development, if in the opinion of the authority, the control of flooding, erosion, dynamic beaches, or pollution or conservation of the land may be affected by such development.
13. Crown Patents	Deal specific, depending on the size and significance of the transaction (although practice varies). Review the Crown Patent to determine what reservations and conditions were imposed in the original grant from the Crown. A copy of the Crown Patent for the relevant lands can be obtained from the Ministry of Natural Resources in Peterborough.	*Public Lands Act*, R.S.O. 1990, c. P.43. Most typical reservations (mines and minerals, white pine trees, etc.) have been released by statute, but the *Act* and predecessor legislation should be checked to determine whether any particular reservation is still in effect.

Type of clearance	When applicable	Relevant legislation
14. Elevating devices — work orders	Deal specific. Always where there are elevators or escalators on the property. Send an inquiry letter to the Technical Standards and Safety Authority (TSSA) requesting a status report and whether there are any outstanding work orders. The cost of this inquiry will depend on how many devices are on the property.	*Technical Standards and Safety Act, 2000*, S.O. 2000, c. 16. s. 6 — the *Act* requires an authorization in accordance with the *Act*, the regulations, or a Minister's Order before operating or otherwise dealing with any elevating devices. s. 9 — a director may suspend or refuse to renew an authorization where the carrying on of operations under the authorization poses an immediate threat to public safety or the safety of any person. s. 13 — a director may suspend or refuse to renew an authorization where the holder of an authorization is in default of the following: (i) the payment of a fee, an administrative penalty, a cost, or other charge owing to the Corporation; (ii) payment of a fine imposed on conviction for an offence under the *Act*; or (iii) an order made under the *Provincial Offences Act*.
15. Boilers & pressure vessels — work orders	Deal specific. Always where there are boilers or pressure vessels on the property. Send an inquiry letter to the TSSA requesting confirmation that a certificate of inspection has been issued, the date of the last periodic inspection, and whether there are any outstanding orders.	*Technical Standards and Safety Act, 2000,* S.O. 2000, c. 16. See sections of the *Act* referred to under Elevating devices, above. *Boilers and Pressure Vessels*, O. Reg. 220/01, made under the *Technical Standards and Safety Act, 2000*. s. 5 — no person shall operate or use a boiler, pressure vessel, fitting, or piping unless a valid certificate of inspection has been issued (there are some exemptions to this *Regulation* including systems that are used exclusively for agricultural uses).
16. Heritage designation	Deal specific. Send an inquiry letter to the clerk of the municipality for confirmation of whether the property is designated, whether any by-law designating the property has been proposed or is pending, and whether there is a lien claimed against the property.	*Ontario Heritage Act*, R.S.O. 1990, c. O.18. s. 27 — a register of all properties designated under the *Act* within the municipality shall be kept by the clerk's office containing the legal description of the property, the name and address of the owner, and a statement of the reason for the designation. s. 29 — where a municipality intends to designate a property of cultural heritage value or interest, it shall serve notice of such intention to the persons listed in this section. s. 39 — a municipality may grant a loan to the owner of a designated property to make repairs or renovations to the property. The amount of such loan together with interest may be added to the tax roll and collected like taxes and, until payment, is a lien on the relevant property.

Type of clearance	When applicable	Relevant legislation
17. Health unit — work orders	Deal specific. Always where there is a food court or restaurant. In other cases, consider whether there are other property uses or circumstances to which the *Health Protection and Promotion Act* and its regulations may apply. Send an inquiry letter to the health department of the municipality to determine whether there are any outstanding requirements, work orders, or deficiencies on file and whether any permits or approvals have been issued.	*Health Protection and Promotion Act*, R.S.O. 1990 c. H.7. s. 10(2) — it is the duty of the medical officer of health for a health unit to cause food premises, boarding houses, and lodging houses to be inspected. s. 13(1) — a medical officer of health or a public health inspector may by a written order require a person to take or to refrain from taking any action that is specified in the order in respect of a health hazard. s. 14 — if the person to whom the order is issued fails to comply, the medical officer of health may cause the actions to be carried out. ss. 15(2)–(3) — if the costs of such actions are not paid within 60 days of demand, they may be added to the tax roll and collected in the same manner as taxes.
18. Development charges	Deal specific. Generally applicable only in cases of new construction. Confirm whether there is a by-law in force exempting the relevant property from development charges. If not, send an inquiry letter to the building department of the municipality inquiring as to either compliance with the registered agreement or, if there is no agreement, whether a development charge is payable, how much, and when it is due.	*Development Charges Act, 1997*, S.O. 1997, c.27. s. 26 — a development charge is payable upon the issuance of a building permit or upon the parties entering into a subdivision agreement or consent agreement unless a development charge by-law provides otherwise. s. 27(1) — a municipality may enter into an agreement with a person who is required to pay a development charge for all or any part of a development charge to be paid before or after it would otherwise be payable. s. 32(1) — if a development charge remains unpaid then it is added to the tax roll and collected in the same manner as taxes.
19. Airport zoning regulations	Deal specific. Only if property is subject to airport zoning regulations registered on title. These regulations pertain to uses of property adjacent to airports that are incompatible with the operation of the airport and/or safety of aircraft. While municipalities have been delegated to handle enforcement of the regulations, there is not a regulatory body who will respond to a letter inquiring about compliance. If you are concerned with the height of a building in proximity to the airport, you will need to request that a surveyor provide you with a form of compliance report. However, if the property is in proximity to a military airport, an inquiry letter can be sent to the Department of National Defence.	*Aeronautics Act*, R.S.C. 1985, c. A-2.

Type of clearance	When applicable	Relevant legislation
20. Highways (a) King's Highways (b) Controlled access highways (400 series)	Deal specific, depending on proximity of property to a King's Highway or controlled access highway. Send a letter to the Ministry of Transportation inquiring as to any breaches of the appropriate section of the *Act* and whether the necessary permits have been issued.	*Public Transportation and Highway Improvement Act*, R.S.O. 1990, c. P.50. (a) King's Highways s. 34 — a permit is required for (i) the construction or alteration of any building, fence, gasoline pump, or other structure or the placement of any tree, shrub, or hedge within 45 metres of the highway or 180 metres of the centre point of an intersection; (ii) any sign within 400 metres of the highway; (iii) use of any land within 800 metres of the highway for a stadium, shopping mall, fairgrounds, race track, drive-in theatre, or any other purpose that causes persons to congregate in large numbers; (iv) the sale or display of produce, goods, or merchandise upon the highway; or (v) the construction or use of any private road or entrance as a means of access onto the highway. (b) Controlled access highways s. 38 — a permit is required for (i) the construction or alteration of any building, fence, gasoline pump, or other structure or the placement of any tree, shrub, or hedge within 45 metres of the highway or 395 metres of the centre point of an intersection; (ii) the sale or display of produce, goods, or merchandise within 45 metres of the highway or 395 metres of the centre point of an intersection; (iii) the erection or alteration of any power or transmission line within 400 metres of the highway; (iv) any sign within 400 metres of the highway; (v) use of any land within 800 metres of the highway for a stadium, shopping mall, fairgrounds, race track, drive-in theatre, or any other purpose that causes persons to congregate in large numbers; or (vi) the construction or use of any private road or entrance as a means of access onto the highway.
21. Cemeteries	Deal specific. This is not a precise search, and the records of the Ministry are not very good. Send an inquiry letter to the municipality or the Cemeteries Branch of the Ministry of Government Services if your client is purchasing an old farm property or church property that is to be developed or subdivided.	*Cemeteries Act (Revised)*, R.S.O. 1990, c. C.4. s. 68 — no person is to disturb a burial site or artifacts associated with human remains except on instruction by the coroner or pursuant to a site disposition agreement. s. 69 — any person discovering or having knowledge of a burial site must notify the coroner or the police.

Type of clearance	When applicable	Relevant legislation
22. Fuels Safety Program	Deal specific. Send an inquiry letter to the TSSA requesting any information on incident reports, fuel oil spills or contamination, retail facilities, or underground storage tanks registered at the property.	*Technical Standards and Safety Act, 2000*, S.O. 2000, c. 16. *Fuel Oil*, O. Reg. 213/01, made under the *Technical Standards and Safety Act, 2000*. s. 7(1) — no distributor shall supply fuel oil to a container or tank system that is connected to an appliance or work unless the distributor is satisfied that the installation and use of the appliance and work complies with this *Regulation* and the distributor has inspected the appliance or work at least once within the previous 10 years. s. 7(4) — no person shall supply fuel oil to an unregistered underground tank. Also note that under the *Liquid Fuels Handling Code, 2007* and the *Fuel Oil Code*, all underground storage tanks must be removed within two years of disuse.
23. Other environmental searches	Deal specific. Most searches that can be conducted by a lawyer merely provide information maintained in historical government records, are quite costly, and take considerable time to obtain a response. The information will generally not provide the current state of the property or any potential environmental liability. In addition to the searches already mentioned above, other possible searches include the following: — When acting for a lender or a purchaser regarding an Ontario property, search the Brownfields Environmental Site Registry to determine if a record of site condition has been filed for the property in question or for adjoining lands (since contamination may migrate from adjoining lands to the subject property). — Request records of the Ministry of Environment or Ministry of Labour under the *Freedom of Information and Protection of Privacy Act*. — For federally regulated properties, request records from Environment Canada under the *Access to Information Act*. — Search the federal inventory of PCB storage sites maintained by Environment Canada. — Search Eco-Log ERIS, an environmental database and information service company that for a fee conducts database searches of environmental and historical records compiled from government and private source records, including some information that is not otherwise accessible directly.	*Environmental Protection Act*, R.S.O. 1990, c. E.19. ss. 147 and 150 — where a person fails to comply with an order or decision made under the *Act*, the Director may cause the necessary work to be carried out, and the Director may issue an order to pay costs to the person who failed to do the work. s. 154(2) — if the person to whom the order to pay costs is issued owns real property and the Director instructs the local municipality to recover the costs for things done in connection with that property, the municipality has a lien on the property. Such lien has priority lien status as described in s. 1 of the *Municipal Act, 2001* and is added to the tax roll and collected like taxes.

Type of clearance	When applicable	Relevant legislation
24. Navigable waters	Deal specific. If there are structures located in the water such as boat houses, pump houses, docks, and piers, conduct the following inquiries: (a) Send a letter to the Ministry of Natural Resources as owner of the bed of water inquiring as to whether there is an approval for the structures located in the water. (b) Send a letter to the Canadian Coast Guard under the Navigable Waters Protection Program inquiring as to whether approval was given to the works and whether there are any outstanding orders regarding them. (c) Send a letter to the Department of Fisheries and Oceans, Fish Habitat Management Program inquiring as to whether approval was given to the works and whether there are any outstanding orders regarding them.	*Beds of Navigable Waters Act*, R.S.O. 1990, c. B.4. s. 1 — where land that borders on a navigable body of water or stream has been granted by the Crown, title to the bed of the body of water or stream did not transfer to the grantee in the absence of an express grant. *Public Lands Act*, R.S.O. 1990, c. P.43. s. 24 — the Crown is the owner of all structures placed or left without authority on public lands. *Navigable Waters Protection Act*, R.S.C. 1985, c. N-22. s. 5 — no work (defined broadly to include any bridge, boom, dam, wharf, dock, pier, tunnel or pipe, dumping of any fill or excavation of material, any telegraph or power cable or wire, or any structure that may interfere with navigation) shall be built or placed in, on, over, under, through, or across any navigable water unless the work has been approved by the Minister or the Minister is satisfied that it does not substantially interfere with navigation. *Fisheries Act*, R.S.C. 1985, c. F-14. s. 35 — no person shall carry on any work or undertaking that results in the harmful alteration, disruption, or destruction of fish habitat. s. 37 — the Minister has the authority to modify, restrict, or prohibit any work or undertaking that is likely to result in the harmful alteration, disruption, or destruction of fish habitat.
25. Railway mortgages	Deal specific. When dealing with lands that have at any time been owned by a railway company, a search of the records of the Registrar General should be conducted to verify that there are no mortgages that affect the property.	*Canada Transportation Act*, S.C. 1996, c.10. s. 104 — a mortgage or hypothec issued by a railway company deposited in the office of the Registrar General and published in the *Canada Gazette* does not need to be registered under any other law or statute affecting real or personal property.
26. Personal property security	Deal specific. Consider a *Personal Property Security Act* (*PPSA*) search if a fixture may be the subject of a security interest under s. 34 of the *PPSA*. When dealing with a transaction that also involves the acquisition of personal property, conduct a standard PPSA search.	*Personal Property Security Act*, R.S.O. 1990, c. P.10.
27. Bankruptcy/insolvency	Deal specific. The search is not necessary prior to a trustee-in-bankruptcy registering a notice on title but is customary as part of the due diligence process in large commercial transactions. Conduct a name search with the Office of the Superintendent of Bankruptcy.	*Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3.

Type of clearance	When applicable	Relevant legislation
28. Septic tank/sewage systems	Deal specific. For all systems installed after April 6, 1998, send an inquiry letter to the building department of the municipality requesting confirmation that a permit was issued and inspections completed. For all systems installed before April 6, 1998, send an inquiry letter to the local office of the Ministry of Environment.	*Building Code Act, 1992*, R.S.O. 1992, c.23. *Building Code*, O. Reg. 350/06, made under the *Building Code Act, 1992*. Part 8 applies to all sewage systems constructed after April 6, 1998. A permit is required from the building department, inspections are required during the course of construction, and a final inspection must be made.
29. Wells/water works	Deal specific. Send an inquiry letter to the Ministry of Environment requesting a copy of the well record. Include a request for confirmation as to whether any order to pay costs has been issued in respect of work on the property. To test for the potability of the water, a water sample should be delivered to the local health unit for testing. If you are dealing with a water system to which the *Safe Drinking Water Act, 2002* applies, include a request for information concerning outstanding work orders and instructions to recover costs.	*Ontario Water Resources Act*, R.S.O. 1990, c. O.40. ss. 83–84 — where a person fails to comply with an order or decision made under the *Act*, the Director may cause the necessary work to be carried out, and the Director may issue an order to pay costs to the person who failed to do the work. s. 88(2) — if the person to whom the order to pay costs is issued owns real property and the Director instructs the local municipality to recover the costs for things done in connection with that property, the municipality has a lien on the property. Such lien has priority lien status as described in s. 1 of the *Municipal Act, 2001* and is added to the tax roll and collected like taxes. *Safe Drinking Water Act, 2002*, S.O. 2002, c. 32 and its regulations. This *Act* contains testing requirements and water treatment standards that must be met if the well services multiple properties. The *Act* gives powers to Directors and provincial officers designated under the *Act* to inspect properties and make orders in connection with the purposes of the *Act*. s. 122 — if the Director issues a notice of emergency response to an imminent drinking water health hazard or appoints an interim operating authority for a drinking water system, the Director can issue an order to pay costs to the owner of the drinking water system if the system is not abandoned or to prescribed persons if the system has been abandoned. ss. 124(1)–(2) — the Director may instruct a municipality to recover amounts specified in an order to pay costs if (a) the person to whom the order is directed owns land in the municipality, and (b) the drinking water system or part thereof is located in the municipality. If such instruction is issued, the municipality has a lien for the amount specified on all land in the municipality owned by the person to whom the order to pay costs is directed, and the specified amount is deemed to be municipal taxes and is added to the tax roll and collected in the same way and with the same priorities as municipal taxes. Similar provisions apply to land in a territory without municipal organization.

Type of clearance	When applicable	Relevant legislation
30. Improvements under the *Drainage Act*	Deal specific. Send an inquiry letter to the clerk of the municipality when the property is not serviced by municipal storm sewers.	*Drainage Act*, R.S.O. 1990, c. D.17. s. 22 — lands, roads, buildings, utilities, or other structures that are increased in value or that are more easily maintained as a result of the construction, improvement, maintenance, or repair of drainage works may be assessed for benefit. s. 61(1) — a municipality that is required to raise the whole or any part of the cost of drainage works shall by by-law impose upon the land assessed for the drainage works the assessment with which it is chargeable, and the amount so imposed is payable in such instalments as the council may prescribe. s. 61(4) — the assessments imposed under the *Act* have priority lien status as described in s. 1 of the *Municipal Act, 2001*.
31. Weed control	Deal specific. Send an inquiry letter to the municipality for information on whether an order to destroy weeds has been issued and, if so, whether it has been complied with or whether there are any outstanding amounts due to the municipality.	*Weed Control Act*, R.S.O. 1990, c. W.5. s. 13(1) — an inspector who finds noxious weeds or weed seeds may order the person in possession of the lands to destroy them. s. 15(1) — if the order is not complied with, then the inspector can cause the weeds to be destroyed in the prescribed manner. s. 15(3) — the municipality may send notice to the owner and the person in possession of the land requesting payment of expenses associated with the destruction of the weeds. ss. 15(5)–(6) — if the expenses are not paid within 15 days, the amount paid by the municipality for the destruction of the weeds is added to the tax roll for the property and obtains priority lien status.
32. Liquor Licence Board	Deal specific. Applies to premises for which a liquor licence has been issued. Send an inquiry letter to the Alcohol & Gaming Commission of Ontario to confirm that no notice to refuse, revoke, or suspend the liquor licence has been issued.	*Liquor Licence Act*, R.S.O. 1990, c. L.19. s. 5 — no person shall keep for sale, offer to sell, or sell liquor except under the authority of a licence or permit.
33. Workplace Safety & Insurance Board	Deal specific. Applies in connection with acquisition of a business. Send an inquiry letter to the board requesting a clearance certificate.	*Workplace Safety and Insurance Act, 1997*, S.O. 1997, c. 16, Sch. A. s. 146 — a purchaser is liable for all obligations owing by an employer who disposes of all or part of his business.
34. Labour Board — work order	Deal specific. Send an inquiry letter to the board requesting information as to any outstanding work orders.	*Occupational Health and Safety Act*, R.S.O. 1990, c. O.1. s. 57(1) — an inspector may issue an order where there is non-compliance under this *Act*.

Type of clearance	When applicable	Relevant legislation
35. Niagara escarpment	Deal specific. If the property lies within the control of the Niagara Escarpment Commission, send a letter to this Commission requesting confirmation as to what restrictions and regulations pertain to the property and verification that a permit has been issued or that development was exempt.	*Niagara Escarpment Planning and Development Act*, R.S.O. 1990, c. N.2. s. 14 — municipal zoning by-laws have no effect in the area of development control designated under this *Act*. s. 24(3) — no building permit, work order, certificate, or licence that relates to development shall be issued with respect to land within an area of development control unless the development is exempt or a permit has been issued.
36. Mining property	Deal specific. In the case of mining land or mining rights, an inquiry letter should be sent to the Ministry of Northern Development and Mines requesting a tax certificate.	*Mining Act*, R.S.O. 1990, c. M.14. s. 79(2) — the owner of surface rights in land on which mining activities are conducted is entitled to compensation for damages sustained to the surface rights. s. 79(6) — the compensation is a special lien upon any mining claim or mining lands, and no further prospecting, staking out, or performing of work, except by leave of the Commissioner, may be done by any person after the time fixed for the payment or securing of the compensation, unless the compensation has been paid or secured as directed. Part XIII — ss. 186–203 provide for assessment of taxes on mining lands and mining rights. Pursuant to s. 200, all taxes, penalties, and costs payable under this Part constitute a special lien on the lands or mining rights against which the tax is levied in priority to every claim, privilege, lien, or encumbrance of any person.

Chapter 63

Commercial leasing

1. Introduction

A commercial leasing matter has attributes of both a contract negotiation (a lengthy document with many issues to be settled) and a commercial transaction (a variety of stages that move to an end result). The file will need to be organized to reflect both characteristics.

Another duality of commercial leasing is that both contract law and property law concepts apply. This was made clear in the leading case of *Highway Properties Ltd. v. Kelly, Douglas and Company Limited*, where the Supreme Court of Canada recognized that it was no longer sensible to pretend that a commercial lease was simply a conveyance and not also a contract.

On the property law side, there are rights in a lease that run with the land, such as the right of the landlord to collect rent, the right of the tenant to quiet enjoyment, and rights of assignment and sublease in favour of the tenant. On the other hand, some lease covenants are contractual only and do not run with the land. These are typically special rights that have been negotiated by the tenant, such as expansion rights, rights to parking, tenant inducements, and exclusive-use rights.

The fact that a lease is an interest in land distinguishes it from a licence. A lease creates property rights that are defensible against third parties. A licence is a contract that binds only the named parties and does not run with the land. The real property concepts applicable to leases do not apply to licences. Where less than full property rights are intended, licences are often used, such as for granting rights for storage areas, kiosks in malls, and rooftop areas.

When acting in this area, lawyers will need to be familiar with both the extensive common law that is applicable to commercial leases as well as the various statutory provisions found in the *Commercial Tenancies Act* and various other statutes.

2. Basic legal requirements

2.1 Certainties required for a valid lease or agreement to lease

To be a valid lease or agreement to lease there must be agreement and certainty as to the parties (the landlord and tenant, as well as any guarantor or indemnifier), the premises to be leased, the commencement and duration of the term, the rent, and all material terms of the contract not incidental to the relation of landlord and tenant.

The commencement date and term must be either fixed or ascertainable. It is common for a lease to provide for a commencement date based on a future event, such as completion of the building by the landlord. In these types of transactions, it is useful to consider some outside date after which the deal aborts, or else there is a risk of the parties having to wait indefinitely (and also the risk of the agreement being held to be void or voidable due to the uncertainty).

The first five requirements (parties, premises, commencement date, term, and rent) are invariable requirements. Whether the sixth requirement is applicable depends on the circumstances. Where either party has raised an issue that is important to it and that is not a normal incident of a landlord and tenant relationship, there must be agreement on the matter for there to be a valid lease or agreement to lease.

In *Ossory Canada Inc. v. Wendy's Restaurants of Canada*, the Ontario Court of Appeal noted that the sixth item on the list of requirements for a binding agreement to lease includes matters that either party raises as important. In this case, matters of the garbage enclosure and pylon sign were important to Wendy's and that importance had been communicated to the landlord. Accordingly, there could be no concluded contract until agreement was reached with respect to those points.

Other cases have shown material terms requiring agreement can include whether there is an obligation to pay by postdated cheques, whether a personal guarantee is to be provided, what liability insurance coverage is required, the lack of a clear definition of available parking, the rental rate in the overholding clause, the prohibition on change of use in a sublease, the relocation right in favour of the landlord, the landlord's right to terminate in lieu of granting consent to an assignment or sublease, and the landlord's right of early termination.

These cases show the importance of fully documenting any preliminary agreement regarding the lease of premises. The failure to deal with all material terms could result in a determination that there was in fact no agreement reached.

2.2 Statute of frauds

A lease or agreement to lease must generally be in writing pursuant to ss. 1–2 of the *Statute of Frauds*. However, there is no requirement that the agreement to lease be a specific form and, as with other contracts, can consist of correspondence or other written documents or letters.

A lease or an agreement to lease not exceeding a term of three years where the rent during the term is at least two-thirds of the full improved value of the premises being leased is not subject to the requirement to be in writing (*Statute of Frauds*, s. 3.). The value referred to is the rental value, and not the sale value.

The equitable concept of part performance may also save an agreement or lease that is not in writing. This doctrine was developed by the Courts of Equity after it became apparent that the *Statute of Frauds* was being relied upon to avoid oral agreements. The necessary circumstances for this doctrine to be successfully applied have been stated in *Halsbury's Laws of England* (3rd ed., vol. 8 at 110, para. 190) as the following: (1) acts are undertaken pursuant to the contract asserted; (2) the contract, if prepared in writing, would have been enforceable; (3) there is proper evidence of the existence of the contract; and (4) denying recognition of the acts of part performance would fraudulently enable the resiling party to take advantage of the fact that the contract was not in writing.

3. Types of leases

3.1 Leases by subject matter

There are three major categories of commercial leases in a commercial leasing practice: industrial, office, and retail. All share many similar concepts and terms, but there are differences.

3.1.1 Industrial leases

Industrial leases tend to be the most basic and not contain some of the additional provisions that office and retail leases do, such as a retail tenant's obligation to continuously occupy the premises or relocation rights in favour of an office or retail landlord. Since industrial premises tend to be more self-sufficient, the maintenance and repair obligations are more often pushed more fully to the tenant. Obviously, environmental issues may be very significant in the industrial context, and therefore leases in the area tend to have more detailed environmental provisions.

3.1.2 Office leases

Office leases tend to rank between industrial leases and retail leases in terms of length and complexity. The landlord and the tenant will not necessarily have the same degree of integration as required in a shopping centre, which is run as an integrated business as far as customers are concerned. However, the tenant will rely on the landlord for more services than it would in an industrial lease, such as heating and air-conditioning (including after-hours services) and elevators. Since office premises tend to cost more to improve than retail, the end-of-term restoration obligation may be more of a focus for an office tenant.

3.1.3 Retail leases

Landlords and tenants in retail complexes are much more in "partnership" than in either the industrial or office setting. The viability of the retail centre is critical to the sales for the tenant and to the income and property value for the landlord. Issues about the permitted uses tend to be fundamental for both parties here. The landlord will want more control on items such as use, operating name, radius restrictions on the tenant having another competing business in close proximity, and an ongoing obligation to refresh the premises (at least at renewals or extensions). Signage rights, including pylon sign rights (i.e., rights to be on the pylon (or pole) signs a landlord often has for its tenants), will be critical for tenants, and that is another area where the landlord will want to exert control to keep tenants within its sign criteria.

3.1.4 Measuring rental areas

Measurement of the rentable area, for the purposes of calculating rent and additional rent obligations, is one area where the three types of leases differ. Measurement in an industrial building is typically to the exterior face of all exterior walls. In a multi-tenant situation, measurement will be to the middle line of any demising walls and to the outside face of any walls separating the premises from common areas. Method A of the Joint BOMA (Building Owners and Managers Association)/SIOR (Society of Industrial and Office Realtors) standard of measurement is commonly used.

Office premises are typically measured in accordance with the BOMA standards of measurement: to the inside face of the glass or exterior walls, to the centre line of walls separating the premises from other premises, and to the outside face of any walls separating the premises from common areas. Columns and projections are not deducted, but items such as elevators, pipe shafts, and vertical ducts are. On a multi-tenanted floor, the rentable area will include the tenant's *pro rata* portion of the common areas on such floor, such as the elevator lobby, corridors, washrooms, and telephone and mechanical rooms. This is often referred to as the "gross-up" factor and tends to be in the range of 10–15%. The most recent

BOMA standards (2010), as well as the previous 1996 standards, include in the gross-up a *pro rata* portion of the main floor lobby and other common areas that serve the building generally. Some landlords continue to use 1980 BOMA, which does not have the additional gross-up.

A retail premises is typically measured from the exterior face of all exterior walls, from the exterior face of interior walls separating the premises from common areas, and from the center line of any interior walls separating the premises from other rentable premises. In interior malls, there is often the concept of a recessed store front with a lease line in front of the store. Generally, there is no gross-up to include any common areas for retail tenants (though some landlords may provide for the inclusion of a proportionate amount of common utility rooms and similar facilities).

In calculating the proportionate share of costs charged to retail tenants, there are often exclusions from the rentable area of the project (the denominator) used to calculate the tenant's share. Common exclusions include free-standing buildings, major tenants (for example, tenancies of 15,000 square feet or more), theatres, areas that do not have direct mall access, and space used by government authorities. These areas may not contribute fully (or at all) to operating costs and realty taxes. Tenants should be aware of the impact of these exclusions and should at least ensure that any contributions to operating costs and taxes made by these excluded tenancies be deducted from the costs before the tenant's share is determined.

3.2 Leases by financial structure

The most common financial structure is a net lease where the tenant pays base rent (also known as basic rent or minimum rent) and additional rent consisting of the costs involved in the use and occupation of the premises (such as realty taxes, landlord's insurance costs, common-area maintenance costs, and utility costs). If it is a single-tenanted building, some of these items may be the direct responsibility of the tenant (with the tenant having the direct obligation to pay). In a multi-tenant building, these costs are generally incurred by the landlord, and each tenant will pay its proportionate share.

A variety of terminology is seen in leases including "net," "net, net," "net, net, net," and "triple net." None of these terms have any real definition in the courts, and the lease provisions must always be looked at to see what costs are passed on. Typically, for a landlord to be able to pass on a cost, it must be specifically identified since it is difficult to rely on broad wording to effect this.

At the other end of the spectrum is a gross lease, where the tenant makes one monthly payment and has most of the above items included in its rent. The usual exception is certain utilities, specifically electricity, which even in a gross lease, most tenants pay directly and on top of the gross rent.

There are also leases in between the two extremes, often referred to as semi-gross leases or escalating leases. In those leases, the costs are generally fixed for the first year and increase by either amounts equal to the actual cost of increases or by a fixed amount, say 3% in each year.

In a retail lease, there is often also the payment of percentage rent by the tenant. This requires a payment of a certain percentage (anywhere in the range of 3% to 8% typically) of gross revenue generated from the premises in excess of the basic rent. The use of the basic rent as a threshold is often referred to as the "natural break point." Sometimes the business deal agreed to creates an "artificial break point." In those leases, the percentage rent payable will be calculated by applying the agreed percentage to the excess of gross revenue above the agreed amount of revenue that constitutes the artificial break point. The percentage rent provisions will require monthly reporting and annual statements to document the amount of gross revenue, as well as audit rights in favour of the landlord.

4. The lease transaction process

4.1 Preliminary documents

The typical lease transaction starts with a preliminary document, such as a term sheet, letter of intent, or agreement to lease. It may be binding or non-binding. The most common method is an offer to lease, usually binding and often conditional.

The preliminary document will need to deal with the legal certainties described above required for a valid lease or agreement to lease. After that, judgment has to be applied as to what provisions should be specifically negotiated at that time and what can be left to be dealt with in the lease. This will depend to some degree on what form of lease is contemplated in the agreement to lease. Leases from sophisticated landlords will usually refer to the landlord's form of lease with all terms of that form to be applied. A tenant will want to review the lease at that time to know what it is getting into or, at a minimum, provide in the agreement for the terms that are important to it and contemplate that those terms will operate notwithstanding what may be in the landlord's form of lease.

The preliminary document should set out the process of getting to the final lease document. Options include

having the lease settled within a specific period of time, failing which the deal becomes null and void (or perhaps one party having a right to terminate). More commonly, timing is set out for the delivery of a draft lease by the landlord and for the tenant to provide comments, with no termination or other specific consequences arising from the lease not being executed.

4.2 Preliminary conditions and due diligence

The preliminary document needs to set out any preliminary conditions that either party wants to satisfy (or waive) before the deal proceeds further.

In many circumstances, the landlord will require an initial condition to satisfy itself on the creditworthiness of the tenant. The tenant will be obligated to deliver financial information to assist the landlord in this.

Although not nearly as common, depending on the economic environment, the size and nature of the landlord, and whether the landlord is obligated to provide an allowance or other inducements to the tenant, the tenant may also need a period to satisfy itself on the financial condition of the landlord.

In certain transactions, a due diligence condition will be necessary for the tenant. The tenant may need to satisfy itself that the zoning allows its proposed use. A liquor licence may be required. If construction is needed, matters such as site plan approval and building permit availability will have to be considered. Depending on the nature of the development and of the landlord, the tenant may want to investigate the landlord's title to ensure it is dealing with the appropriate party and that there are no restrictions that would impact the ability of the tenant to use the premises for its intended use.

It is very common for leases to contemplate the tenant taking the space "as is," and in those circumstances, provision should be made for the tenant to inspect the building and the heating, ventilation, air-conditioning, and other systems.

4.3 Negotiation

Following the waiver or satisfaction of any preliminary conditions, the landlord will typically provide its draft lease. The tenant's review will include ensuring that the lease contains all of the terms from the preliminary agreement and is consistent with it. The tenant and its lawyer will also want to focus on pursuing other changes that are important to the tenant. These could include negotiating terms of the landlord's form that do not necessarily represent "market terms" for a lease given all the circumstances, such as the size of the development, the size of the premises, the financial strength of the tenant, and the location of the premises. The relative strength of the bargaining positions of the two parties will be a key factor here.

The tenant's lawyer will usually submit these changes through a revised blacklined draft or a mark-up. The negotiation will then continue through the exchange of drafts, telephone calls, and/or meetings until a document is finalized. Attention should be paid to the terms of the preliminary agreement in this regard, since many landlords will require that the lease be fully executed before possession is granted (often referred to as a landlord's "no lease, no keys" rule). Also, usually the tenant is not entitled to any allowance or similar inducement until the lease is signed.

4.4 Priority issues and non-disturbance agreements

The cases of *Goodyear v. Burnhamthorpe Square Inc.* and *1420111 Ontario Ltd. v. Paramount Pictures* set out the common-law position as it relates to the interplay of priorities between leases and mortgages. Essentially, a tenant under a lease that has priority over a mortgage is bound by the lease if the mortgagee (lender) enters into possession. In this situation, the mortgagee-in-possession must also honour the lease and cannot oust the tenant. However, a tenant under a lease that is subordinate to a mortgage is not bound by the lease if the mortgagee enters into possession and, accordingly, the tenant can vacate the premises rather than recognize the mortgagee as its landlord. Correspondingly, where the lease is subordinate to the mortgage, the mortgagee is similarly not bound to the lease and may evict the tenant.

Non-disturbance agreements serve to alter the common law. A non-disturbance agreement typically provides that upon the landlord's default under its mortgage, the mortgagee will not terminate the lease or otherwise disturb the tenant's occupation of the premises. In return, the tenant agrees to "attorn" to the mortgagee in these circumstances (when a tenant attorns to the mortgagee, the tenant promises to recognize the mortgagee as its landlord).

If a title subsearch discloses a prior mortgage on title, a tenant's lawyer should seek instructions from its client as to whether the client wishes to obtain a non-disturbance agreement from the landlord's mortgagee. Depending on the terms of the lease, it may also be appropriate to negotiate a clause providing that non-disturbance agreements will be obtained from future mortgagees. From a tenant's point of view, a non-disturbance agreement offers security of tenure in the event the mortgagee goes into possession. A tenant will have the comfort of knowing, for example, that it will not lose a

critical business location or money invested in leasehold improvements.

4.5 Registration

Upon execution of the lease agreement, a lawyer should seek instructions from the client as to whether the client wishes to register the lease, or a notice or short-form thereof, on title to the applicable property. Where the tenant does not register its lease, it risks losing priority to subsequent purchasers, mortgagees, and other third parties having dealings with the property. This could result in the purchaser, mortgagee, or other third party refusing to recognize the lease and, consequently, terminating the lease.

It is important to note, however, that registration is not always required to protect a tenant's priority. In Ontario, the legal doctrine of actual notice applies. This doctrine provides that subsequent third parties are bound to unregistered leases if they have actual notice of the lease. Actual notice may be inferred where the third party has knowledge of the specific terms of the lease, is provided with a copy of the lease, or is provided with an estoppel certificate containing details of the lease. There are also statutory exemptions to registration that serve to protect tenants. Specifically, s. 70(2) of the *Registry Act* provides that a lease of property under the registry system does not have to be registered to bind third parties where the lease has a term not exceeding seven years and where actual possession goes along with the lease. Similarly, for property under the land titles system, s. 44(1)(4) of the *Land Titles Act* states that a property is deemed encumbered by an unregistered lease if the lease has a period yet to run that does not exceed three years and if there is actual occupation under the lease.

Another key point to note is that most commercial leases prohibit the tenant from registering the lease itself but, in lieu, permit the tenant to register a notice or short-form of the lease. Landlords also typically insist on the right to approve the tenant's notice or short-form of lease so as to ensure that it does not disclose information that the landlord considers sensitive or confidential (such as the rent payable or other financial terms of the lease). At a minimum, the notice or short-form should include the names of the parties, the length of the term, brief details regarding any rights to extend or renew the term, and details as to any rights to purchase. A tenant may also want to include details of other key provisions of which they want to give subsequent third parties notice so as to better protect the tenant's rights. This would include details as to rights to expand, restrictive covenants (e.g., an exclusive use), restrictions on the landlord's ability to alter the property, and parking rights.

4.6 Landlord security

In order to better ensure that the tenant fulfills its rent and other obligations under the lease, the landlord will often seek security from the tenant. The requirement for security becomes even more heightened where the landlord is not satisfied with the financial wherewithal of the tenant or where the landlord will incur significant up-front costs as part of the lease transaction (such as costs of landlord's work, agent commissions, and tenant inducement payments).

The most common form of security is the collection of pre-paid rent and security deposits. Pre-paid rent is intended to be applied to future rent due under the lease, commonly for the first and last months of the term. On the other hand, a security deposit is held as ongoing security and is typically only returned to the tenant after the end of the term and then only if it has fulfilled all of its obligations under the lease. A key point to remember is that if a lease is disclaimed or repudiated pursuant to the *Bankruptcy and Insolvency Act*, the courts have held that a trustee-in-bankruptcy may not seek return of pre-paid rent that has yet to be applied. It may, however, seek recovery of a security deposit delivered under the lease. Accordingly, in order to avoid having to return security deposits in the face of a tenant bankruptcy, landlords will often avoid collecting security deposits, opting instead to collect rent on account of the last month of the term and expressly reserve the right to re-apply the funds towards a tenant default if it occurs prior to the last month of the term.

A guarantee or indemnity is another common form of lease security. The guarantee or indemnity is typically provided by one or more principals of the tenant entity or by a parent company or other entity related to the tenant. Due to case law, which historically favoured indemnities over guarantees following a tenant bankruptcy, landlords usually seek indemnities as opposed to guarantees from their tenants. While this historical distinction is no longer applicable, it still remains common practice for landlords to seek indemnities in lieu of guarantees.

Letters of credit are also often sought by landlords as a means of securing the performance of the tenant's obligations under the lease. The tenant's bank will usually charge the tenant a fee in exchange for the bank's agreement to issue the letter of credit. In addition, the issuance of the letter of credit often reduces the amount of credit that otherwise could be made available to the tenant for other purposes.

Landlords may also require a personal property security interest against the tenant's personal property located on the premises or, in some cases, against all of the tenant's

personal property wherever it may be located. Prior to granting any such security interest, the tenant should ensure that the grant will not conflict with the tenant's existing credit agreements with its bank and other third-party creditors.

4.7 Reporting to the client

At the conclusion of any commercial transaction, it is common for the lawyer to deliver to its client some form of reporting letter or summary. Whether or not a report or summary is required or appropriate following the execution of a lease agreement depends on the nature of the client and the relationship between the lawyer and client. A landlord or tenant actively involved in leasing (such as a national chain retailer or a landlord of a significant real estate portfolio) may not require any form of report or summary and, in fact, may have its own internal reporting or tracking system. However, some form of report or summary may be appropriate where the client is only involved in leasing transactions on an irregular basis. The level of detail to be included in any such report or summary will require the exercise of some judgment on the part of the lawyer (of course, generally speaking, the less sophisticated the client is with leasing matters, the greater the amount of detail that should be included in the report). At a minimum, a report or summary should note any follow-up items that the client needs to attend to or be aware of. This would include any ancillary documents that have yet to be finalized or fully executed, as well as any tenant inducement or allowance that is to be paid in the near future. The report or summary should also point out to the client any significant dates or times by which certain steps must be taken (such as the last day in which an option to renew or extend may be exercised) and should clearly articulate to the client that the lawyer will not be diarizing these dates and, therefore, it is the client's sole responsibility to do so.

5. Remedies

5.1 For tenant defaults

5.1.1 Characterization of tenant defaults

Before exercising any remedy for a tenant default, the landlord should determine the nature of the default since this will dictate the rights and remedies that are available to the landlord and the next steps the landlord should take.

Generally speaking, there are two types of tenant defaults. The first type is a monetary default, which arises when the tenant fails to pay any instalment of rent or other amount due to the landlord under the lease. The most typical example of a monetary default is the tenant's failure to pay the monthly basic or minimum rent, operating costs, realty taxes, or utilities. However, in some instances, the definition of "rent" under the lease is drafted to also include amounts payable by the tenant to third parties (for example, any utility for which the tenant is billed directly by the applicable utility company). Accordingly, a failure to pay these third parties will render the tenant in monetary default under the lease.

The second type of default is a non-monetary default. This is a default by the tenant in the performance of a lease obligation that does not relate to the payment of money. Common examples include the failure to make a required repair or conducting business on the premises in violation of the permitted-use clause. It should be noted, however, that leases often permit the landlord to convert a non-monetary default to a monetary default. This is accomplished by way of provisions in the lease that allow the landlord to perform, on the tenant's behalf, the obligation that is the subject matter of the default. Once the expense is incurred, the landlord can recover the expense from the tenant as rent. By converting a non-monetary default to a monetary default, the landlord is able to resort to the rights and remedies available to it for a monetary default. The rights and remedies available for monetary defaults tend to be broader and less onerous on the landlord; thus, there is sometimes a benefit in effecting the conversion.

5.1.2 Notice and cure periods

Most commercial leases include default provisions describing what rights and remedies the parties have when a tenant default occurs. In many cases, prior to exercising any remedy for a tenant default, the landlord must provide the tenant with prior written notice describing the default, as well as a cure period, during which time the tenant is afforded the opportunity to rectify the default. These notice and cure periods, whether statutory or set out in the lease, must be strictly adhered to. A failure to do so could invalidate the exercise of the landlord's remedy and may expose the landlord to liability.

For monetary defaults, it is typical for commercial leases to provide relatively short notice and cure periods (usually five days or less). Where the lease is completely silent on the issue of notice and cure periods in relation to the payment of rent, s. 18(1) of the *Commercial Tenancies Act* provides that the landlord has the right to terminate the lease once rent has been outstanding for more than 15 days (without any requirement to provide the tenant prior notice of the default or an opportunity to cure). It should be noted that s. 18(1) is limited to the exercise of the right of termination. Accordingly, for the

purposes of the landlord's other remedies, where a lease is silent on the issue of notice and cure periods in relation to the payment of rent, the tenant could be considered in default the day immediately following the date the required payment was due.

For non-monetary defaults, commercial leases tend to provide longer notice and cure periods (usually 10 days or more). However, irrespective of the notice and cure periods that may be expressly set out in the lease, the landlord is bound by s. 19(2) of the *Commercial Tenancies Act*, which provides that prior to exercising its right to terminate, the landlord must give the tenant written notice of the non-monetary default and a reasonable amount of time to correct it. It is generally accepted that s. 19(2) cannot be contracted out of. Accordingly, where a lease dispenses with notice or stipulates a cure period that is not reasonable having regard to the nature of the default, the landlord must nonetheless comply with s. 19(2) prior to terminating. Note that as is the case with s. 18(1), s. 19(2) is limited to the exercise of the right of termination and does not effect the exercise of the landlord's other remedies.

5.1.3 Where landlord wishes to preserve lease

Having determined that the tenant is in default and the nature of the default, the landlord must then determine whether it wants to employ a remedy that will preserve the landlord-tenant relationship or it wishes to terminate the relationship and lease. Common remedies employed by landlords who wish to keep the lease intact include distraining, commencing court proceedings for the recovery of damages, and seeking an injunction or order for specific performance.

Distress is a self-help remedy whereby the landlord is entitled to seize and sell the goods of the tenant upon the leased premises to satisfy any existing rental arrears. The remedy is only available when there is both a default in the payment of rent and a landlord and tenant relationship (therefore, distress cannot be carried out after the lease has been terminated). Extreme care must be taken in carrying out the remedy since it is subject to many detailed and onerous procedures, which if not strictly followed, could lead to the landlord being liable for trespass and/or even termination of the lease. For example, distress may only be exercised between sunrise and sunset, and never on a Sunday. In addition, the landlord may not use force to enter the premises to effect the distress. A landlord's right of distress may be further complicated by third-party security claims and trust claims by government authorities, such as the Canada Revenue Agency for unpaid harmonized sales tax and employee remittances. These claims often have priority over the landlord's right to distrain. Landlords will often retain the services of a bailiff in order to assist in carrying out a distress.

In carrying out a distress, the landlord may seize those goods upon the premises belonging to the tenant and any other party liable to pay rent. However, there are numerous exceptions to this general rule, including the fact that the landlord can only distrain against chattels of the tenant and not its fixtures (including both the tenant's trade fixtures and any leasehold improvements).

Section 53 of the *Commercial Tenancies Act* requires that the tenant be provided with proper notice following the distress. Also, before the seized goods may be sold, the landlord must wait five clear days so as to give the tenant an opportunity to pay the arrears and landlord's costs. Section 53 also requires the landlord to obtain two independent appraisals before the landlord may sell the tenant's goods.

Another common remedy employed by landlords is to simply sue the tenant for damages resulting from the tenant's breach. This would be effected by initiating a court action or application. This might be an appropriate remedy where the tenant is in arrears of rent or refuses to pay an invoiced amount, but the tenant is financially stable and the landlord wants to keep the tenant in the premises. In certain circumstances, a landlord could also seek injunctive relief or specific performance. Injunctive relief might be appropriate where the landlord seeks to halt the tenant's on-going breach of a lease provision (such as the breach of a permitted-use clause). An order for specific performance might be sought where the tenant fails to effect a repair where the work can be specified with sufficient particularity.

5.1.4 Where landlord wishes to terminate lease

If the landlord has determined that it wants to end the landlord-tenant relationship, the landlord may terminate the lease (this is also known as a forfeiture of the lease). The most common way to terminate the lease is to deliver a written notice of termination to the tenant and to physically bar the tenant from the premises by changing the locks. Simply delivering a notice of termination to the tenant is not sufficient. Landlords will often retain the services of a bailiff (although it is not necessary to do so) in order to assist in delivering the notice and to change the locks (which is normally done after the tenant's business hours in order to avoid confrontation). Another common way to terminate a lease is for the landlord to apply to the court under Part III of the *Commercial Tenancies Act* for a writ of possession. Proceeding by way of a writ of possession is a good alternative if physical re-

entry is not possible or if there is a question as to whether the landlord is lawfully entitled to terminate.

If the landlord has terminated the lease, the landlord has the right to sue for the present value of the rent that would have been payable for the balance of the lease term. This ability to sue for future rent was confirmed in the landmark case of *Highway Properties Ltd. v. Kelly, Douglas & Company Limited*. In addition to future rent, the landlord may make a claim for other losses stemming from the tenant's default and the lease termination including legal costs and the costs of re-renting the premises (for example, brokerage commissions and costs to demolish the premises and remove the tenant's fixtures and other property). It should be noted, however, that unlike the other remedies, following a termination, the landlord has a positive obligation to mitigate its losses by, amongst other things, trying to secure a replacement tenant for the premises.

In order to preserve its right of termination, the landlord must be careful not to do anything that could be interpreted as a waiver of its right. Case law has held that unless a default relates to a "continuing default" such as a failure to repair or some other default that can be considered to renew each day, the landlord's right to terminate a lease may be forever waived where, after the landlord has knowledge of the tenant's breach, the landlord does something that serves to confirm the existence of the lease (whether or not a notice of default has been issued). Moreover, case law has held that a landlord cannot avoid the waiver by relying on a "non-waiver" clause in its lease or by advising the tenant that it is acting on a "without prejudice" basis to its right to terminate. The most common act confirming the existence of a lease is the acceptance of rent due after a tenant has breached its lease (acceptance of rent on account of arrears relating to the period prior to a tenant's breach will not result in a waiver). The exercise of the remedy of distress is another act that serves to confirm the existence of a lease.

A landlord seeking to terminate a lease should also be aware of the tenant's right under s. 20(1) of the *Commercial Tenancies Act* and s. 98 of the *Courts of Justice Act* to apply to the court for relief from forfeiture (i.e. to seek to nullify the termination of the lease). The court has very broad discretion to grant relief and will often rule in favour of tenants in circumstances where it is the tenant's first default, the default was inadvertent, the hardship to the landlord is not as great as the hardship to the tenant, or the court believes the landlord has an ulterior motive in terminating (such as where the lease terms are below-market).

5.2 For landlord defaults

5.2.1 Tenant remedies

A tenant's rights and remedies in the face of a landlord default tend to be much more limited than the landlord's.

A tenant seeking to enforce its rights should first review the lease to determine if it contains any remedies that benefit the tenant. While some commercial leases do contain express tenant remedies, most do not. Tenants with a great degree of negotiating leverage are sometimes able to negotiate self-help rights that permit the tenant, following notice and a cure period, to remedy the landlord's breach and to recover from the landlord the costs incurred in so doing. In extremely rare instances (typically where the tenant has extraordinary negotiating leverage), a tenant is able negotiate rights to abate or suspend rent or to terminate a lease where the landlord is in default.

In the typical situation where the lease does not contain any tenant remedies for a landlord default, the tenant must rely on its common-law and statutory rights. These include pursuing a claim for damages and seeking equitable remedies such as an injunction or specific performance. The tenant may also seek equitable relief pursuant to the general power of the courts to do so under the *Courts of Justice Act*. These remedies would be pursued by way of a court application or action, just as they would for a breach of any contract.

Where the landlord's breach is so severe that it essentially deprives the tenant of the very essence of what it contracted for (known as a "fundamental breach"), the law provides the tenant with the additional remedy of treating the lease as at an end. Fundamental breach has been described as a breach "going to the root of the contract" and as a breach that deprives a party of "the very heart of what it bargained for." It is important to note, however, that the courts typically set a high threshold for establishing a fundamental breach. Nonetheless, Canadian courts have granted orders terminating leases for fundamental breach in instances where a landlord unreasonably refused to grant its consent to a lease assignment, a landlord altered the means of access to the premises such that it became extremely difficult to deliver merchandise both in and out of the premises, and a landlord failed to recognize the tenant's right of first refusal to lease adjoining space.

Tenants should be aware that while s. 35(1) of the *Commercial Tenancies Act* allows tenants to set off a debt due to the tenant by the landlord, this right is almost always waived by tenants in their leases by virtue of the fact that they agree to pay rent "without abatement, set-off, or deduction." Aside from s. 35(1), a

tenant does not have a statutory or common-law right to withhold or suspend its rent payments in the face of a landlord default. Any such right must be expressly set out in the lease.

As noted above, where the tenant seeks to nullify a landlord's purported termination of the lease, the tenant may seek relief from forfeiture under s. 20(1) of the *Commercial Tenancies Act* and s. 98 of the *Courts of Justice Act*.

5.2.2 Quiet enjoyment

The most basic right of a tenant is that of "quiet enjoyment." This right may be expressly provided for in the lease, but if it is not, there is an implied right to quiet enjoyment both at common law and under statute. In Ontario, s. 23(1) of the *Conveyancing and Law of Property Act* states that every lease for valuable consideration has an implied covenant for quiet enjoyment.

The landlord's covenant for quiet enjoyment is often misunderstood as relating to noise. However, in reality, it has little to do with noise. What it does represent is a covenant on the part of the landlord to the effect that the landlord has good title to the premises and can therefore lawfully enter into the lease. It is also a covenant that serves to assure the tenant that the landlord, and those claiming under the landlord, will refrain from doing anything that would substantially interfere with the tenant's use, possession, and enjoyment of the premises. A key point to note is that the covenant of quiet enjoyment extends only to the landlord and those claiming under the landlord. Accordingly, where a third party not claiming under the landlord (e.g. a neighbouring property owner) disturbs the quiet enjoyment of the tenant, the covenant of quiet enjoyment offers no protection to the tenant.

6. Common lease issues

6.1 Operating costs

Most leases (other than gross leases) require the tenant to contribute in one way or another to the landlord's costs to operate, maintain, and repair the property. The landlord will usually try to make the operating cost recovery provisions as broad as possible so as to avoid any future disputes as to the landlord's ability to recover any particular cost item. At the same time, the tenant will want to negotiate as many exclusions as possible to the landlord's recovery provisions. Any ability of the tenant to move the landlord off its standard operating cost model will be dependent on the tenant's negotiating strength. Typical exclusions sought by tenants include those in respect of the costs for structural repairs and for correcting defects in the initial design or construction of the building, as well as costs that may be recovered by the landlord through other sources, such as insurance or warranty claims. In addition, tenants often seek assurances from the landlord that the landlord will not seek to recover capital expenditures fully in the year incurred but, rather, the capital expenditure will be recovered on an amortized basis spread out over a reasonable period of time.

As part of its operating cost recoveries, the landlord will also typically want to recover an administration fee or a management fee. Tenants typically seek to preclude the landlord from recovering both and also seek assurances that the amount of administration or management fee will be reasonable having regard to the size of the property and the nature of the services provided by the landlord. It is not uncommon to see administration fees equal to 15 per cent of the tenant's share of operating costs, and management fees ranging from two to five per cent of the gross rent payable by the tenant under the lease.

Tenants should be aware that most commercial leases that allocate operating costs on a proportionate-share basis usually include a provision that allows the landlord to increase or "gross up" operating costs to reflect what the expenses would amount to if the property was fully occupied (or nearly so). That is, the landlord is empowered to overstate the expenses as if the property was fully tenanted. As a result, the amount the tenant must pay, based on its proportionate share, increases. At first glance, this may appear to be unfair for tenants. However, generally speaking, the concept of grossing up expenses is fair and reasonable since it ensures that tenants pay their fair share of operating costs. An example best illustrates this point. Assume a tenant occupies 25% of a property and that the balance of the property is vacant. Also assume that because the balance of the property is vacant, all of the water consumption at the property is due to the tenant's operations. If the tenant is required to pay its proportionate share of operating costs, then the tenant would only be required to pay 25% of the water bill notwithstanding that it was responsible for 100% of this expenditure. Gross-ups eliminate this inequity by effectively making the tenant responsible for payment of all of the water costs.

6.2 Repairs, maintenance, and restoration

Most commercial leases allocate repair and maintenance responsibilities between the landlord and tenant. For multi-tenant properties, the tenant is typically responsible for repairing and maintaining the premises, the contents of the premises (including leasehold improvements and the tenant's trade fixtures), and any equipment or facilities exclusively serving the premises (for example, heating and air-conditioning systems). At

the same time, the landlord is made responsible for repairing and maintaining the common areas and facilities (including the parking areas, roof, and structure) forming part of the property. For single-tenant properties, it is not uncommon to find tenants responsible for the repair and maintenance of the whole of the interior and exterior of the property, although tenants of single tenant buildings will often want the landlord to be responsible for repairs and replacements that are of a structural nature or that would constitute a capital or major expenditure (for example, roof replacements, heating and air-conditioning system replacements, and repaving of parking areas). While the landlord of single tenant buildings can typically be convinced to assume these repair and replacement responsibilities, the landlord will usually want to ensure that it is able to recover all or part of the associated costs from the tenant on an amortized or some other basis.

Typically, a landlord's form of commercial lease also includes provisions requiring the tenant, at the landlord's option, to remove any or all leasehold improvements at the end of the term. This removal obligation is often coupled with the requirement to restore the premises back to "shell" or "base-building" condition. From a tenant's point of view, the removal and restoration obligations can be costly and an unwelcome distraction at a time when it should be focussed on transitioning its business to new premises. Accordingly, tenants often seek to eliminate the removal and restoration provisions from the lease. Where the landlord will not agree, a compromise might be appropriate. A typical compromise requires the tenant to remove only those improvements that are non-standard or atypical having regard to the nature of the premises and their typical use.

6.3 Insurance

It is typical for commercial leases to stipulate minimum insurance coverage requirements for both the landlord and tenant. Should an unexpected casualty or other event occur, the availability of insurance proceeds helps ensure that the parties have access to funds so that they can continue to meet their respective repair and financial obligations under the lease. For example, if the tenant's premises are damaged by fire, a typical lease will ensure that the tenant has access to insurance proceeds that will enable it to rebuild its premises and to continue to pay its fixed expenses if it has had to cease operations due to the resulting damage.

In a typical commercial lease, tenants are usually required to insure for (a) property damage relating to their premises, leasehold improvements, trade fixtures, furniture, equipment, inventory, and personal property; (b) the tenant's liability arising out of its operations on the premises and the balance of the property; and (c) business interruption. Landlords are usually required to insure for (a) property damage relating to the building and the common areas (including fixtures and furnishings in those areas); (b) the landlord's liability arising out of its operations in these areas; and (c) any interruption to the landlord's rental income stream.

Most leases also expressly allocate risk between the landlord and tenant through the use of releases and indemnities. Typically, the landlord seeks to shift as much risk as possible onto the tenant. Landlords argue that by doing so, the landlord is able to reduce the number of claims made against its policies and, in turn, reduce its premiums and deductibles (thereby lowering operating costs for all tenants).

In cases where the tenant has significant bargaining leverage, the landlord may agree upon a reciprocal risk allocation structure through the use of mutual releases and indemnities. Commonly, mutual releases and indemnities allocate risk on the basis of insurance availability (e.g. the party that is insured for the risk assumes it) or on the basis of physical boundaries (e.g. the tenant is responsible for matters within its premises, and the landlord for matters outside the premises). In other cases, in lieu of a mutual release and indemnity structure, the landlord may agree that the tenant will not be liable or responsible for damage to property insured by the landlord (typically this property comprises the structure and base-building components of the property) or for third-party injury and third-party damage to property caused by the landlord outside of the premises. Tenants will often also try to avoid being responsible for the landlord's indirect, consequential, and special damages and having to indemnify the landlord for claims involving the landlord's own negligence.

Prior to entering into any new lease, a lawyer should advise its client (whether the client is the landlord or tenant) to consult with the client's insurance advisor to confirm that the client's existing insurance policies satisfy the insurance requirements stipulated in the lease or, alternatively, that it is able to purchase any necessary new or additional coverage at a reasonable cost.

6.4 Assignment and sublease

Although the terms assignment and subletting almost always appear together, these concepts have different legal consequences. The transfer of a tenant's entire interest in a leasehold estate (i.e., the entire leased premises for the entire term) is an assignment. A sublease is the transfer of all or a part of the premises for less than the entire term. A sublease of all of the premises for the entire term, because it conveys the tenant's entire interest, could be construed as an assignment. To avoid this, the last day is not included in subleases.

If a lease does not restrict the tenant's rights to assign and/or sublease, then the tenant is free to do so.

However, it is very rare for a lease not to contain restrictions. The typical provision is to require landlord's consent, such consent not to be unreasonably withheld. If the landlord's consent is required and the lease is silent on the point, s. 23(1) of the *Commercial Tenancies Act* provides that the lease is deemed to provide that the consent is not to be unreasonably withheld.

Some tenants, especially those with multiple locations, will want to negotiate for a right to assign or sublease in certain circumstances without having to obtain the landlord's consent. Common examples are a right to transfer to an affiliate, subleases to franchisees, an assignment in connection with a merger or amalgamation, or an assignment in connection with the sale of the business.

Commercial leases often contain an option in favour of the landlord to terminate or recapture the lease upon a request for consent to an assignment or sublease. If a tenant has negotiated situations where no landlord consent is required, it will also want to ensure the termination right does not apply. Even where consent is required, a tenant may want to seek exemption from the termination right in situations such as the sale of the business as a going-concern. If the standard form does not provide for such, the tenant should pursue a right to withdraw its application for consent and negate the termination right if the landlord exercises the right.

The landlord's right to receive any excess rent or other profit from the lease on an assignment or sublease is often the subject of negotiations. Landlords feel it is legitimate for it to receive any upside. Tenants will say they have committed for a term and should get the upside. Sometimes a 50/50 split is a negotiated compromise.

6.5 Use

A typical use clause will commit the tenant to carry on only a specific and identified use. A generic description such as "office use" may be adequate. In a retail situation, the landlord will want to define the use as restrictively as possible to control the business operating in the centre (often referred to as the landlord controlling the "tenant mix"). That could put pressure on a tenant in a couple of ways. It can limit the way its business evolves. It can also severely limit its ability to assign or sublease since if it is not successful within the permitted use, it may well have difficulty finding a subtenant or assignee willing to take on that use. Rights to change the use with the landlord's consent and subject to negotiated terms are often pursued.

Some specific issues in the use provision come up more commonly in retail leases. A retail lease will usually commit the tenant to continuously carry on its use. The landlord does not want vacant space since it affects the business in the shopping centre and thereby affects the business of other tenants and eventually the market value of the centre. A strong tenant may be able to negotiate a right to cease conducting business at the premises (i.e., "go dark") at some point. In those situations, the landlord will likely want to negotiate a right to terminate the lease should the tenant go dark.

Tenants in a retail situation will often try to negotiate for some exclusive rights to keep competition out of the centre. Landlords need to be careful to not extend any exclusive rights in a manner that would limit ancillary sales by other tenants. For example, a landlord may agree that there will be no other shoe stores in a centre but would not agree that no other tenants will sell shoes (since a sporting goods store or others may sell shoes).

6.6 Options to extend/renew

A tenant may negotiate for a right to renew or extend. Case law has distinguished between renewals and extensions. An extension leaves the original lease intact. As a result, the original tenant may remain liable under the original lease during an extension term, even if that extension term was exercised after an assignment of the lease. Another result is that personal rights (which do not run with the land) may survive. A renewal creates a new lease, and in the absence of express language to the contrary, the original tenant will not necessarily remain liable to the landlord for the renewal term after an assignment to a third party, and personal rights will not continue unless expressly provided for. A renewal lease effectively operates as a surrender of the original lease and a grant of a new lease. As a result, the common practice has developed for landlords to draft any such rights as extension rights rather than renewal rights.

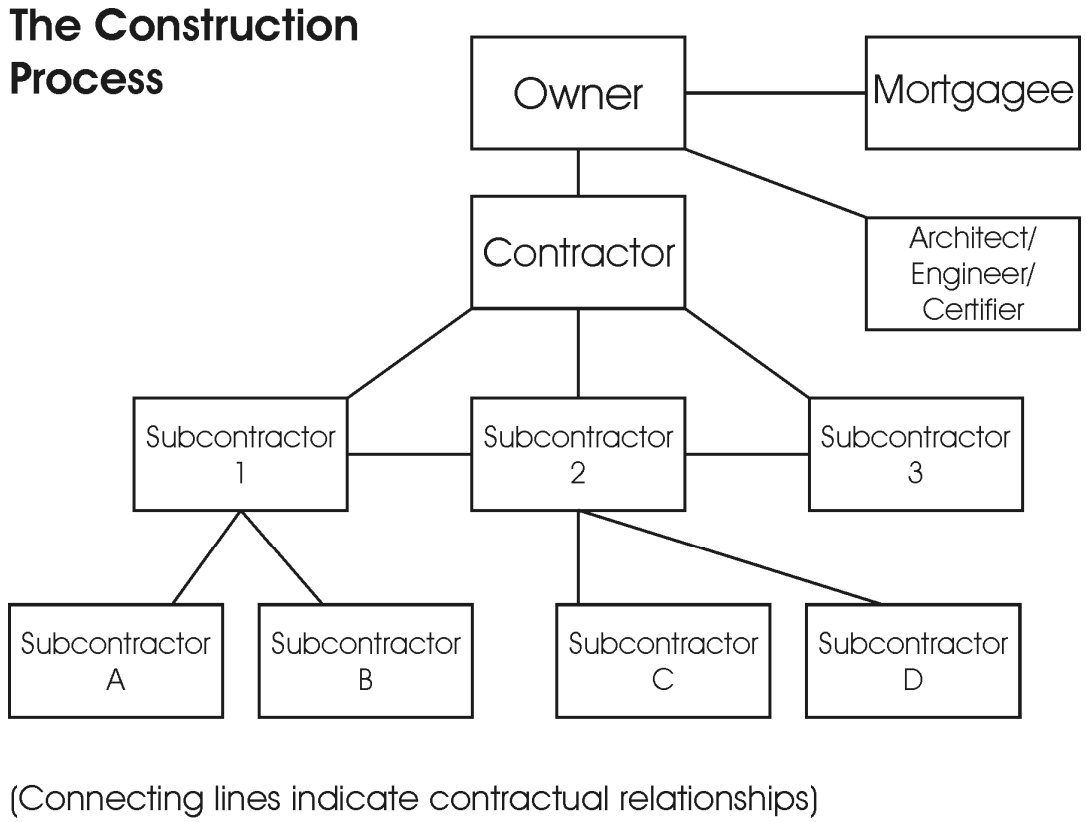
The extension or renewal provision must cover off all the legal requirements for a lease. Most of these will not change so it is not an issue, other than in respect of rent. If the rent is not a fixed, agreed-upon amount, then the rental amount must be determinable. Typically the parties will reference a market rent and use arbitration as the method of resolving any disagreement. However, the key is to reference a market rent so that even if there is no arbitration provision a court would hold that it is a determinable amount.

Another key point in drafting the renewal provision is to ensure only appropriate terms are referenced. Other than rent, it is common for the lease to continue on the same terms and conditions. From a landlord's perspective, it will want to ensure that initial items such as inducements, fixturing periods, and rent-free periods are not inadvertently applied to any renewal or extension term.

Chapter 64

Construction liens

1. Introduction



The *Construction Lien Act* (*CLA*) is unique in that it represents a governmental reaction to the prevalence and size of financial failures in one singular industry. The *CLA* embodies a special set of rules designed to protect those supplying goods and services. No other industry is afforded this type of protection.

2. The construction process

The owner of the project will, in most cases, have retained the services of an architect or engineer for the purpose of preparing drawings of the work to be done. The existing land or building will typically be subject to an existing mortgage. In addition, the owner will usually have arranged new mortgage financing that will be drawn down during the course of construction for the purpose of paying for the work. This mortgage is referred to as a "building mortgage."

The owner will typically enter into a contract with a general contractor to perform the entire work contemplated by the drawings and specifications. The general contractor may do some of the work on the job but usually enters into subcontracts for significant portions of the work with specialty subtrades such as mechanical and electrical work, forming, finishes, carpentry, etc. Subcontractors may in turn contract elements of their work to sub-subcontractors and so forth. On large jobs there can be literally hundreds of different companies all supplying services.

The structure of the relationship resembles a pyramid and is customarily referred to in the chart as the "construction pyramid."

The object of the *CLA* is to protect suppliers of services or materials in this pyramid against the default, insolvency, or bankruptcy of others above them in the pyramid. For example, Sub-subcontractor A supplies its work and services and then submits a bill to Subcontractor 1. In calculating its bill to the General Contractor, Subcontractor 1 incorporates this bill together with the work that Subcontractor 1 has done itself. The General Contractor follows the same process, collecting bills from all the Subcontractors and submitting a progress draw to

the Owner for these amounts plus its own work. The Owner then applies for an advance from the Mortgagee. The Mortgagee advances money to the Owner. The Owner pays the General Contractor. The General Contractor pays each Subcontractor, and each Subcontractor then pays its Sub-subcontractor, including Sub-subcontractor A.

The objects of the *CLA* are accomplished through the creation of three statutory mechanisms: the trust, the holdback, and the lien.

The trust is designed to prevent outside parties such as secured creditors from intercepting funds intended for payment of materials and services supplied to the improvement. The trust also operates to prevent the recipient of funds from appropriating those funds to the recipient's own use, thereby depriving those lower on the pyramid of payment.

The holdback creates a type of minimal insurance to those on the pyramid, ensuring that even in the event of default, insolvency, or bankruptcy by those higher on the pyramid, they will receive at least a portion of the balance outstanding.

The lien creates an interest in the land in favour of those who supply materials or services, thereby creating a form of security. The lien operates to prevent the owner or mortgagee from receiving an improvement to his or her land without making payment for the improvement. In October 2010, the definition of "improvement" under the *CLA* was broadened to afford greater protection to the suppliers of services or materials. "Improvement" is now defined as:

> (a) any alteration, addition or repair to the land,
>
> (b) any construction, erection or installation on the land, including the installation of industrial, mechanical, electrical or other equipment on the land or on any building, structure or works on the land that is essential to the normal or intended use of the land, building, structure or works, or
>
> (c) the complete or partial demolition or removal of any building, structure, or works on the land.

This is important because a party only has lien rights if it supplies services or materials to an "improvement."

Each of the above noted statutory mechanisms, though in some respects linked and interrelated, is conceptually separate. One cannot contract out of the provisions of the *CLA*.

3. The trust remedy

One of the chief objectives of the *CLA* is to ensure that the creditors of the various participants in the payment chain do not seize the flow of payments that have been generated as a result of the work of those further down the payment chain. The trust fund provisions of the *CLA*, which are contained in Part II, accomplish this end. The *CLA* provides, in ss. 7—8, that all funds received by a party in the payment chain are held in trust for the next person in the chain—i.e., the person with whom the recipient has privity of contract.

Once the owner receives money from the mortgagee, he or she holds the money in trust for the general contractor to the extent that the general contractor has yet to be paid. When the general contractor receives payment, the owner's trust obligation is satisfied to the extent of the payment, and the general contractor holds the funds in trust for each of the subcontractors to the extent that it is not itself able to use the funds to reimburse itself for the cost of its own work. When the general contractor pays a subcontractor, this subcontractor holds the funds in trust for the subcontractors beneath it. Accordingly, if the general contractor became bankrupt after having received the money from the owner but before paying the subcontractors, the general contractor's outside creditors would have no claim to the funds to the extent that they could be identified or traced beyond the limited portion claimed by the general contractor for its own work. The balance of the money received from the owner would not be the general contractor's funds and therefore could not be seized by the trustee-in-bankruptcy for the benefit of outside creditors.

In reality, trust funds received by members of the pyramid are often intermingled with other funds so that it is often difficult to trace the trust funds. This intermingling has been found by the courts to itself give rise to liability for breach of trust. Pursuant to s. 13 of the *CLA*, directors and officers and persons having effective control of a corporation may become liable for a breach of trust if the funds are consciously applied to other purposes or intermingled with non-trust funds. If the directors of the company take money flowing from one project that ought to be paid to subtrades and use it for personal purposes, to keep another failing project alive, or even to pay overhead expenses, they could be subjecting themselves to personal liability.

Notwithstanding the existence of the trust relationship, the parties maintain their right of set-off. Accordingly, if the general contractor has a dispute with the subcontractor over the amount of its bill or the quality of its work, the existence of the trust does not prohibit the general contractor from retaining funds with respect to this dispute.

Further, trust obligations are not avoided by an owner who conveys its interest in the land. A vendor's trust is maintained in a sum equivalent to the value received by

the owner from the sale, less repayment of any existing mortgage on the premises and expenses arising from the sale. The balance is deemed to be a trust fund for the general contractor.

The *CLA* trust concept is absolute. There is nothing that a party needs to do to preserve, perfect, or protect its trust interests. The trust continues to exist whether or not lien rights continue, and all funds that are paid in respect of the work are impressed with the trust completely aside from any considerations of whether liens are filed, holdbacks have been maintained, etc.

4. The lien

The lien is a mechanism by which the members of the pyramid are given rights similar to those of secured creditors. It is necessary to distinguish the contractor's lien rights from those of all other members of the pyramid. The contractor's lien secures for the contractor the full amount owing by the owner under the contract. The lien in favour of those in the pyramid below the level of the contractor merely secures the claim that these parties have against the holdbacks, subject to the "notice holdback" discussed below.

5. The contractor's lien

From the date that work commences, the contractor obtains the right to a lien on the property that is the subject of the improvement. As a result, the contractor becomes the functional equivalent of a secured creditor for the amount that it is owed. Like a secured creditor, the general contractor has

- priority against the other creditors of the owner with respect to the property that is being improved by the general contractor's efforts; and
- certain rights to enforce the lien by way of sale of the property in the event that the owner fails to pay.

The general contractor does not have to take any step in order to obtain its lien. The right to lien arises as soon as the work on the contract commences. The requirement to register the contractor's lien—or any construction lien—is merely to preserve the lien. Ensuring proper preservation is essential to the contractor's ability to maintain the lien.

The general contractor is entitled to recover from the land and the owner the full amount of the lien. The general contractor also has his or her trust fund rights that would apply to the tracing of any funds that were advanced to the owner by the mortgagee whether or not his or her lien was preserved or protected.

Due to the direct contractual relationship with the owner, the concept of holdback is irrelevant when the lien remedy is viewed from a general contractor's perspective. The holdback is a relevant concept with respect to the positions of the subtrades.

6. General liens

Sometimes services or materials are supplied concurrently by a contractor to several construction sites or several lots on a subdivision owned by the same owner. Section 20 of the *CLA* provides for a special lien in such circumstances known as a general lien. A general lien attaches to each of the sites or lots equally for the full extent of all moneys that are owed. This provision is particularly useful in the construction of subdivisions.

There are four requirements for the registration of a general lien:

- There must be common ownership of the properties.
- There must be a single contract for work to be done on the properties.
- There must have been supply by the lien claimant under that single contract.
- The contract must not provide that lien rights arise on a lot-by-lot basis.

If a general lien is improperly registered, when no right to a general lien exists, all lien rights will be lost.

If, as is common in the case of a subdivision, some of the lots have been sold off before the lien claimant registers its lien, the lien claimant is still entitled to claim the full amount outstanding as against the remaining lots.

However, where there are competing lien priorities, general liens rank with other liens of the same class to the full extent of the general lien, divided by the number of premises to which the person supplied those services or materials. The balance of the general lien ranks next in priority to all other liens registered against the premises, whether or not of the same class.

7. Subcontractor's lien and holdback

Unlike the contractor, the subcontractors have no privity of contract with the owner. In the absence of the *CLA*, subcontractors would have no security and no opportunity to obtain security against the owner's land because they have no direct dealings with the owner.

One of the objectives of the *CLA* is to attempt to lessen the impact of the abandonment of a project or of the bankruptcy or insolvency of a member of the pyramid, by establishing a form of fund for the members of the pyramid that works a little bit like insurance. This "insurance" fund is called the "holdback." The owner is responsible for the maintenance of the holdback, and the subcontractors' lien created by the *CLA* secures the owner's obligation to maintain the holdback against the

owner's interest in the land and buildings improved by the efforts of the members of the construction pyramid. The subcontractors can preserve their lien by registering it against that land and those buildings.

As the job progresses, the general contractor will typically apply on a monthly basis for what are known as progress draws. The progress draws are based on the value of the work done in a particular payment period. The value of this work is judged in relation to the overall contract price and not with respect to market conditions, etc. The progress request is typically accepted by the owner or certified by the architect or engineer. The owner then makes the payment. However, by the operation of ss. 22 and 24 of the *CLA*, the owner is required to at all times "hold back" from the payments due to the general contractor at least 10% of the value of the work done. The 10% holdback is referred to as a "statutory" holdback and will be held until released to the contractor on the expiry of lien rights. Once the general contractor receives its payment, it will in turn pay the subtrades while retaining a similar holdback.

Not only do holdback obligations exist at every level of the pyramid, but holdback obligations may also apply to purchasers. Purchasers may be said to become "owners" for the purposes of the *CLA* if they do not fall within the definition of "home buyer." This concept is discussed in greater detail below.

The best way of illustrating the manner in which the holdback works is to give an example. The general contractor and its subtrades perform $1,000 worth of work, and the general contractor sends an invoice to the owner for this amount. The owner pays the general contractor $900, retaining $100 as holdback. Assume that the general contractor has a $100 mark-up so that it itself owes $900 to the subcontractors for the work done on the owner's land. The general contractor would then pay $810 of the funds it received from the owner to the subcontractors. The general contractor records in its books that it has paid 90% of the subcontractor's invoices and has a remaining 10% holdback obligation to the subcontractors equal to $90. The amount held back by the general contractor will be paid when the holdback is released by the owner. In this way, the funds held back by the owner from the general contractor, secured by the general contractor's lien on the property for the contract price, protect the payment of holdback to everyone in the construction pyramid.

It should be immediately apparent that the amount of the holdback could very easily be insufficient to satisfy all the claims made against it. In this case, there are complicated priority rules that come into play to allocate the shortfall. Essentially these resemble a *per stirpes* distribution of an estate with those lower down the payment chain having priority over those higher up and those on the same level (having contracts with the same persons) sharing *pro rata*.

8. Notice holdback

The term "notice holdback" is not found anywhere in the *CLA*. Notice holdback arises from s. 24(2) of the *CLA*, which requires every payor in the chain of payment to retain, out of payments made in addition to the statutory 10% holdback, an amount equal to the value of any lien in respect of which a party lower in the chain gives the payor written notice. This can be illustrated by an example:

Referring to the chart, assume that Subcontractor 1 was unpaid. It would be entitled to give written notice of its lien rights to the General Contractor, the Owner, and the Mortgagee. Upon receiving this written notice and without regard to whether Subcontractor 1's lien has been preserved by registration, the Owner would be required to hold back from the General Contractor not only the statutorily required 10% holdback mentioned above, but also a further amount that would be equal to Subcontractor 1's lien claim, the notice holdback.

As a result of the Owner receiving such a notice and retaining the additional holdback, the amount available for distribution to the lien claimants below the General Contractor would be larger than the statutory minimum of 10%. The notice holdback does not belong to the lien claimant who served the notice (Subcontractor 1). All that has happened is that the amount of money comprising the holdback against which all lien claimants may claim has grown by the amount of the lien of the claimant who gave its notice. The particular lien claimant will still have to wait for a final accounting, together with the determination of the validity of all outstanding liens and the priorities associated therewith, in order to determine whether it will be paid in full.

As will be seen in the section dealing with mortgage priorities, this notice is critical to establishing priority as against future advances by a mortgagee. It is of paramount importance for a solicitor to give written notice to every party, including the mortgagee, who is above his or her client in the payment chain in order to create notice holdback, and this should be done in addition to registering the lien against the owner's title. It is not necessary to hold off giving this notice until there has actually been a registration of the lien against the property. Because the lien right exists from the date that the work commences, written notice of the existence or intention to lien can be given at any time.

9. Expiration of liens

In order to allow owners and contractors to finalize the project and release holdbacks, the *CLA* contains rules that provide for the expiration of liens. One of the most critical elements of lien practice is to be able to identify the relevant expiration date. A mistake in this area will almost certainly lead to a professional negligence lawsuit.

The rules regarding the expiry of a lien are set out in s. 31 of Part V of the *CLA*. There are two deadlines. One is for the "preservation" of a lien, that is to say the date by which a registration must be made against the land where the work was done or the material or services were provided (or a notice of lien served in the case of Crown land in accordance with s. 16). A lien may be "preserved" during the supply of services or materials or at any time before it expires. Where the lien attaches to the premises, it may be preserved by the registration of a claim for lien on title of the premises in the proper land registry office in accordance with Part V of the *CLA*, i.e. within 45 days from the date of the contractor's last supply of materials or services.

Where the lien does not attach to the premises, as is the case of Crown land, it may be preserved by giving to the owner a copy of the claim for lien together with the affidavit of verification required by s. 34(6) of the *CLA* (s. 34(1)). Where the Crown is the owner of a premises within the meaning of the *CLA* or where the premises is a public street or highway owned by a municipality or a railway right-of-way, the lien does not attach to the premises but constitutes a first charge as provided in s. 21, and the provisions of the *CLA* have effect without requiring the registration of a claim for lien against the premises (*CLA*, s. 16(3)). Where the claim for lien is in respect of a public street or highway owned by a municipality, the copy of the claim for lien and affidavit must be given to the clerk of the municipality (*CLA*, s. 34(2)).

The second deadline is for "perfection" of the lien, which is the date by which an action must have been commenced and a certificate of action issued and registered against the property (or in the case of Crown land solely the date by which an action must have been commenced). Both steps must be completed within designated time periods that commence to run from the same date. A lien must be preserved within 45 days of the designated date, while the lien must be perfected within 90 days.

The relevant dates from which the limitation periods commence to run are determined by s. 31. This section should be reviewed every time one is called upon to make a decision about the dates from which the limitation period will commence to run.

The limitation period begins to run from the earliest of the potential dates set out in s. 31. As a consequence, it is entirely possible for the client to be actually working on a job site and nevertheless have lien rights expire for a substantial portion of the work done.

There are four basic "triggers" for the commencement of the limitation period:

- publication of a certificate of substantial performance;
- last supply of material or services;
- completion of a contract; and
- completion of a subcontract.

9.1 Substantial performance

The *CLA* allows for an early release of most of the holdback following the expiry of lien rights after substantial performance of the project. The requirement to retain holdback causes financial strain on those in the construction pyramid—especially those who work in the early stages who must wait until lien rights expire before their full invoices can be paid. Accordingly, the *CLA* permits the release of holdback amounts before the job is absolutely complete.

Substantial performance is defined in s. 2 of the *CLA*. To paraphrase, substantial performance is achieved when the project is ready to be used and the cost of finishing the work or rectifying deficiencies is not more than 3% of the first $500,000 of the contract price, 2% of the next $500,000, and 1% of the balance. Once this state of completion is attained, a certificate of substantial performance may be issued by the project architect and published. On publication of the certificate of substantial performance, the time to preserve a lien begins to run for work done up to the date certified as the date of substantial performance. As a result, a contractor may still be working on the job and would satisfy all other criteria for maintaining its lien but nevertheless lose its lien rights for work done prior to the date of substantial performance.

The publication of a certificate of substantial performance will be made in a designated publication called the *Daily Commercial News*, of which virtually all members of the construction community are aware and which is now available online. Liens for work done prior to the date of substantial performance must be filed within 45 days of the publication date or they will expire with respect to the work done up to the date of substantial performance. A lien may be asserted with respect to work done after the date of substantial

performance because a new holdback called the finishing holdback must be retained by the owner for work done after the date of substantial performance. This holdback will only be released following completion and the expiration of all remaining lien rights.

9.2 Last supply of material or services

If a lien has not expired by reason of any other rule, it will expire within 45 days of the date of last supply of material or services.

Solicitors should be aware of what is known as a prevenient arrangement. This is an arrangement where there is an overriding understanding that material will be supplied to a project on an ongoing basis. An example is the case of a lumber store that has undertaken to supply all the required lumber to a particular project and delivers it on an as-needed basis. If a court were to hold that a prevenient arrangement existed, the court would consider the supply of these materials as the performance of one contract, even though there is a series of individual transactions and invoices. The court's finding on this point will determine whether the supplier can preserve a lien for all amounts owing by the contractor by registering within 45 days of the last supply.

9.3 The completion of a contract

Completion is defined by s. 2 of the *CLA*. The project is complete when what remains to be done is the lesser of 1% of the contract price or $1,000. The definitions sections indicate that this concept of completion applies only to the contract, which is logical since payment of holdback by the owner is made on the expiry of the contractor's lien.

9.4 The completion of a subcontract

Section 33 allows for a certificate of completion of an individual subcontract to be issued. The portion of the holdback that would be attributable to the amount of the subcontract can then safely be released 45 days following the issuance of the certificate if no lien has been preserved by the particular subcontractor or those below it in the payment chain.

10. Leasehold improvements

There are specific provisions in the *CLA* to address a situation in which improvements are carried out on a leasehold interest. These are provided for by s. 19. Where a tenant commissions improvements, the freehold interest may become subject to a lien, but only if the proper procedure is followed.

Section 19 of the *CLA* requires that first, the contractor provide written notice to the landlord of the improvement to be made. Unless the landlord responds within 15 days of receipt of such notice by giving written notice that the landlord assumes no responsibility for the improvement to be made, the interest of the landlord shall be subject to a lien to the same extent as the interest of the tenant.

Case law has established that in order to be operative, the notice must contain the following elements:

- the name of the landlord and the reference to its capacity as landlord;
- the details of the contract entered into between the contractor and the tenant;
- a description of the improvement to be made;
- a sufficient description of the premises to identify the landlord's property;
- a reference to the contractor and tenant by name and capacity;
- language sufficient to make it clear that the contractor is looking to the landlord's interest in the land, in addition to the tenant and its interest in the leasehold, to be responsible for payment for the improvement to be made;
- additional language to make it clear that the landlord must provide written notice back to the contractor within the time prescribed in s. 19(1), wherein the landlord is to state that it disclaims responsibility for payment of the improvement to be made;
- additional language sufficient for the landlord to know when the 15-day period commences, within which it may disclaim liability.

If the landlord declines to assume responsibility, the contractor will only have a right to lien the leasehold interest.

In the event of a default in the lease by the tenant that results in the landlord terminating the lease or enforcing forfeiture, the lien claimant will be entitled to notice of the intention and of the amount of unpaid rent. The lien claimant then has 10 days to pay to the landlord the amount of the unpaid rent, and that amount may be added to that person's claim for lien.

11. Perfection and procedure

A preserved lien must be perfected by the commencement of an action along with the issuance and registration of a certificate of action against the land within 90 days of the appropriate triggering event (except in the case of Crown land, in which case only the commencement of an action within the required time frame is necessary). The elements of a *CLA* action are very similar to those of an ordinary action. The following are important differences:

- The defendants are usually all the parties who are above the plaintiff in the payment chain.
- The mortgage company is generally sued for the purposes of claiming priority. In the course of the action, if not beforehand, information will be obtained from the mortgage company that will allow the plaintiffs' solicitor to determine the date of the advances as well as other issues relating to priority in order to determine whether to proceed with this assertion.
- The owner is included in the action even though it is commenced by a subtrade because of the owner's obligation to maintain a holdback.
- The statement of claim contains a verbatim recitation of the lien (or has attached a copy of the lien).
- There is no concept of a notice of intent to defend; therefore, all defences must be delivered within 20 days.
- There is a unique concept of settlement meetings for parties to regulate the conduct of the action.
- There is no right of appeal from an interlocutory order.

Although it is not stated in the title of the proceedings, a construction lien action is similar to a class action, although not governed by the *Class Proceedings Act, 1992*. This is important when one considers the obligation to perfect the lien by the commencement of an action along with the issuance and registration of a certificate of action within 90 days. Because the action is akin to a class action, it is only necessary that one of the lien claimants in the payment stream of the construction pyramid has commenced a lien action and registered the certificate of action (in all cases except Crown land) within the 90-day period and not that every lien claimant itself have done so. It is recommended that each lien claimant commence its own action rather than rely on this "sheltering"—first, in order to have adequate pleadings to proceed with the action, and second, out of an abundance of caution. A defect in the lien under which someone is sheltering can result in one's claim not being properly protected since a lien claimant cannot shelter under a defective lien.

However, in late 2010, s. 44(9) was amended to provide better protection for a sheltered lien:

> A lien claimant whose lien is sheltered, in accordance with subsection 36(4), under the lien that was the subject of the order may proceed with an action to enforce the sheltered lien as if the order had not been made.

Typically, the various actions will be consolidated or ordered tried together at the time of the settlement meeting or pre-trial.

The *CLA* requires that a settlement meeting be held. Settlement meetings are extremely important, particularly in situations where there are numerous liens. Counsel must attend, usually with his or her client, and produce documentation to establish the extent and timeliness of the client's claim. At the settlement meeting, various orders with respect to expediting the hearing of the case will be agreed to among the parties. The matters typically addressed in a settlement meeting are

- consolidation of actions;
- which lien claimant will take carriage (i.e., primary responsibility for moving the case to trial); and
- which liens may be accepted as timely and valid as to certain amounts.

Failure to attend could lead to a lien claimant's lien being lost.

Generally, in Toronto, lien matters are referred for hearing to a master and are not heard by judges of the Superior Court. The master will then manage the progress of the action, including making all necessary interlocutory orders, and will then ultimately preside at trial.

It is also important to note that a lien action is confined to the subject matter of the lien. Items such as claims for delay and other unliquidated claims, including claims for breach of trust under the *CLA*, may not be advanced in a construction lien action. In such situations, it is necessary to start a separate action by the normal court procedures. Often the lien action is simply stayed until such time as the larger civil action is determined, following which a lien judgment is given for the lienable component of the claim.

12. "Vacating" a lien

When a lien is registered on a project, the mortgage company will ordinarily refuse to advance any further funds. As a result, the *CLA* provides a mechanism by which either a payment may be made into court or a bond may be lodged in favour of the action whereupon the lien can be "vacated."

Vacating of a lien will also be required in order to transfer title or often is a requirement of general contractors or subcontractors under the terms of their contract should liens be filed by their subcontractors. An order vacating the lien can be obtained upon the posting of either a bond from an acceptable bonding company or a letter of credit or cash for the full amount of the lien plus 25% on account of costs. Once the order to vacate the lien is obtained and registered on title, the land is freed from the lien and the security posted, being the

bond, letter of credit, or cash, is substituted for the security of the land. It is not good enough for the mortgage company to simply retain an amount equal to the lien claim. The registration of a lien establishes priority for all other liens so that the registered lien must be vacated. Lien claimants should not mistake the bond as being security for their individual claim for the same reason that lien claimants should not consider notice holdback as being held for their sole benefit. The bond, letter of credit, or cash used to vacate the lien stands as security for all lien claimants.

13. Priority over mortgages

Under s. 78 of the *CLA*, the relative priority of liens and mortgages turns upon three considerations:

- the time when the mortgage was registered;
- the time when the mortgagee made advances to the owner; and
- the amount of the advances.

Section 78 sets out three classes of mortgages for the purpose of establishing the priority of mortgagees:

- building mortgages;
- non-building prior mortgages, being mortgages that were registered prior to the time the first lien arose; and
- non-building subsequent mortgages, being mortgages that were registered after the time the first lien arose.

The commonly used term "building mortgage" is described by s. 78(2) of the *CLA* as one that is taken "with the intention to secure the financing of an improvement." If a mortgage is found to be a building mortgage, then s. 78(2) provides that it will be subordinate in priority to lien claims to the "extent of any deficiency in the holdbacks required to be retained by the owner" under the *CLA*.

As a lien claimant considering whether its claim has a priority vis-à-vis a mortgage, it is important to serve a request for information pursuant to s. 39(2) of the *CLA*. The request for information should be made to the owner, general contractor, and mortgagee, as applicable. Information may be obtained about the details of the general contract such as the contract price and state of accounts, as well as the state of mortgage advances. This will therefore allow the claimant to examine the history of mortgage advances and arrears and will include other information enabling a determination as to whether the mortgage was a building mortgage. Once information is obtained, a decision must be made when perfecting the lien as to whether to name the mortgagee as a defendant to the proceeding and to assert a claim for priority. When in doubt, err on the side of caution and name the mortgagee and claim the priority. The request for information may also assist in decisions as to where to preserve a lien or advance a claim under any performance and/or labour and material payment bond that may exist.

Subsection 78(3) provides that a prior mortgage has priority over liens arising from the improvement to the extent of the lesser of the actual value of the premises at the time the first lien arose and the total of all amounts advanced prior to that time under the mortgage. Subsection 78(4) provides that if the mortgage is not a building mortgage, advances made under a prior mortgage subsequent to the time that the first lien arose have priority over lien claims to the extent of the advance, provided that

- at the time when the advance was made no preserved or perfected lien existed against the premises; or
- prior to the time when the advance was made, the person making the advance had not received written notice of a lien.

Subsection 78(5) provides that liens arising from an improvement have priority over mortgages registered after the first lien arose to the extent of any deficiency in the holdbacks required to be retained by the owner under the *CLA*. Therefore, a lien claimant will have priority over a subsequent mortgage where it is established that the mortgage was registered after the first work was done or the first materials were supplied to the improvement.

14. Other priorities

The topic of priorities is a complex one that may involve a variety of other pieces of legislation including the *Companies' Creditors Arrangement Act*, *Bankruptcy and Insolvency Act*, *Income Tax Act*, and the *Personal Property Security Act*. Therefore, the complete details of all the priority disputes in which a construction lien claimant may become embroiled will not be undertaken here. However, it is important to have a basic understanding of the competing priorities as between lien claimants, which are detailed in ss. 77, 80–82, and 85 of the *CLA* and provide for the following priorities:

- **Workers' wage claims:** Section 81 of the *CLA* gives a special priority for wages (which includes claims for benefits payable to a worker's trust fund) of workers who supplied services to the project. Such claims have priority over all other liens in the same class to a maximum amount a worker would earn in 40 regular-time working days.
- **Between lien claimants:** Persons who supplied services or materials to the same payor compose a class. All amounts available to satisfy lien claimants

are distributed rateably among members of each class. Liens of class members take priority to the payer of that class. This means that the subcontractors claims have priority to the claim of the general contractor, and so forth.

- **General liens:** General liens rank with the class to which they otherwise belong to the full extent of the general lien, divided by the number of premises to which the person supplied those services or materials. The balance of the general lien ranks next in priority to all other liens against the premises, whether or not of the same class.
- **Judgments, executions, etc.:** Liens under the *CLA* have priority over all judgments, executions, assignments, attachments, garnishments, and receiving orders, except those executed or recovered upon before the time when the lien arose.
- **Insolvency:** Section 85 of the *CLA* provides for the distribution of holdback and trust funds upon insolvency (generally failing to meet financial obligations as they fall due). When a payor becomes insolvent, beneficiaries of the trust, with a proven lien, hold a priority with respect to those funds. The funds are then distributed among those with proven liens. The remaining funds are then distributed in accordance with the priorities in place had the liens been proven.
- **Lenders to a trustee under the *CLA*:** Interests in the premises granted to those making advances to trustees appointed pursuant to Part IX of the *CLA* will have priority, to the extent of the advance, over every lien claim existing at the date of the trustee's appointment.

15. Home buyer exception

The *CLA* excludes home buyers of certain model homes and other accommodations from the obligations of owners. A "home buyer" was excluded from the definition of "owner" and the onerous holdback obligations associated with that definition. A "home buyer" is defined in s. 1(1) as a person who buys an interest of an owner in a premises that is a home whether built or not at the time that the agreement of purchase and sale has been entered into, provided that both of the following are true:

- Not more that 30% of the purchase price, excluding money held in trust pursuant to the *Condominium Act, 1998* is paid prior to the conveyance.
- The home is not conveyed until it is ready for occupancy evidenced by a certificate of completion and possession.

The term "home" is further defined so that the property cannot consist of more than two self-contained one family dwellings under one ownership or single family condominium unit.

A purchaser who qualifies as a "home buyer" of a "home" as defined in s. 1(1) of the *Act* is excluded from the definition of "owner" under the *Act* and consequently relieved of any holdback responsibility.

If the purchaser is not a "home buyer" (i.e., if the purchaser has paid more than 30%), he or she will be deemed to be an "owner." Under those circumstances, when the agreement of purchase and sale pursuant to which the home was purchased provides for the making or completion of an improvement, s. 5(2) of the *CLA* provides for the retention of a holdback by the purchaser at the time of closing. The *CLA* deems such a holdback to be a term of any agreement of purchase and sale that provides for the making or completion of an "improvement."

16. What to do upon discovery of a lien prior to closing

In the event that in the course of a real estate transaction a lien is found on title to the property, steps must be taken to address it.

From a purchaser's perspective, it is recommended that a requisition for discharge of the lien be made. The purchaser does not want to purchase the property and have the property exposed to the lien claim.

From the vendor's perspective, once a requisition for removal is obtained, it may or may not be possible to provide a discharge. In the event that the lien has been registered but was not perfected in a timely manner, i.e., the lien has expired, it is still a cloud on title that must be removed before closing. The vendor's solicitor may make an application to amend the register with a solicitor's statement confirming that pursuant to the *CLA*, the lien has expired. This is a simple and relatively inexpensive remedy.

However, if the lien has been registered and the time to perfect has not yet been reached or the lien is already perfected, this option is not available. Instead, the vendor has the option of either posting security for the lien and having the lien vacated, or paying the lien claimant an amount satisfactory to settle the lien in exchange for a discharge from title.

While a discharge of the lien is final and preferable, if the lien is vacated, it no longer attaches to the land, and therefore, the purchaser can be satisfied the property is secure from the lien. However, before this is a satisfactory remedy, the purchaser should satisfy itself that there are no other liens registered on title immediately prior to closing and that the time for lien registration has expired, so none can be registered concurrently with the closing. Each and every lien that is

registered must be either vacated or discharged prior to closing. The order vacating or discharging the lien must then be registered on title.

The only other option is that the purchaser continues to hold back a portion of the purchase price sufficient to vacate all liens on the property (the amount of the lien, plus an additional 25% for costs).

It is important for a purchaser to remember that the perfection of even one lien may operate to enable other claimants to shelter their liens. As a result, even those liens that appear not to have been perfected in a timely manner may have "quasi-perfected" rights by virtue of their ability to shelter under the perfected lien of another claimant. In any event, all liens should be vacated or discharged prior to closing or moneys held back sufficient to satisfy all lien claimants, including those with rights that appear to have expired.

Where one may fall under the *CLA* definition of "owner," it is of course important to ensure that no registrations may be made after closing. It is prudent to wait at least 45 days between the completion of any and all work on the premises and the transfer of title to ensure that all persons who may claim liens have been paid or at least that their lien rights have expired. The exception to the foregoing is a purchase from a mortgagee under power of sale proceedings (*CLA*, s. 78(10)).

17. 2011 recent amendments to the CLA

On July 1, 2011, the following amendments to the *CLA* came into force:

(1) Section 33.1 of the *CLA* was enacted. It requires an owner of land intended to be registered as a condominium under the *Condominium Act, 1998* to publish notice of the intended registration in a construction trade newspaper at least five and not more than 15 days before the condominium description is submitted for approval under s. 9(3) of the *Condominium Act, 1998*. This was done to give potential lien claimants notice before a condominium is registered, since it is much easier to register a claim for lien on title prior to registration.

(2) Subsection 34(6) of the *CLA* was repealed. Previously, s. 34(6) required each claim for lien to be verified by an affidavit of verification, sworn by the lien claimant or an agent of the lien claimant. This change was due to the online Teraview registration system, whose lien form includes a statement by the lien claimant verifying its contents. Thus, the affidavit of verification became redundant and was no longer necessary.

18. The essentials of liens

(1) Notify the owner, all mortgagees, and the general contractor in writing of the claim for lien immediately.

(2) Immediately determine the description of the land in question and the date for preserving the lien by determining the earliest of

- the date of the last work of the client;
- the publication date of a certificate of substantial completion; and
- the date the contract or subcontract was completed or abandoned.

(3) Register the lien against title within 45 days of the earliest of the dates in (2), above.

(4) Commence legal action and issue and register a certificate of action against the owner's title (in the case of lands other than Crown lands) within 90 days of the earliest of the dates in (2) above.

(5) Claim for the full amount that is owing to the lien claimant against all defendants, including all those above in the construction pyramid.

(6) Claim priority over any mortgage as part of the relief sought in the statement of claim.

(7) Obtain a copy of any performance or labour and material payment bonds from the contractor, owner, or architect. Read the bond and strictly comply with its requirements to file a claim against the bond, if available (claims usually are required to be made within 90–120 days).

(8) Set the action down for trial within two years from the date the action was commenced as required by s. 37, failing which the lien action will expire.

Chapter 65
Aboriginal property issues

1. Jurisdiction

1.1 Division of powers

Jurisdiction respecting Aboriginal property issues falls mainly to the federal Parliament pursuant to s. 91(24) of the *Constitution Act, 1867,* "Indians and lands reserved for Indians." However, each province also has authority flowing from the following sources under the Constitution:

- property and civil rights;
- matters of a local and private nature; and
- as owners of Crown lands.

1.2 Constitutional recognition and affirmation of existing Aboriginal and treaty rights

Any action by the federal or provincial governments that interferes with or restricts existing Aboriginal rights or treaty rights of an Aboriginal person or group infringes those rights. Although there is no explicit justification requirement or test laid out in s. 35 of the *Constitution Act, 1982*, the Supreme Court of Canada has ruled that Aboriginal and treaty rights may be infringed if the infringement is "justified" according to the test set by the court (*R. v. Sparrow*). In *Delgamuukw v. B.C.*, the court reviewed the test for justification. First, the infringement of the right must be in furtherance of a legislative objective that is compelling and substantial. The Supreme Court of Canada in *R. v. Gladstone* defined "compelling and substantial objectives" as those that were directed at either one of the purposes underlying the recognition and affirmation of Aboriginal rights in s. 35(1), namely, the recognition of the prior occupation of North America by Aboriginal peoples or the reconciliation of Aboriginal prior occupation with the assertion of the sovereignty of the Crown. The second part of the test requires an assessment of whether the infringement is consistent with the special fiduciary relationship between the Crown and the Aboriginal peoples. The theory behind this principle is that the fiduciary relationship demands that Aboriginal interests be placed first, although they need not always be given priority. The degree of scrutiny and the form which the fiduciary duty takes will be a function of the nature of the Aboriginal right at issue.

To justify an infringement of Aboriginal title, the government must prove that its objectives in infringing title are "compelling and substantial." The Supreme Court in *Delgamuukw* notes that the range of legislative objectives that can justify infringement of Aboriginal title is fairly broad and that most objectives can be traced to the "*reconciliation* of the prior occupation of North America by Aboriginal peoples with the assertions of Crown sovereignty" (the court's emphasis). The court thus accepted that the development of agriculture, forestry, mining, hydroelectric power, the general economic development of an area, protection of the environment or an endangered species, the building infrastructure, and the settlement of foreign populations to support those aims may be sufficient to meet the first part of the justification.

The second part of the test requires that the government demonstrate "both that the process by which it allocated the resource and the actual location of the resource which results from that process reflect the prior interest of the holders of Aboriginal title in the land." This could mean that governments must accommodate the participation of Aboriginal peoples in, for example, the development of resources in Aboriginal title areas, the conferral of fee simple for agriculture, and the issuance of leases and licences for forestry and mining. This type of accommodation should reflect both the prior occupation of Aboriginal title lands and the economic barriers to Aboriginal uses of their own land. The aspects of Aboriginal title and the government's fiduciary duty to Aboriginal peoples also mandate, at a minimum, a duty to engage in good faith consultations with the holders of Aboriginal title; however, in most cases, much more than consultation is required, including full consent. The court finally notes that because of the inescapable economic component of Aboriginal title, fair compensation will ordinarily be required when Aboriginal title is infringed even where justification is found.

1.3 Application of provincial laws on reserves

Provincial laws apply to Indians in two ways. First, provincial laws apply directly to Indians of their own force (*ex proprio vigore*) as long as the laws do not invade exclusive federal authority over Indians and lands reserved for Indians or are not inconsistent with a federal law. A major limitation to provincial jurisdiction is that a provincial law cannot affect "Indianness" or derogate from the "status and capacities" of Indians and may not affect Indian reserve lands or Aboriginal rights.

The second way in which provincial laws may apply to Indians is through s. 88 of the *Indian Act*, which says:

> **88.**— Subject to the terms of any treaty and any other Act of Parliament, all laws of general application from time to time in force in any province are applicable to and in respect of Indians in the province, except to the extent that those laws are inconsistent with this Act or the *First Nations Fiscal and Statistical Management Act*, or with any order, rule, regulation or law of a band made under those *Acts*, and except to the extent that those provincial laws make provision for any matter for which provision is made by or under those Acts.

Section 88 of the *Indian Act* operates to incorporate into federal law those provincial laws of general application that do not invade exclusive federal authority. However, the operation of the incorporated provincial statute is subject to treaties and to federal laws and is only applicable to the extent that such laws are not inconsistent with the *Indian Act* or the *First Nations Fiscal and Statistical Management Act* or any order, rule, regulation, or band law made under those laws.

Subsection 35(1) of the *Constitution Act, 1982* still applies to provincial law that might be referentially incorporated as a result of s. 88. In other words, even if such a law is found to apply to Indians as a result of s. 88, it still must not unjustifiably infringe Aboriginal or treaty rights. The province must comply with the same test to justify infringement of rights. Moreover, although the federal government had the capacity to extinguish Aboriginal and treaty rights in certain circumstances prior to 1982, provincial governments have never had jurisdiction to do so. Since Aboriginal and treaty rights go to the "core of Indianness," it is not within the jurisdiction of the province to legislate in relation thereto.

Examples of provincial legislation that has been held to apply to Indians on reserves are

- seizure legislation, except to the extent that it calls upon seizure of property that is exempt according to s. 89 of the *Indian Act*;
- some hunting and fishing legislation, except where it conflicts with the *Indian Act*, band by-laws, and Aboriginal and/or treaty rights; and
- occupiers' liability legislation.

Examples of legislation that has been held not to apply to Indians on reserve include

- landlord-tenant legislation;
- provincial legislation dealing with prescriptive rights to property and dedication of roads; and
- portions of hunting and fishing legislation.

2. On-reserve real estate issues

2.1 Definition of "reserve"

Subsection 2(1) of the *Indian Act* defines reserve as "a tract of land, the legal title to which is vested in Her Majesty, that has been set apart by her Majesty for the use and benefit of a band." Except in the case of "special reserves" (see below), title to reserve lands is vested in the Crown. The only way for the property to be sold or transferred outside of the First Nations is if it is first surrendered according to the requirements of the *Indian Act*.

2.2 Nature of title on reserve

The *Indian Act* states that bands (First Nations) are to have the use and benefit of reserve lands. Subsection 18(1) reads:

> **18.—(1)** Subject to this Act, reserves are held by Her Majesty for the use and benefit of the respective bands for which they were set apart, and subject to this Act and to the terms of any treaty or surrender, the Governor in Council may determine whether any purpose for which lands in a reserve are used or are to be used is for the use and benefit of the band.

The purpose of this subsection is to ensure that lands reserved for Indians are and remain used for the use and benefit of the band. Additional protection for the integrity of the reserve is contained in s. 29 of the *Indian Act*, which exempts all reserve lands from seizure under legal process.

The use and benefit of reserve land is vested in the entire band and is a collective right of the band members as a body, and not of any individual band member.

2.3 Special reserves

The *Indian Act* contains the following provision with respect to reserves that are not Crown land:

> **36.**— Where lands have been set apart for the use and benefit of a band and legal title thereto is not vested in Her Majesty, this Act applies as though the lands were a reserve within the meaning of this Act.

The question as to who may set aside a special reserve and who is capable of holding title to special reserves remains to be determined by the courts.

2.4 Subsurface rights

The Supreme Court of Canada in *Delgamuukw* conclusively confirmed that the Aboriginal interest in reserve land includes mineral subsurface rights.

2.5 Water rights

There are two important aspects to the water rights that attach to reserve lands: first, provincial laws may not

encroach upon the water rights attached to reserve lands, and second, the process by which each reserve was created must be examined to see if special water rights attach to that reserve that may differ from the general water rights attached to a piece of land in the province.

2.6 Surrenders

Pursuant to s. 18(2) of the *Indian Act*, reserve land must be first surrendered to the Crown (or designated) before it can be leased or sold (*Indian Act*, s. 37, except for certain leases under s. 18(2)). If reserve land is not validly surrendered, any purported sale is void. Any such leases are also invalid. A surrender can be conditional (i.e., upon the Crown entering into a lease on particular terms) or unconditional.

Under s. 38(2) of the *Indian Act*, a First Nation may also "designate" lands. "Designated lands" are defined in s. 2(1) of the *Act* as "a tract of land or any interest therein the legal title to which remains vested in Her Majesty and in which the band for whose use and benefit it was set apart as a reserve has, otherwise than absolutely, released or surrendered its rights or interests ...." This concept allows a First Nation to "designate" lands rather than surrender them, meaning that the land remains reserve land for the purposes of many sections of the *Act*, and the constitutional jurisdiction of the lands remains with Parliament and the Department of Indian Affairs and Northern Development (also known as Indian and Northern Affairs Canada (INAC)). One of the primary benefits of designation of lands is that it allows First Nations to enter into long-term commercial leases (through the Crown) on unused land. It is also used on some reserves in "cottage country" where non-Indian cottagers enter into leases for cottages on designated lands.

According to s. 38 of the *Act*, there are three requirements for a valid surrender or designation of Indian lands: it must be made to Her Majesty, it must be assented to by a majority of the electors of the band, and it must be accepted by the Governor-in-Council.

The effect of the surrender or designation is to confer all rights that are necessary to enable the Crown to carry out the terms of the surrender or designation. When any surrender or designation is made to the Crown, the Crown is bound by fiduciary obligation to deal with the land in the best interests of the First Nation.

2.7 Individual possession of reserve land

The basic rule of Canadian law is that reserves are set apart for First Nations; they are not set apart for individual Indians. Individual members of a First Nation may acquire possessory or residency rights to build a house, establish a business, or otherwise use land on a reserve either through formal *Indian Act* procedures or through custom.

There is no individual right of residence on a reserve except by statute. Within many First Nations, members reside on reserves pursuant to some form of band custom, often unwritten and unspoken. Members, however, do not acquire common-law "squatter's rights" on their own reserve; the property must somehow be allocated by the governing authority of the First Nation, generally, the chief and council. Subsection 20(1) of the *Indian Act* reads:

> **20.—(1)** No Indian is lawfully in possession of land in a reserve unless, with the approval of the Minister, possession of the land has been allotted to him by the council of the band.

An individual Indian in lawful possession of reserve land has all of the incidents of ownership in the allotted part of the reserve, with the exception of legal title to the land itself, which remains with the Crown in trust for the band. Individual possession of reserve land is a unique form of land tenure not equivalent to any other type of land ownership under Canadian law.

A s. 20 allotment (referred to as a Certificate of Possession (CP)) is similar to fee simple ownership in the following ways:

- It may continue indefinitely so long as there are heirs to the estate.
- The owner may occupy and develop the lands in accordance with applicable laws.
- It may be sold or transferred during the lifetime of the owner.
- It is exclusive.

However, the class of persons who may inherit or otherwise acquire the right to possession is strictly limited by the *Indian Act*. In the case of a transfer during the owner's lifetime, s. 24 of the *Act* says that the land may be transferred only to a band member or to the band. That the band member must be someone who has a right to reside on the reserve is implied by s. 25, which states that when an Indian ceases to be entitled to reside on a reserve, the land must be sold. When a right to possession forms part of an estate, the eligible heirs are those who are entitled to reside on the reserve.

A CP is evidence of the right to possession of reserve land and is issued by the Minister of Indian Affairs and Northern Development (Minister) after an allotment by the band council. Since a CP is only evidence of a band member's right to possession of land in a reserve, it is possible that an Indian may be lawfully in possession of reserve land without the issuance of a CP.

A CP may be terminated in several ways, including

- cancellation by the Minister, if it was issued through fraud or in error;
- setting aside by a provincial superior court (and presumably the Federal Court) where the allocation was not properly made;
- expropriation under s. 18(2) or 35 of the *Indian Act*;
- surrender of the reserve lands under s. 38 of the *Indian Act*; and
- cessation of the Indian's entitlement to reside on a reserve.

2.8 Special residence rights of non-member children

The *Indian Act* contemplates the possibility that the children of band members who reside on reserve may not be band members and thereby not have the automatic right to reside on reserve. Section 18.1 of the *Indian Act* provides that children who are not band members may reside on reserve lands if they are dependants of or in the custody of a band member resident on the reserve. In addition to the fact that some children may not be entitled to status because of the requirements of s. 6 of the *Indian Act*, this situation may arise in cases of adoption, custody and guardianship orders, and foster children.

2.9 Occupation of reserve land by non-members

For First Nations in Ontario that have opted in to the land management regime under the *First Nations Land Management Act* (*FNLMA*), occupation of reserve land by non-members is governed by this *Act* and by the First Nations' respective land codes. For the great majority of First Nations in Ontario who have not opted into the *FNLMA* regime, the *Indian Act* provisions continue to apply.

Subsection 28(1) of the *Indian Act* restricts anyone who is not a member of the First Nation from occupying or possessing reserve land, except in accordance with the *Indian Act*. The subsection states:

> **28.—(1)** Subject to subsection (2), any deed, lease, contract, instrument, document or agreement of any kind whether written or oral, by which a band or a member of a band purports to permit a person other than a member of that band to occupy or use a reserve or to reside or otherwise exercise any rights on a reserve is void.

Permits for the use of unallocated reserve lands of the band (by non-members) are available under s. 28(2) of the *Indian Act*:

> **28.—(2)** The Minister may by permit in writing authorize any person for a period not exceeding one year, or with the consent of the council of the band for any longer period, to occupy or use a reserve or to reside or otherwise exercise rights on a reserve.

Tenancy agreements that have not received Ministerial consent and are, therefore, not made in accordance with s. 28, are unenforceable.

The provisions of s. 28(2) are augmented by ss. 58(1)(b) and (3), which provide for non-Indian occupation of individually possessed reserve land by lease, as follows:

> **58.—(1)** Where land in a reserve is uncultivated or unused, the Minister may, with the consent of the council of the band ...
>
> (b) where the land is in the lawful possession of any individual, grant a lease of that land for agricultural or grazing purposes or for any purpose that is for the benefit of the person in possession of the land ....
>
> **—(3)** The Minister may lease for the benefit of any Indian, on application of that Indian for that purpose, the land of which the Indian is lawfully in possession without the land being designated.

2.10 Trespass

What actions constitute trespass on a reserve depend upon the applicable laws, including:

- the First Nation's customs;
- any by-laws enacted by the band council (under s. 81(1) of the *Indian Act*); and
- the *Indian Act*.

A First Nation may regulate who is and who is not permitted on the reserve. Section 30 of the *Indian Act* creates a summary conviction offence of trespass, which is within the jurisdiction of the provincial court.

There is no definition of "trespass" within the *Indian Act*; therefore, courts refer to and apply common-law principles developed with respect to trespass on non-Indian land. Trespass has thus been defined as involving "the entering upon another's land without lawful justification, such that a provincial official entering a reserve to serve a statement of claim upon a band member would not constitute trespass."

Section 31 of the *Indian Act* further provides the Attorney General the power to commence a civil action in trespass.

The fact that the Crown is empowered under s. 31 to bring an action in trespass does not preclude a First Nation or a member thereof in lawful possession of reserve lands from commencing or maintaining a civil action in trespass in relation to such lands, independent of action by the Crown.

2.11 Rights of way

Common-law principles and provincial statutes related to adverse possession, prescriptive easements, and dedication do not apply on reserve land.

2.12 Reserve land registries

Section 21 of the *Indian Act* requires INAC to maintain a "Reserve Land Register," where particulars will be entered relating to CPs, Certificates of Occupation, and other transactions respecting lands.

It should be noted that this registry is not the same as provincial land registries. Instruments are registered for information purposes only, and there is no priority of registration; therefore, non-registered interests may take priority over registered. There is also no requirement that instruments be registered. As a result, the Reserve Land Register is not necessarily an accurate depiction of the interests on any reserve property.

In addition to the Reserve Land Register, s. 55(1) of the *Indian Act* requires that INAC maintain a "Surrendered and Designated Lands Register," which contains particulars in connection with any transaction affecting absolutely surrendered or designated lands. The remainder of s. 55 permits the registration of assignments and, in fact, provides a priority of registration, unlike s. 21. Subsection 55(4) states, "An assignment registered under this section is valid against an unregistered assignment or an assignment subsequently registered."

On March 1, 2011, the *First Nations Certainty of Land Titles Act* came into force. This federal statute expands the existing regulation-making powers found within the *Indian Act*, in order to establish a system for the registration of reserve lands for First Nations that desire it.

2.13 First Nations Land Management Act

The *FNLMA* changes a number of provisions in the land regime on reserves in many First Nation communities. The legislation is applicable to First Nations who wish to opt in to the regulatory framework.

Under the *FNLMA*, participating First Nations adopt their own "land code," dealing with issues such as rules and procedures governing use and occupancy of reserve land, transfers of property related to estates, rules and procedures respecting revenues, and processes for community consultation.

Of the 134 First Nations in Ontario, 13 First Nations have "opted in" to the *FNLMA*.

3. Off-reserve real estate issues

3.1 Aboriginal claims

Practitioners should be aware that Aboriginal claims to lands and resource rights are not limited to Indian reserves. In fact, lawyers in general practice may expect to confront Aboriginal issues in the fields of real estate law, commercial resource development law, and possibly other fields as well. For example, standard title insurance policies contain an exemption from coverage for claims that arise by reason of Indian land claims. Practitioners will have to advise their clients accordingly.

The Supreme Court of Canada has recognized a spectrum of Aboriginal interests in land outside of reserves. These rights may arise because of treaties entered into between the Crown and a particular Aboriginal group, or they may arise out of a particular group's use or occupation of land prior to contact with the Europeans or, in the case of Aboriginal title, prior to the assertion of British sovereignty. It should be noted that both First Nations and Métis may assert Aboriginal rights that affect off-reserve real estate. The extent to which a burden is created on the Crown grant depends upon the nature of the right that is in question.

This section will review four types of claims to off-reserve land that may be made by a First Nation or Aboriginal group:

- claims where a treaty has not been honoured — specific claims;
- access to off-reserve lands pursuant to treaty rights;
- access to off-reserve lands pursuant to Aboriginal rights; and
- claims where no treaty was signed — Aboriginal title.

3.2 Treaty issues

Unlike Aboriginal rights, which derive from the fact that Aboriginal peoples pre-existed Europeans in North America, treaty rights are based upon negotiated agreements between First Nations and the Crown. Most of the treaties in Canada were signed between 1800 and the early 1900s. The written text of most, but not all, treaties in Ontario provides that Aboriginal peoples give up their title to large tracts of land in exchange for reserves, small annual payments to individuals, and the right to hunt and fish off the reserve in certain circumstances.

Existing treaty rights are now recognized and affirmed along with Aboriginal rights in s. 35(1) of the *Constitution Act, 1982*. Furthermore, s. 88 of the *Indian Act*, which incorporates provincial legislation of general application to Indians, cannot apply to derogate from

treaty rights; thus, treaty rights take precedence over provincial laws.

Courts have now accepted that treaties should not be interpreted strictly on the written words contained in the treaty. The Supreme Court of Canada stated that courts must consider the historical context and perception of each party as to the nature of the transaction.

3.2.1 Claims where a treaty has not been honoured

There are several bases upon which First Nations may claim that a treaty has not been honoured. The *Final Report of the Royal Commission on Aboriginal Peoples* (vol. 2, ch. 4 at 49) lists its observations as to the non-fulfillment of historical treaties as follows:

- Treaty nations may not have given informed consent to the extinguishment of their rights and title.
- Important components of the treaties may not have been included in the written text drafted by the Crown.
- The letter of the treaty text may have been fulfilled, but the spirit and intent, which require a broader interpretation of the text, may have been breached.
- The failure of the Crown to provide some treaty entitlements may constitute a fundamental breach.
- Treaties might be found unconscionable, or agreement might be found to have been induced by fraud, undue influence, or duress.
- Implementation of the treaties might be found to fall short of the standards required of a fiduciary.

Where there has been non-fulfillment of terms of a treaty, a First Nation or Aboriginal group may file a claim under the federal government's Specific Claims Process. In June 2008, the *Specific Claims Tribunal Act*, received Royal Assent. The statute created a Specific Claims Tribunal, an independent body whose mandate is to decide issues of validity and compensation in relation to specific claims that have been rejected by the Minister or where negotiations have been unsuccessful. Alternatively, Aboriginal groups who have a specific claim against the federal Crown have the option to pursue their action through the judicial system.

3.2.2 Treaty rights

Various treaty rights, both implied and explicit in the written text, have repercussions for off-reserve property. For example, the *Robinson Superior Treaty* and *Robinson Huron Treaty*, both of 1850, permit treaty beneficiaries to hunt and fish on unoccupied land.

3.3 Aboriginal rights issues

The Supreme Court of Canada in *Delgamuukw* summarizes how different categories of Aboriginal rights may be connected with the land:

> ... Aboriginal rights which are recognized and affirmed by s. 35(1) fall along a spectrum with respect to their degree of connection with the land. At the one end, there are those Aboriginal rights which are practices, customs and traditions that are integral to the distinctive Aboriginal culture of the group claiming the right. However, the "*occupation and use of the land*" where the activity is taking place is not "*sufficient to support a claim of title to the land*" (at para. 26 (emphasis in original)). Nevertheless, those activities receive constitutional protection. In the middle, there are activities which, out of necessity, take place on land and indeed, might be intimately related to a particular piece of land. Although an Aboriginal group may not be able to demonstrate title to the land, it may nevertheless have a site-specific right to engage in a particular activity. ... At the other end of the spectrum, there is Aboriginal title itself. As *Adams* makes clear, Aboriginal title confers more than the right to engage in site-specific activities which are aspects of the practices, customs and traditions of distinctive aboriginal cultures. Site-specific rights can be made out even if title cannot. What Aboriginal title confers is the right to the land itself.

3.3.1 Aboriginal rights

In order for an activity to be an Aboriginal right, it must be an element of a practice, custom, or tradition integral to the distinctive culture of the Aboriginal group claiming the right. Such rights, if existing prior to the proclamation of the *Constitution Act, 1982* are constitutionally affirmed and recognized under s. 35(1).

Aboriginal title is a subset of Aboriginal rights and requires proof of occupation of the land sufficient to claim a right of exclusive possession.

An Aboriginal group need not prove that they have Aboriginal title to an area to enjoy Aboriginal rights to certain activities in the area given that many Aboriginal nations are nomadic "hunter-gatherers," and although certain activities would be integral to their distinctive cultures, they would not necessarily be related to exclusive occupation of a particular territory.

Likewise, the Supreme Court of Canada recognizes that "... if an Aboriginal people demonstrates that hunting on a specific tract of land was an integral part of their distinctive culture then, even if the right exists apart from title to that tract of land," the Aboriginal right to hunt may nonetheless be defined as the right to hunt on that specific tract of land.

In 2003, the Supreme Court of Canada had its first opportunity to address Aboriginal rights of the Métis. In

R. v. Powley, the court recognized that members of the Métis community near Sault Ste. Marie have site-specific hunting rights that were infringed, without justification, by Ontario's hunting legislation.

3.3.2 Aboriginal title

In *Delgamuukw*, the Supreme Court of Canada finally settled that Aboriginal title is a property right. However, the court reiterated that its nature was *sui generis*, in that it is distinct from "normal" proprietary interests, such as fee simple, found at common law. The court refers to various "dimensions" of Aboriginal title that distinguish it:

- Aboriginal land cannot be transferred, sold, or surrendered to anyone other than the Crown and, as a result, is inalienable to third parties.
- Aboriginal title arises from
  - the occupation of Canada by Aboriginal peoples prior to assertion of British sovereignty.
  - the relationship between common-law and pre-existing systems of Aboriginal law.
- Aboriginal title cannot be held by individual Aboriginal persons; it is a collective right to land held by all members of an Aboriginal nation.

The Supreme Court then put forth two propositions on the content of Aboriginal title:

- Aboriginal title encompasses the right to exclusive use and occupation of the land held pursuant to that title for a variety of purposes, which need not be aspects of those Aboriginal practices, customs, and traditions that are integral to distinctive Aboriginal cultures.
- Those protected uses must not be irreconcilable with the nature of the group's attachment to the land.

In order to make out a claim for Aboriginal title, the Aboriginal group asserting title must satisfy the following criteria:

- The land must have been occupied prior to sovereignty.
- If present occupation is relied on as proof of occupation pre-sovereignty, there must be a continuity between present and pre-sovereignty occupation, although there need not be an "unbroken chain of continuity."
- At sovereignty, that occupation must have been exclusive, although joint title may arise from shared exclusivity. The claimants must have also maintained a substantial connection with the land since sovereignty.

Holders of Aboriginal title are limited in the use that they may make of such lands in that the lands cannot be used in a manner that is irreconcilable with the nature of the claimants' attachment to the land. This does not, however, require that the use be tied to practice, custom, or tradition. In fact, the court in *Delgamuukw* equated the Aboriginal interest in tribal lands to that of a First Nation's interest in their reserve lands (*Indian Act*, s. 18(2)).

3.3.3 The duty to consult

One of the tests required to justify an infringement of Aboriginal rights or title is that the Crown must adequately demonstrate that it consulted with the Aboriginal people affected and accommodated their rights. The Supreme Court of Canada in *Haida Nation v. British Columbia (Minister of Forests) and Weyerhaeuser* and *Taku River Tlingit First Nation v. British Columbia (Project Assessment Director)* has expanded upon this test and held that the duty to consult and accommodate is triggered when the Crown has knowledge of an Aboriginal right or title and that the duty to consult can be enforced prior to the judicial determination of the existence and scope of the Aboriginal or treaty rights in question. The duty to consult also arises at the strategic planning stage and cannot be delayed until any point afterwards. The court stated that the scope and content of the duty to consult depends upon the content of the rights asserted and the circumstances but that it can include revenue sharing of a resource that is being exploited.

While the duty to consult and accommodate belongs solely to the Crown and cannot be delegated to resource developers, a challenge to Crown actions in relation to resource development could easily translate into serious disruption for industry. Thus, the costs and effort of the Crown's duty can be pushed down to private industry, which risks future costs and delays if the Crown fails to adequately consult and accommodate Aboriginal interests at any point in development. As a result, industrial developers are increasingly choosing to negotiate directly with Aboriginal groups and/or participate in consultations with Aboriginal groups and the Crown in an attempt to reach contractual agreements that provide greater certainty and stability regarding the development of Crown land.

Chapter 66

Fraud in real estate transactions

1. Introduction

Fraud in real estate transactions is a major area of concern. Two of the more common types of fraud are value fraud and identity fraud. In a value fraud, the value of the property is inflated and usually a third party advances money on the strength of the higher value. In an identity fraud, the fraudster misappropriates the identity of a third party to facilitate the fraud.

This chapter presents some resources to assist lawyers to recognize fraud in real estate transactions and understand their ethical obligations when engaged in transactions involving real estate fraud:

- fact scenarios outlining how a real estate fraud may occur;
- practice tips containing some possible indicators of fraud; and
- Qs and As dealing with practice issues and some of the lawyer's ethical obligations when acting in transactions in which a fraud has been or may be occurring.

2. Fact scenarios — how might a real estate fraud occur?

The following fact scenarios are examples of how a value or identity fraud may occur in the context of a real estate transaction. However, it should be noted that sometimes elements of more than one type of fraud might be present in the same transaction.

2.1 Value fraud

2.1.1 Fact scenario 1 — flip transactions

A fraudster arranges for a purchaser (Purchaser 1) to purchase a property from a legitimate vendor (Vendor 1). Purchaser 1 and Vendor 1 agree on a purchase price of $200,000.

The fraudster and/or Purchaser 1 retains Lawyer A to act on the purchase transaction.

The fraudster then arranges for another purchaser (Purchaser 2) to purchase the same property from Purchaser 1 (who becomes Vendor 2 in the second transaction) at a purchase price of $300,000. Lawyer A is also retained to act for both Vendor 2 and Purchaser 2 in the second transaction (a practice that is now prohibited by the two-lawyer rule under r. 2.04.1 of the *Rules of Professional Conduct*, which states that an individual lawyer may not act for both the transferor and transferee in a transfer of title to real property).

Purchaser 2 then applies to a bank for a high-ratio mortgage (95% of $300,000), and the bank approves Purchaser 2 for a mortgage of $285,000. The amount of mortgage proceeds received from the bank on closing is greater than the amount required to close the first transaction.

Both transactions close on the same day or within a short time period of each other. Where the transactions close on the same day, Vendor 2 and Purchaser 2 instruct the lawyer to change the Transfer/Deed delivered by Vendor 1 to show the higher consideration of $300,000. On closing, a portion of the mortgage proceeds is used to complete the first transaction, and the balance or excess is paid to the fraudster, Purchaser 1, and/or Purchaser 2.

After closing, the fraudster and/or Purchaser 2 may reside in the property for a period of time and make the mortgage payments, or alternatively, the fraudster may rent out the property and use the rental moneys to make the mortgage payments. At a certain point, Purchaser 2 or the fraudster stop making the mortgage payments. The bank sells the property under power of sale, and the bank is unable to realize the full amount owing on the mortgage because the real fair market value of the property in the second transaction is substantially less than the fraudulent value of $300,000 on which the bank's loan was based.

2.1.2 Fact scenario 2 — misrepresentation of the sale price

A fraudster agrees to purchase a property from a legitimate vendor. The fraudster and the vendor agree on a purchase price of $250,000. The parties sign an agreement of purchase and sale indicating a purchase price of $250,000.

The parties then sign a one-page amendment to the agreement indicating that the purchaser will be given a credit of $50,000 on closing to effect repairs to the property. The fraudster does not disclose the amendment to the bank.

The fraudster applies to the bank for a high-ratio mortgage. The fraudster is approved for a mortgage of $237,500, being 95% of $250,000.

On closing, some of the mortgage proceeds are used to close the transaction, and the balance of proceeds are paid to the fraudster.

After the closing, the fraudster makes mortgage payments for a period of time and then stops. The bank sells the property under power of sale and is unable to realize sufficient moneys to cover the full amount owing on the mortgage because it over-advanced approximately $47,500, being 95% x ($250,000 - $200,000).

2.2 Identity fraud

2.2.1 Fact scenario 3 — forged bank drafts and certified cheques

A new and previously unknown client, such as a contact allegedly from a major bank, will ask the lawyer to act on a mortgage loan. The source of the referral will be unknown to the lawyer (i.e., a person the lawyer doesn't know or recognize). Shortly thereafter, the lawyer will receive mortgage instructions and a legitimate looking bank draft drawn on a major bank. The client (the lender) will be in a rush to complete the deal. The closing date may be specified as the Friday before a long weekend. Fraudsters are very active around holiday times—times when banks are closed and firms are often short-staffed.

The transaction documents and the bank draft received from the lender look legitimate, but they are not. Typically the client borrowing the funds and the lender institution are both new to the firm. The bank draft is counterfeit, but the lawyer does not detect this. The lawyer draws a certified cheque on his or her trust account and delivers it to the "borrower." On the next business day, the bank notifies the lawyer that the draft is a forgery. The firm is left with a shortfall in the trust account.

2.2.2 Fact scenario 4 — theft of owner's identity

A fraudster (imposter) appropriates the identity of an owner of real property and applies to a bank for financing. The imposter supplies the bank with a false letter of employment and other false information or documents.

The bank approves the financing.

The imposter retains a lawyer to act on the mortgage transaction, and the bank retains the same lawyer to act on its behalf in the mortgage transaction. The lawyer does a title search and finds that there are no encumbrances against the property.

The lawyer completes the transaction and pays the mortgage proceeds to the imposter. After closing, the imposter makes mortgage payments for a period of time and then stops.

The lawyer discovers after closing that the imposter is not the owner of the property but an imposter who forged the signature of the owner on the mortgage document.

2.2.3 Fact scenario 5 — theft of corporate identity

A fraudster (imposter) targets real property owned by a corporation. The fraudster creates minute books for the corporation and either appropriates the identity of one of the controlling individuals of the corporation or creates a new identity to act as the controlling individual of the corporation. The fraudster applies to a bank for financing in the name of the corporation. The fraudster supplies the bank with false corporate documentation and false financial information.

The bank approves the financing.

The imposter retains a lawyer to act on the mortgage transaction, and the bank retains the same lawyer to act on its behalf in the mortgage transaction. The lawyer does a title search and finds that there are no encumbrances against the property.

The lawyer completes the transaction and pays the mortgage proceeds to the corporation and/or fraudster. After closing, the lawyer discovers that the identities of the corporation and of the individual controlling the corporation were stolen and that the mortgage documents were signed by an imposter.

2.2.4 Fact scenario 6 — theft of lawyer's identity

A fraudster enters into an agreement of purchase and sale with a legitimate vendor.

The fraudster appropriates the identity of a lawyer who is in good standing with the Law Society. The fraudster creates letterhead using the lawyer's name but containing a false address, telephone number, and fax number. The fraudster establishes a trust account using the lawyer's name.

The fraudster applies to a bank for mortgage financing and is approved. The fraudster then provides the bank with the lawyer's name and the false address, telephone number, and fax number. The bank retains the same lawyer to act on its behalf in the mortgage transaction.

The bank sends mortgage instructions to the lawyer at the address provided by the fraudster and forwards funds payable to the lawyer in trust. The mortgage proceeds are deposited into the trust account established by the fraudster. Prior to closing, the fraudster steals the mortgage money and disappears, and the transactions do not close.

Appendix A

Practice tips: Recognizing fraud in real estate transactions

Real estate fraud can occur in a number of different ways. The following is a list of some possible indicators of fraud in residential real estate transactions. The presence of one or more of these indicators in a transaction does not necessarily mean that a fraud is occurring or has occurred in the transaction. This list is not intended to replace the lawyer's professional judgment. Whether a fraud is being committed in the course of a real estate transaction will depend upon the circumstances of the individual matter or transaction.[1]

Note: Many of these indicators are also present in transactions involving security or property other than real estate, such as business loans.

Recent property purchase

- The client has recently purchased a property on an all-cash basis and is subsequently placing a mortgage on the property.
- The client has a copy of his or her Transfer/Deed but does not have any other documents relating to the property (purchase documents, lawyer's report, title insurance policy, or survey).
- The client does not retain the same lawyer who acted in the purchase transaction to act in the mortgage transaction, and the client instructs the new lawyer not to contact the former lawyer.
- The search of title indicates recent transfers of the property at higher prices, and the same lawyer acted on each of the transfers.

The agreement of purchase and sale

- The agreement of purchase and sale contains no hand-written amendments.
- The agreement of purchase and sale contains an amendment that provides for a reduction in the purchase price or a payment to the vendor after closing.
- The vendor in the transaction acknowledges receipt of deposit moneys that are not required pursuant to the agreement of purchase and sale.
- The deposit is paid to the vendor directly rather than to the lawyer in trust or to the real estate agent.
- There is no real estate agent involved in the transaction.
- A real estate agent is listed in the agreement, but the lawyer does not receive any communication from the agent (e.g., payment of commission).
- The property is vacated or tenanted.

The transaction(s)

- The client does not have fire insurance on the home.
- The utility companies are unaware of the vendor owning the home.
- The client needs to close the transaction very quickly.
- The client is a new client and promises to refer more transactions to the lawyer.
- The client arranges the mortgage through a broker, and the brokerage fee is unusually high.
- The client is prepared to pay higher legal fees than normal for the lawyer's services.
- The purchase price is much higher than the purchase price of recent transfers of the same property.
- There are large and unusual adjustments in the statement of adjustments (e.g., large credit for renovations).
- The statement of adjustments does not reflect the terms of the agreement of purchase and sale and any amendment thereto.
- The title indicates a pattern of mortgages being registered and discharged shortly afterwards.

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1 Some of the items contained in this list of possible indicators were adapted from the following sources: LawPRO, "The Many Faces of Fraud," June 2004; Law Society of Upper Canada CLE program, "Real Estate Fraud: Protecting Your Practice From the Brazen New Breed of Fraudster," January 26, 2004.

- All of the funds required to close the transaction come from the institutional lender.
- The client is in a rush to complete the transaction.
- The name of the client in the identification produced by the client does not match the name of the client in other documents in the transaction.
- The closing is scheduled just before a long weekend.

Mortgage proceeds

- There is a surplus of mortgage proceeds after the closing of the transaction that are to be paid to the borrower or to a third party.
- The client directs part of the mortgage proceeds to third parties (e.g., off-shore recipients and currency exchange).
- The client instructs the lawyer that it is unnecessary to prepare written directions authorizing the payment of funds to third parties.
- The mortgage is a cash-back mortgage, and the cash-back is the full amount of the equity in the property.
- The client directs the lawyer to rebate a portion of the mortgage surplus to the vendor.

Client is a facilitator

- A new client (facilitator) refers a number of real estate files to the lawyer, and the client, although not a party to the transaction, controls the transaction (e.g., gives instructions to the lawyer, arranges for the parties to the transaction to sign documents, etc.) and directs the parties in the transaction.
- The client was not referred by anyone you know.
- The client does not have a personal cheque for the client's pre-authorized debit plan but provides a blank "counter cheque."
- The lawyer is instructed to pay the excess mortgage proceeds to the facilitator even though the facilitator does not appear to have an interest in the transaction.

Flip transaction

- The vendor acquires the property the same day that it is being sold for a higher purchase price (flip transaction).
- The lawyer is asked to act for both the purchaser and the vendor in the flip transaction.
- A bank loans money on the strength of the consideration contained in the flip agreement.
- The client instructs the lawyer not to disclose to the lender that the transaction is a flip or that the lender is lending money on the higher consideration.
- In a paper-based (non-electronic) transaction, the land transfer tax affidavit shows the higher consideration. The Transfer/Deed of Land signed by the original vendor containing a lower consideration is manually altered prior to closing to match the consideration set out in the land transfer tax affidavit.

Multiple transactions

- A new client begins referring a number of real estate files to the lawyer, and the same parties (purchasers and vendors) are involved over and over in transactions.
- The client indicates that he or she is in the business of renovating homes.
- The same real estate agency appears regularly on the agreements of purchase and sale.
- The mortgages arranged in these transactions are usually high-ratio mortgages with mortgage insurance.
- The lawyer is instructed to use the excess mortgage proceeds for the purchase of another property.

Corporations

- The original minute books for the company are not available or incomplete.
- The minute books contain irregularities such as the lack of the "pink-stamped" articles of incorporation. (Note that pink-stamped articles are becoming less common since corporations may now be incorporated through Internet service providers using electronic procedures that create articles of incorporation without being stamped at a government office.)
- The corporation may have a recent filing with the Ontario government under the *Corporations Information Act*, or other government having jurisdiction, in which the names of the officers and directors and perhaps the

corporation's address have been changed to those of the fraudster. These filings can also easily be done electronically and without proper identification.

Powers of attorney

- Forged powers of attorney may be used by a fraudster claiming to represent the owner of a property.
- Similarly, a titled spouse may try to sell a matrimonial home using a forged power of attorney from the non-titled spouse to sign the consent of the non-titled spouse. In such a situation, the spouses may in reality be separated, or the non-titled spouse may simply not know what is happening or may be mentally incapable.
- The donor of the power of attorney will often be out of the country or otherwise unavailable so that the donor's identity and signature cannot be verified.
- The power of attorney may not have been witnessed by two independent witnesses as required under s. 10 of the *Substitute Decisions Act, 1992* or your attempts to contact the witnesses may be unsuccessful.

Fraudulent conveyance

- A debtor, perhaps insolvent or soon to be insolvent, may retain you to transfer the title of his or her home or other assets to another person or a corporation controlled by another person in violation of s. 2 of the *Fraudulent Conveyances Act*. By asking about the purpose of the conveyance before participating in it, you can avoid assisting the debtor's malfeasance.

Appendix B

Qs & As — Fraud in real estate transactions: Some ethical issues

Dishonesty or fraud by the client

A lawyer acts for a purchaser in a real estate transaction. The lender is separately represented. During the course of the transaction, the lawyer discovers that the purchaser is committing a fraud on the mortgagee. May the lawyer continue to act for the client?

The *Rules of Professional Conduct* (*Rules*) specifically prohibit lawyers from assisting in any dishonesty or fraud. Subrule 2.02(5) provides that a lawyer shall not knowingly assist in or encourage any dishonesty, fraud, crime, or illegal conduct or instruct the client on how to violate the law and avoid punishment. The commentary to the subrule warns lawyers to guard against becoming the tool or dupe of an unscrupulous client or persons associated with such a client.

Where in the course of a transaction a lawyer determines that the client is committing a fraud, the lawyer cannot assist in the fraud. In this regard, r. 2.09(7) provides that where during the course of the retainer it becomes clear to the lawyer that the lawyer's continued employment will lead to a breach of the *Rules*, the lawyer must withdraw from representing the client. The presence of fraud essentially voids the lawyer's retainer.

What if the lawyer suspects that the client is committing a real estate fraud?

Where a lawyer suspects that a client may be engaged in a fraud, the lawyer may wish to discuss these concerns with the client. If the lawyer is unsatisfied with the client's explanation, the lawyer should assess whether withdrawing from representing the client is appropriate. Subrule 2.09(2) provides that where there has been a serious loss of confidence between the lawyer and the client, the lawyer may withdraw.

Disclosure to third parties

A lawyer acts for a purchaser in a real estate transaction. During the course of the retainer, the lawyer determines that the client is engaged in a real estate fraud and withdraws from representing the client.

May the lawyer disclose the information that he has learned in the course of the retainer to a third party?

Lawyers have a duty to hold in strict confidence all information concerning the business and affairs of the client acquired in the course of the professional relationship. The duty survives the professional relationship and continues indefinitely after the lawyer has ceased to act for the client, whether or not differences have arisen between them.

A lawyer who discovers during the course of a retainer that a client has committed or is committing a fraud may only disclose confidential information about the client to a third party if the disclosure is permitted or justified under the *Rules*. Subrules 2.03(1)–(5) outline the circumstances in which a lawyer may or must disclose confidential information.

A lawyer must disclose confidential information where disclosure is required by law or by order of a tribunal of competent jurisdiction.

A lawyer may disclose confidential information in any of the following situations:

- The client has expressly authorized the lawyer to disclose the information.
- The client has impliedly authorized the lawyer to disclose the information.
- The lawyer believes upon reasonable grounds that there is an imminent risk to an identifiable person or group of death or serious bodily harm (including serious psychological harm that substantially interferes with health or well-being) and it is necessary to do so to prevent the death or harm. The lawyer should disclose the information pursuant to a judicial order where practicable and must not disclose more information than is required.
- Disclosure is required to defend against allegations that the lawyer or the lawyer's associates or employees are guilty of a criminal offence involving a client's affairs, civilly liable with respect to a matter involving a client's affairs, or guilty of malpractice or misconduct. The lawyer, however, must not disclose more information than is required.

- Disclosure is necessary to establish or collect the lawyer's fees.

Furthermore, where a lawyer discloses confidential information in accordance with the *Rules*, the lawyer must ensure that he or she does not disclose more information than is required.

Disclosure obligations in a joint retainer

A lawyer acts for both the borrower and the institutional lender in a mortgage transaction. During the course of the retainer, the lawyer discovers that the borrower misrepresented the purchase price of the property to the lender. What are some of the lawyer's ethical obligations to the lender when acting in a joint retainer?

A lawyer who acts for both the borrower and the lender in a mortgage transaction is acting in a joint retainer and must comply with rr. 2.04(6)–(10). In a joint retainer, the lawyer has a duty to act in the best interests of all of the clients in the retainer and must use care not to prefer the interests of one of the clients to those of the others. Furthermore, no information received from one client in connection with the matter can be treated as confidential so far as any of the other clients in the retainer are concerned. Where a lawyer acts for both the lender and borrower in a mortgage transaction and the lawyer obtains information that is relevant to the lender's decision to advance funds to the borrower, the lawyer must disclose this information to all of the clients in the joint retainer. If upon disclosure of the information a conflict develops that cannot be resolved, the lawyer cannot continue to act for both clients and may have to withdraw completely. Additionally, if one of the clients in the joint retainer instructs the lawyer to take steps that are inconsistent with the lawyer's obligations to the other clients in the retainer, the lawyer cannot continue to act for all of the clients and may have to withdraw completely.

Release of contents of file to a client in a joint retainer

A lawyer acted for a purchaser/borrower and a lender in a mortgage transaction. After closing, the lender advises the lawyer that the purchaser/borrower misrepresented the purchase price of the property to the lender and the lender will be selling the property under power of sale. The lender requests that the lawyer provide the lender with copies of all documents, correspondence, and information in the file relating to the transaction. May the lawyer release the requested information to the lender?

The lawyer acted for both the lender and the borrower in the mortgage transaction. In a joint retainer, there is no confidentiality as between the parties to the retainer (rr. 2.04(6)–(10)). The lawyer is therefore entitled to release information from the file to the lender. When acting in a joint retainer, however, the lawyer also has a duty to keep an even hand as between the clients and must not prefer the interests of one of the clients to those of the others. It would therefore be prudent for the lawyer to advise the borrower of the lender's request and to make copies of the information to be provided to the lender also available to the borrower. Where the file contains original documents that belong to both clients, it would be prudent for the lawyer to require a written direction from both parties authorizing the release of such documents to one of the parties or alternatively a court order authorizing the release of the documents.

Lawyer is the tool or dupe of an unscrupulous client

A lawyer acted for both the lender and borrower in a mortgage transaction. After closing, the lawyer learns that the borrower client was engaged in a fraud and that the lawyer was duped by the client. What are some of the lawyer's ethical obligations in these circumstances?

Subrule 6.09(2) provides that a lawyer shall give prompt notice of any circumstance that the lawyer may reasonably expect to give rise to a claim to an insurer or other indemnitor so that the client's protection from that source will not be prejudiced. Additionally, where the lawyer discovers an error or omission in connection with a matter for which a lawyer is responsible that is or may be damaging to a client and that cannot be rectified readily, the lawyer must promptly inform the client and follow the procedure set out in r. 6.09(1).

Obligation to report misconduct of a lawyer

A lawyer acts for a vendor in a real estate transaction. During the course of the retainer, the lawyer discovers that the lawyer on the other side of the transaction is or may be engaged in a real estate

fraud. Does the lawyer have an obligation to report the misconduct of the other lawyer to the Law Society?

Where a lawyer becomes aware that another lawyer is assisting a client in or is engaged in a real estate fraud, the lawyer may have a duty to report that lawyer to the Law Society. The *Rules* provide that in certain situations lawyers must report to the Law Society the misconduct of other lawyers unless to do so would be unlawful or a breach of solicitor-client confidentiality. These situations are set out in r. 6.01(3) and include

- the misappropriation or misapplication of trust moneys;
- the abandonment of a law practice;
- participation in serious criminal activity related to a lawyer's practice;
- the mental instability of a lawyer of such a serious nature that the lawyer's clients are likely to be severely prejudiced; and
- any other situation where a lawyer's clients are likely to be severely prejudiced.

The lawyer should review the facts of the particular situation as well as the provisions of the subrule in order to make a determination. The commentary to r. 6.01(3) provides that in certain circumstances it would be proper for a lawyer to report the misconduct of another lawyer even if the breach is minor in nature. The commentary states that evidence of minor breaches may, on investigation, disclose a more serious situation or may indicate the commencement of a course of conduct that may lead to serious breaches in the future. It is therefore proper (unless it is privileged or otherwise unlawful) for a lawyer to report to the Law Society any instance involving a breach of the *Rules*.

Where a lawyer is in doubt whether a report should be made to the Law Society, the lawyer may wish to seek guidance from the Practice Advisory department of the Law Society either directly or indirectly through another lawyer.

Identity fraud

A lawyer acts for a vendor of a property. The vendor provides the lawyer with the name and contact information of the purchaser's lawyer. The lawyer recalls having had dealings with the purchaser's lawyer in the past and notes that the purchaser's lawyer's address is different than his previous address. In fact, the lawyer's recollection is that the purchaser's lawyer practised in a different city.

What are some of the steps that the lawyer might consider taking to protect her client?

The address and phone number of the purchaser's lawyer can be verified by matching it with the information on file with the Law Society. This may be done by searching through the Law Society's online member directory. If there is a discrepancy, the lawyer may wish to contact the other lawyer at the telephone number or address on file with the Law Society to confirm that he or she is acting on the transaction.

What if the lawyer discovers that he or she is the victim of identity theft?

Where a lawyer discovers that he or she is the victim of an identity theft, in addition to pursuing any available legal remedies and/or reporting the matter to the appropriate law enforcement authority, the lawyer should report the identity theft to the Law Society by calling 416-947-3315 or toll-free at 1-800-668-7380, ext. 3315. Lawyers may also wish to report it to LawPRO.

Lawyer subpoenaed to testify about a client matter

What are the lawyer's ethical obligations if the lawyer is subpoenaed to testify as a witness regarding a client matter?

Provided that the subpoena has been issued by order of a tribunal of competent jurisdiction, the lawyer must obey the order requiring his or her attendance at the hearing. Once sworn as a witness and if ordered by the court, the lawyer must answer proper questions relating to confidential information.

Subrule 2.03(2) mandates disclosure of confidential information if required by law or by order of a tribunal of competent jurisdiction.

However, the ethical rule regarding confidentiality must be distinguished from the evidentiary rule of lawyer-and-client privilege concerning oral or documentary communications passing between the client and the lawyer. The ethical rule is wider and applies without regard to the source of the information or the fact that others may share the knowledge.

Where the lawyer believes that the information requested is not only confidential, but also privileged, then the lawyer must assert solicitor-client privilege on behalf of the client. If the lawyer is correct and the tribunal accepts the lawyer's assertion that the information is privileged (and not subject to any exceptions to the privilege), then the information must not and will not be disclosed. If the tribunal does not readily accept the lawyer's opinion or requires further submissions to satisfy itself that the information is protected by solicitor-client privilege, then legal argument will be required to determine whether the information is privileged.

Whereas the determination of whether confidential information must be disclosed is made with reference to the *Rules*, the determination of whether confidential information is also privileged information and therefore not subject to disclosure is made by reference to case law.

If at the hearing the client is represented by counsel, then the client's own lawyer will be available to make submissions on the legal issue of solicitor-client privilege. If the client is not represented or not a party to the proceeding, then the lawyer should consider having his or her own counsel available to address the tribunal on the issue of solicitor-client privilege.

The subpoenaed lawyer should have his or her own counsel at the hearing because the lawyer appears as a witness at the hearing and not as an advocate. Subrule 4.02(2) of the *Rules* generally prohibits a lawyer who testifies to appear in the same proceeding as an advocate:

> Subject to any contrary provisions of the law or the discretion of the tribunal before which a lawyer is appearing, a lawyer who appears as advocate shall not testify before the tribunal unless permitted to do so by the rules of court or the rules of procedure of the tribunal, or unless the matter is purely formal or uncontroverted.

In summary, when a lawyer is called to testify as a witness, the lawyer should take the following general steps:

(1) Review the order compelling the lawyer's attendance and comply with the requirement to attend and to bring any documents to the hearing.

(2) If the client is not a party to the proceeding or is not represented by counsel, the lawyer should retain his or her own counsel to
   - attend at the hearing to be available to make submissions to the court on the issue of solicitor-client privilege; and
   - advise the lawyer as to his or her legal obligation to disclose information that may be subject to solicitor-client privilege.

(3) Once sworn as a witness and asked to answer questions, the lawyer should ensure that if confidential information is to be disclosed, the tribunal has clearly ordered the disclosure.

(4) The lawyer should not disclose more information than is required.

(5) If the lawyer is asked to disclose information that the lawyer believes is privileged information, the lawyer must assert the privilege on behalf of the client.

(6) If there is any disagreement on whether the information requested is subject to solicitor-client privilege, counsel for the client (or counsel for the lawyer in cases where the client is not a party) may then make submissions as to the admissibility of the information requested.

(7) If the lawyer is under any doubt as to the lawyer's legal obligation to disclose information that he or she believes is subject to the legal doctrine of solicitor-client privilege, then the lawyer should seek legal advice from his or her own counsel.

Practice tips to fight fraud

- Obtain photo identification of borrowers and retain evidence of confirmation of identity in the file. Remember that ss. 22–23 of By-Law 7.1, made under the *Law Society Act*, provide a mandatory comprehensive procedure for verifying the identity of every client.
- Keep the lender informed when acting for the lender.
- Question unusual directions and instructions.
- Obtain title insurance.

- Safeguard Personal Security Packages (PSPs) used to access the e-reg™ system in accordance with the *Rules* and the terms of the Teraview licence.
- Implement procedures within the law firm to ensure that lawyers and staff do not share their PSPs.
- Implement appropriate internal controls within the law firm for handling and documenting all types of financial transactions.

A more detailed discussion of these practice tips and other useful information on real estate fraud is contained in the June 2004 issue of the LawPRO magazine "*The Many Faces of Fraud*," which may be found at www.lawpro.ca.

LawPRO also maintains an active blog at *avoidaclaim.com*. Check it periodically to keep up to date on real estate fraud.

LET RIGHT PREVAIL

The Law Society of Upper Canada | Barreau du Haut-Canada

Rules of Professional Conduct

~Effective November 1, 2000~

Adopted by Convocation June 22, 2000
Amendments Current to September 22, 2011

Table of Contents

Rule 1 Citation and Interpretation

1.01 CITATION

1.01 These rules may be cited as the *Rules of Professional Conduct.*

1.02 DEFINITIONS

1.02 In these rules, unless the context requires otherwise,

"affiliated entity" means any person or group of persons other than a person or group authorized to practice law in or outside Ontario;

[New – May 2001]

"affiliation" means the joining on a regular basis of a lawyer or group of lawyers with an affiliated entity in the delivery or promotion and delivery of the legal services of the lawyer or group of lawyers and the non-legal services of the affiliated entity;

[New – May 2001]

"associate" includes:

(a) a licensee who is an employee of the law firm in which the licensee practices law or provides legal services; and

(b) a non-licensee employee of a multi-discipline practice providing services that support or supplement the practice of law in which the non-licensee provides his or her services.

[Amended – September 2010]

"client" includes a client of the law firm of which the lawyer is a partner or associate, whether or not the lawyer handles the client's work;

> Commentary
>
> A solicitor and client relationship is often established without formality. For example, an express retainer or remuneration is not required for a solicitor and client relationship to arise. Also, in some circumstances, a lawyer may have legal and ethical responsibilities similar to those arising from a solicitor and client relationship. For example, a lawyer may meet with a prospective client in circumstances that impart confidentiality, and, although no solicitor and client relationship is ever actually established, the lawyer may have a disqualifying conflict of interest if he or she were later to act against the prospective client. It is, therefore, in a lawyer's own interest to carefully manage the establishment of a solicitor and client relationship.

"conduct unbecoming a barrister or solicitor" means conduct, including conduct in a lawyer's personal or private capacity, that tends to bring discredit upon the legal profession including, for example,

(a) committing a criminal act that reflects adversely on the lawyer's honesty, trustworthiness, or fitness as a lawyer,

(b) taking improper advantage of the youth, inexperience, lack of education, unsophistication, ill health, or unbusinesslike habits of another, or

(c) engaging in conduct involving dishonesty or conduct which undermines the administration of justice;

[Amended – May 2008]

Commentary

Dishonourable or questionable conduct on the part of a lawyer in either private life or professional practice will reflect adversely upon the integrity of the profession and the administration of justice. If the conduct, whether within or outside the professional sphere, is such that knowledge of it would be likely to impair the client's trust in the lawyer, the Society may be justified in taking disciplinary action.

Generally, however, the Society will not be concerned with the purely private or extra-professional activities of a lawyer that do not bring into question the lawyer's professional integrity.

"consent" means

(a) a consent in writing, provided that where more than one person consents, each may sign a separate document recording his or her consent, or

(b) an oral consent, provided that each person giving the oral consent receives a separate letter recording his or her consent;

"independent legal advice" means a retainer where

(a) the retained lawyer, who may be a lawyer employed as in-house counsel for the client, has no conflicting interest with respect to the client's transaction,

(b) the client's transaction involves doing business with

(i) another lawyer,

(ii) a corporation or other entity in which the other lawyer has an interest other than a corporation or other entity whose securities are publicly traded, or

(iii) a client of the other lawyer,

(c) the retained lawyer has advised the client that the client has the right to independent legal representation,

(d) the client has expressly waived the right to independent legal representation and has elected to receive no legal representation or legal representation from the other lawyer,

(e) the retained lawyer has explained the legal aspects of the transaction to the client, who appeared to understand the advice given, and

(f) the retained lawyer informed the client of the availability of qualified advisers in other fields who would be in a position to give an opinion to the client as to the desirability or otherwise of the proposed investment from a business point of view;

"independent legal representation" means a retainer where

(a) the retained lawyer, who may be a lawyer employed as in-house counsel for the client, has no conflicting interest with respect to the client's transaction, and

(b) the retained lawyer will act as the client's lawyer in relation to the matter;

> Commentary
>
> Where a client elects to waive independent legal representation but to rely on independent legal advice only, the retained lawyer has a responsibility that should not be lightly assumed or perfunctorily discharged.

"interprovincial law firm" means a law firm that carries on the practice of law in more than one province or territory of Canada;

"law firm" includes one or more lawyers practising

(a) in a sole proprietorship,

(b) in a partnership,

(c) as a clinic under the Legal Aid Services Act 1998,

(d) in a government, a Crown corporation, or any other public body, or

(e) in a corporation or other body;

"lawyer" means a person licensed by the Society to practise law as a barrister and solicitor in Ontario and includes a candidate enrolled in the Society's Licensing Process for lawyers;

"legal practitioner" means a person

(a) who is a licensee; or

(b) who is not a licensee but who is a member of the bar of a Canadian jurisdiction, other than Ontario, and who is authorized to practise law as a barrister and solicitor in that other jurisdiction;

[New – June 2009]

"licensee" means a lawyer or a paralegal;

"limited scope retainer" means the provision of legal services by a lawyer for part, but not all, of a client's legal matter by agreement between the lawyer and the client;

[New – September 2011]

"paralegal" means a person licensed by the Society to provide legal services in Ontario;

"professional misconduct" means conduct in a lawyer's professional capacity that tends to bring discredit upon the legal profession including

(a) violating or attempting to violate one of the rules in the *Rules of Professional Conduct* or a requirement of the *Law Society Act* or its regulations or by-laws,

(b) knowingly assisting or inducing another legal practitioner to violate or attempt to violate the rules in the *Rules of Professional Conduct*, the *Paralegal Rules of Conduct* or a requirement of the *Law Society Act* or its regulations or by-laws,

(c) knowingly assisting or inducing a non-licensee partner or associate of a multi-discipline practice to violate or attempt to violate the rules in the *Rules of Professional Conduct* or a requirement of the *Law Society Act* or its regulations or by-laws,

(d) misappropriating or otherwise dealing dishonestly with a client's or a third party's money or property,

(e) engaging in conduct that is prejudicial to the administration of justice,

(f) stating or implying an ability to influence improperly a government agency or official, or

(g) knowingly assisting a judge or judicial officer in conduct that is a violation of applicable rules of judicial conduct or other law;

[Amended – June 2009]

"Society" means The Law Society of Upper Canada;

"tribunal" includes courts, boards, arbitrators, mediators, administrative agencies, and bodies that resolve disputes, regardless of their function or the informality of their procedures.

1.03 INTERPRETATION

Standards of the Legal Profession

1.03 (1) These rules shall be interpreted in a way that recognizes that

(a) a lawyer has a duty to carry on the practice of law and discharge all responsibilities to clients, tribunals, the public, and other legal practitioners honourably and with integrity,

(b) a lawyer has special responsibilities by virtue of the privileges afforded the legal profession and the important role it plays in a free and democratic society and in the administration of justice, including a special responsibility to recognize the diversity of the Ontario community, to protect the dignity of individuals, and to respect human rights laws in force in Ontario,

[Amended – June 2009]

Commentary

A lawyer should, where appropriate, advise a client of the client's French language rights relating to the client's matter, including where applicable

(a) subsection 19 (1) of the *Constitution Act*, 1982 on the use of French or English in any court established by Parliament,

(b) section 530 of the *Criminal Code* about an accused's right to a trial before a court that speaks the official language of Canada that is the language of the accused,

(c) section 126 of the *Courts of Justice Act* that requires that a proceeding in which the client is a party be conducted as a bilingual (English and French) proceeding, and

(d) subsection 5(1) of the *French Language Services Act* for services in French from Ontario government agencies and legislative institutions.

[New – June 2001]

(c) a lawyer has a duty to uphold the standards and reputation of the legal profession and to assist in the advancement of its goals, organizations, and institutions,

(d) the rules are intended to express to the profession and to the public the high ethical ideals of the legal profession,

(e) the rules are intended to specify the bases on which lawyers may be disciplined, and

(f) rules of professional conduct cannot address every situation, and a lawyer should observe the rules in the spirit as well as in the letter.

General Principles

(2) In these rules, words importing the singular number include more than one person, party, or thing of the same kind and a word interpreted in the singular number has a corresponding meaning when used in the plural.

Rule 2 Relationship to Clients

2.01 COMPETENCE

Definitions

2.01 (1) In this rule

"competent lawyer" means a lawyer who has and applies relevant skills, attributes, and values in a manner appropriate to each matter undertaken on behalf of a client including

(a) knowing general legal principles and procedures and the substantive law and procedure for the areas of law in which the lawyer practises,

[Amended – June 2007]

(b) investigating facts, identifying issues, ascertaining client objectives, considering possible options, and developing and advising the client on appropriate courses of action,

(c) implementing, as each matter requires, the chosen course of action through the application of appropriate skills, including,

(i) legal research,

(ii) analysis,

(iii) application of the law to the relevant facts,

(iv) writing and drafting,

(v) negotiation,

(vi) alternative dispute resolution,

(vii) advocacy, and

(viii) problem-solving ability,

(d) communicating at all stages of a matter in a timely and effective manner that is appropriate to the age and abilities of the client,

(e) performing all functions conscientiously, diligently, and in a timely and cost-effective manner,

(f) applying intellectual capacity, judgment, and deliberation to all functions,

(g) complying in letter and in spirit with the Rules of Professional Conduct,

(h) recognizing limitations in one's ability to handle a matter or some aspect of it, and taking steps accordingly to ensure the client is appropriately served,

(i) managing one's practice effectively,

(j) pursuing appropriate professional development to maintain and enhance legal knowledge and skills, and

(k) adapting to changing professional requirements, standards, techniques, and practices.

Commentary

As a member of the legal profession, a lawyer is held out as knowledgeable, skilled, and capable in the practice of law. Accordingly, the client is entitled to assume that the lawyer has the ability and capacity to deal adequately with legal matters to be undertaken on the client's behalf.

A lawyer who is incompetent does the client a disservice, brings discredit to the profession, and may bring the administration of justice into disrepute. In addition to damaging the lawyer's own reputation and practice, incompetence may also injure the lawyer's partners and associates.

A lawyer should not undertake a matter without honestly feeling competent to handle it or being able to become competent without undue delay, risk, or expense to the client. This is an ethical consideration and is to be distinguished from the standard of care that a tribunal would invoke for purposes of determining negligence.

A lawyer must be alert to recognize any lack of competence for a particular task and the disservice that would be done to the client by undertaking that task. If consulted in such circumstances, the lawyer should either decline to act or obtain the client's instructions to retain, consult, or collaborate with a lawyer who is competent for that task. The lawyer may also recognize that competence for a particular task may require seeking advice from or collaborating with experts in scientific, accounting, or other non-legal fields, and, in such a situation, the lawyer should not hesitate to seek the client's instructions to consult experts.

A lawyer should clearly specify the facts, circumstances, and assumptions upon which an opinion is based. Unless the client instructs otherwise, the lawyer should investigate the matter in sufficient detail to be able to express an opinion rather than mere comments with many qualifications. If the circumstances do not justify an exhaustive investigation with consequent expense to the client, the lawyer should so state in the opinion.

When a lawyer considers whether to provide legal services under a limited scope retainer, he or she must carefully assess in each case whether, under the circumstances, it is possible to render those services in a competent manner. An agreement to provide such services does not exempt a lawyer from the duty to provide competent representation. As in any retainer, the lawyer should consider the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation. The lawyer should ensure that the client is fully informed of the nature of the arrangement and clearly understands the scope and limitation of the services. See also subrule 2.02(6.1) to 6.3).

[Amended – September 2011]

A lawyer should be wary of bold and confident assurances to the client, especially when the lawyer's employment may depend upon advising in a particular way.

In addition to opinions on legal questions, the lawyer may be asked for or may be expected to give advice on non-legal matters such as the business, policy, or social implications involved in the question or the course the client should choose. In many instances the lawyer's experience will be such that the lawyer's views on non-legal matters will be of real benefit to the client. The lawyer who expresses views on such matters should, where and to the extent necessary, point out any lack of experience or other qualification in the particular field and should clearly distinguish legal advice from other advice.

In a multi-discipline practice, a lawyer must be particularly alert to ensure that the client understands that he or she is receiving legal advice from a lawyer supplemented by the services of a non-licensee. If other advice or service is sought from non-licensee members of the firm, it must be sought and provided independently of and outside the scope of the retainer for the provision of legal services and will be subject to the constraints outlined in the relevant by-laws and regulations governing multi-discipline practices. In particular, the lawyer should ensure that such advice or service of non-licensees is provided from a location separate from the premises of the multi-discipline practice.

Whenever it becomes apparent that the client has misunderstood or misconceived the position or what is really involved, the lawyer should explain, as well as advise, so that the client is apprised of the true position and fairly advised about the real issues or questions involved.

The requirement of conscientious, diligent, and efficient service means that a lawyer should make every effort to provide service to the client. If the lawyer can reasonably foresee undue delay in providing advice or services, the client should be so informed.

[Amended - June 2009]

Competence

(2) A lawyer shall perform any legal services undertaken on a client's behalf to the standard of a competent lawyer.

Commentary

This rule does not require a standard of perfection. An error or omission, even though it might be actionable for damages in negligence or contract, will not necessarily constitute a failure to maintain the standard of professional competence described by the rule.

Incompetent professional practice may give rise to disciplinary action under this rule.

In addition to this rule, the *Law Society Act* provides that the Society may conduct a review of a lawyer's practice to determine if the lawyer is meeting standards of professional competence. A review will be conducted in circumstances defined in the by-laws under the *Law Society Act.*

A lawyer may also be subject to a hearing at which it will be determined whether the lawyer is failing or has failed to meet standards of professional competence.

The Act provides that a lawyer fails to meet standards of professional competence if there are deficiencies in (a) the lawyer's knowledge, skill, or judgment, (b) the lawyer's attention to the interests of clients, (c) the records, systems, or procedures of the lawyer's professional business, or (d) other aspects of the lawyer's professional business, and the deficiencies give rise to a reasonable apprehension that the quality of service to clients may be adversely affected.

2.02 QUALITY OF SERVICE

Honesty and Candour

2.02 (1) When advising clients, a lawyer shall be honest and candid.

Commentary

The lawyer's duty to the client who seeks legal advice is to give the client a competent opinion based on a sufficient knowledge of the relevant facts, an adequate consideration of the applicable law, and the lawyer's own experience and expertise.

The advice must be open and undisguised and must clearly disclose what the lawyer honestly thinks about the merits and probable results.

When Client an Organization

(1.1) Notwithstanding that the instructions may be received from an officer, employee, agent, or representative, when a lawyer is employed or retained by an organization, including a corporation, in exercising his or her duties and in providing professional services, the lawyer shall act for the organization.

Commentary

A lawyer acting for an organization should keep in mind that the organization, as such, is the client and that a corporate client has a legal personality distinct from its shareholders, officers, directors, and employees. While the organization or corporation will act and give instructions through its officers, directors, employees, members, agents, or representatives, the lawyer should ensure that it is the interests of the organization that are to be served and protected. Further, given that an organization depends upon persons to give instructions, the lawyer should ensure that the person giving instructions for the organization is acting within that person's actual or ostensible authority.

In addition to acting for the organization, the lawyer may also accept a joint retainer and act for a person associated with the organization. An example might be a lawyer advising about liability insurance for an officer of an organization. In such cases the lawyer acting for an organization should be alert to the prospects of conflicts of interest and should comply with the rules about the avoidance of conflicts of interest (rule 2.04).

[New – March 2004]

Encouraging Compromise or Settlement

(2) A lawyer shall advise and encourage the client to compromise or settle a dispute whenever it is possible to do so on a reasonable basis and shall discourage the client from commencing useless legal proceedings.

(3) The lawyer shall consider the use of alternative dispute resolution (ADR) for every dispute, and, if appropriate, the lawyer shall inform the client of ADR options and, if so instructed, take steps to pursue those options.

Threatening Criminal Proceedings

(4) A lawyer shall not advise, threaten, or bring a criminal or quasi-criminal prosecution in order to secure a civil advantage for the client.

Dishonesty, Fraud etc. by Client

(5) When acting for a client, a lawyer shall not

(a) knowingly assist in or encourage any dishonesty, fraud, crime, or illegal conduct;

(b) advise the client on how to violate the law and avoid punishment.

(5.0.1) When retained by a client, a lawyer shall make reasonable efforts to ascertain the purpose and objectives of the retainer and to obtain information about the client necessary to fulfill this obligation.

(5.0.2) A lawyer shall not use his or her trust account for purposes not related to the provision of legal services.

[Amended – April 2011]

Commentary

A lawyer should be on guard against becoming the tool or dupe of an unscrupulous client or persons associated with such a client. A lawyer should be alert to and avoid unwittingly becoming involved with a client engaged in criminal activity such as mortgage fraud or money laundering. Vigilance is required because the means for these and other criminal activities may be transactions for which lawyers commonly provide services such as: establishing, purchasing or selling business entities; arranging financing for the purchase or sale or operation of business entities; arranging financing for the purchase or sale of business assets; and purchasing and selling real estate. The requirement in subrule (5.0.1) is especially important where a lawyer has suspicions or doubts about whether he or she might be assisting a client in crime or fraud.

To obtain information about the client and about the subject matter and objectives of the retainer, the lawyer may, for example, need to verify who are the legal or beneficial owners of property and business entities, verify who has the control of business entities, and clarify the nature and purpose of a complex or unusual transaction where the purpose is not clear. The lawyer should make a record of the results of these inquiries.

A client or another person may attempt to use a lawyer's trust account for improper purposes, such as hiding funds, money laundering or tax sheltering. These situations highlight the fact that when handling trust funds, it is important for a lawyer to be aware of his or her obligations under these subrules and the Law Society's By-laws that regulate the handling of trust funds.

A *bona fide* test case is not necessarily precluded by subrule 2.02(5) and, so long as no injury to the person or violence is involved, a lawyer may properly advise and represent a client who, in good faith and on reasonable grounds, desires to challenge or test a law and the test can most effectively be made by means of a technical breach giving rise to a test case.

[Amended – April 2011]

Dishonesty, Fraud, etc. when Client an Organization

(5.1) When a lawyer is employed or retained by an organization to act in a matter and the lawyer knows that the organization intends to act dishonestly, fraudulently, criminally, or illegally with respect to that matter, then in addition to his or her obligations under subrule (5), the lawyer for the organization shall

(a) advise the person from whom the lawyer takes instructions that the proposed conduct would be dishonest, fraudulent, criminal, or illegal,

(b) if necessary because the person from whom the lawyer takes instructions refuses to cause the proposed wrongful conduct to be abandoned, advise the organization's chief legal officer, or both the chief legal officer and the chief executive officer, that the proposed conduct would be dishonest, fraudulent, criminal or illegal,

(c) if necessary because the chief legal officer or the chief executive officer of the organization refuses to cause the proposed conduct to be abandoned, advise progressively the next highest persons or groups, including ultimately, the board of directors, the board of trustees, or the appropriate committee of the board, that the proposed conduct would be dishonest, fraudulent, criminal, or illegal, and

(d) if the organization, despite the lawyer's advice, intends to pursue the proposed course of conduct, withdraw from acting in the matter in accordance with rule 2.09.

(5.2) When a lawyer is employed or retained by an organization to act in a matter and the lawyer knows that the organization has acted or is acting dishonestly, fraudulently, criminally, or illegally with respect to that matter, then in addition to his or her obligations under subrule (5), the lawyer for the organization shall

(a) advise the person from whom the lawyer takes instructions and the chief legal officer, or both the chief legal officer and the chief executive officer, that the conduct was or is dishonest, fraudulent, criminal, or illegal and should be stopped,

(b) if necessary because the person from whom the lawyer takes instructions, the chief legal officer, or the chief executive officer refuses to cause the wrongful conduct to be stopped, advise progressively the next highest persons or groups, including ultimately, the board of directors, the board of trustees, or the appropriate committee of the board, that the conduct was or is dishonest, fraudulent, criminal, or illegal and should be stopped, and

(c) if the organization, despite the lawyer's advice, continues with the wrongful conduct, withdraw from acting in the matter in accordance with rule 2.09.

Commentary

The past, present, or proposed misconduct of an organization may have harmful and serious consequences not only for the organization and its constituency but also for the public, who rely on organizations to provide a variety of goods and services. In particular, the misconduct of publicly traded commercial and financial corporations may have serious consequences to the public at large. Rules 2.02 (5.1) and (5.2) address some of the professional responsibilities of a lawyer acting for an organization, which includes a corporation, when he or she learns that the organization has acted, is acting, or proposes to act in a way that is dishonest, fraudulent, criminal or illegal. In addition to these rules, the lawyer may need to consider, for example, the rules and commentary about confidentiality (rule 2.03).

Rules 2.02 (5.1) and (5.2) speak of conduct that is dishonest, fraudulent, criminal or illegal, and this conduct would include acts of omission as well as acts of commission. Indeed, often it is the omissions of an organization, for example, to make required disclosure or to correct inaccurate disclosures that would constitute the wrongful conduct to which these rules relate. Conduct likely to result in substantial harm to the organization, as opposed to genuinely trivial misconduct by an organization, would invoke these rules.

Once a lawyer acting for an organization learns that the organization has acted, is acting, or intends to act in a wrongful manner, then the lawyer may advise the chief executive officer and shall advise the chief legal officer of the misconduct. If the wrongful conduct is not abandoned or stopped, then the lawyer reports the matter "up the ladder" of responsibility within the organization until the matter is dealt with appropriately. If the organization, despite the lawyer's advice, continues with the wrongful conduct, then the lawyer shall withdraw from acting in the particular matter in accordance with rule 2.09. In some but not all cases, withdrawal would mean resigning from his or her position or relationship with the organization and not simply withdrawing from acting in the particular matter.

These rules recognize that lawyers as the legal advisers to organizations are in a central position to encourage organizations to comply with the law and to advise that it is in the organizations' and the public's interest that organizations do not violate the law. Lawyers acting for organizations are often in a position to advise the executive officers of the organization not only about the technicalities of the law but about the public relations and public policy concerns that motivated the government or regulator to enact the law. Moreover, lawyers for organizations, particularly in-house counsel, may guide organizations to act in ways that are legal, ethical, reputable, and consistent with the organization's responsibilities to its constituents and to the public.

[New – March 2004]

Client Under a Disability

(6) When a client's ability to make decisions is impaired because of minority, mental disability, or for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal lawyer and client relationship.

Commentary

A lawyer and client relationship presupposes that the client has the requisite mental ability to make decisions about his or her legal affairs and to give the lawyer instructions. A client's ability to make decisions, however, depends on such factors as his or her age, intelligence, experience, and mental and physical health, and on the advice, guidance, and support of others. Further, a client's ability to make decisions may change, for better or worse, over time. When a client is or comes to be under a disability that impairs his or her ability to make decisions, the impairment may be minor or it might prevent the client from having the legal capacity to give instructions or to enter into binding legal relationships. Recognizing these factors, the purpose of this rule is to direct a lawyer with a client under a disability to maintain, as far as reasonably possible, a normal lawyer and client relationship.

A lawyer with a client under a disability should appreciate that if the disability of the client is such that the client no longer has the legal capacity to manage his or her legal affairs, the lawyer may need to take steps to have a lawfully authorized representative appointed, for example, a litigation guardian, or to obtain the assistance of the Office of the Public Guardian and Trustee or the Office of the Children's Lawyer to protect the interests of the client. In any event, the lawyer has an ethical obligation to ensure that the client's interests are not abandoned.

A lawyer who is asked to provide legal services under a limited scope retainer to a client under a disability should carefully consider and assess in each case how, under the circumstances, it is possible to render those services in a competent manner.

[Amended – September 2011]

Legal Services Under a Limited Scope Retainer

2.02 (6.1) Before providing legal services under a limited scope retainer, a lawyer shall

advise the client honestly and candidly about the nature, extent and scope of the services that the lawyer can provide, and, where appropriate, whether the services can be provided within the financial means of the client.

[New - September 2011]

(6.2) When providing legal services under a limited scope retainer, a lawyer shall confirm the services in writing and give the client a copy of the written document when practicable to do so.

[New - September 2011]

Commentary

Reducing to writing the discussions and agreement with the client about the limited scope retainer assists the lawyer and client in understanding the limitations of the service to be provided and any risks of the retainer. In certain circumstances, such as when the client is in custody, it may not be possible to give him or her a copy of the document. In this type of situation, the lawyer should keep a record of the limited scope retainer in the client file and, when practicable, provide a copy of the document to the client. A lawyer who is providing legal services under a limited scope retainer should be careful to avoid acting such that it appears that the lawyer is providing services to the client under a full retainer.

A lawyer who is providing legal services under a limited scope retainer should consider how communications from opposing counsel in a matter should be managed. See rule 6.03(7.1)

[New - September 2011]

(6.3) Subrule (6.2) does not apply to a lawyer if the legal services are

(a) legal services or summary advice provided as a duty counsel under the *Legal Aid Services Act, 1998* or through any other duty counsel or other advisory program operated by a not-for-profit organization;

(b) summary advice provided in community legal clinics, student clinics or under the *Legal Aid Services Act, 1998*;

(c) summary advice provided through a telephone-based service or telephone hotline operated by a community-based or government funded program;

(d) summary advice provided by the lawyer to a client in the context of an introductory consultation, where the intention is that the consultation, if the client so chooses, would develop into a retainer for legal services for all aspects of the legal matter; or

(e) *pro bono* summary legal services provided in a non-profit or court-annexed program.

[New - September 2011]

Commentary

The consultation referred to in subrule (6.3)(d) may include advice on preventative, protective, pro-active or procedural measures relating to the client's legal matter, after which the client may agree to retain the lawyer.

[New - September 2011]

Medical-Legal Reports

(7) A lawyer who receives a medical-legal report from a physician or health professional that is accompanied by a proviso that it not be shown to the client shall return the report immediately to the physician or health professional unless the lawyer has received specific instructions to accept the report on this basis.

Commentary

The lawyer can avoid some of the problems anticipated by the rule by having a full and frank discussion with the physician or health professional, preferably in advance of the preparation of a medical-legal report, which discussion will serve to inform the physician or health professional of the lawyer's obligation respecting disclosure of medical-legal reports to the client.

(8) A lawyer who receives a medical-legal report from a physician or health professional containing opinions or findings that if disclosed might cause harm or injury to the client shall attempt to dissuade the client from seeing the report, but if the client insists, the lawyer shall produce the report.

(9) Where a client insists on seeing a medical-legal report about which the lawyer has reservations for the reasons noted in subrule (8), the lawyer shall suggest that the client attend at the office of the physician or health professional to see the report in order that the client will have the benefit of the expertise of the physician or health professional in understanding the significance of the conclusion contained in the medical-legal report.

Title Insurance in Real Estate Conveyancing

(10) A lawyer shall assess all reasonable options to assure title when advising a client about a real estate conveyance and shall advise the client that title insurance is not mandatory and is not the only option available to protect the client's interests in a real estate transaction.

Commentary

A lawyer should advise the client of the options available to protect the client's interests and minimize the client's risks in a real estate transaction. The lawyer should be cognizant of when title insurance may be an appropriate option. Although title insurance is intended to protect the client against title risks, it is not a substitute for a lawyer's services in a real estate transaction.

> The lawyer should be knowledgeable about title insurance and discuss with the client the advantages, conditions, and limitations of the various options and coverages generally available to the client through title insurance. Before recommending a specific title insurance product, the lawyer should be knowledgeable about the product and take such training as may be necessary in order to acquire the knowledge.

(11) A lawyer shall not receive any compensation, whether directly or indirectly, from a title insurer, agent or intermediary for recommending a specific title insurance product to his or her client.

(12) A lawyer shall disclose to the client that no commission or fee is being furnished by any insurer, agent, or intermediary to the lawyer with respect to any title insurance coverage.

> Commentary
>
> The fiduciary relationship between lawyer and client requires full disclosure in all financial dealings between them and prohibits the acceptance of any hidden fees by the lawyer, including the lawyer's law firm, any employee or associate of the firm, or any related entity.

(13) If discussing TitlePLUS insurance with the client, a lawyer shall fully disclose the relationship between the legal profession, the Society, and the Lawyers' Professional Indemnity Company (LawPRO).

Reporting on Mortgage Transactions

(14) Where a lawyer acts for a lender and the loan is secured by a mortgage on real property, the lawyer shall provide a final report on the transaction, together with the duplicate registered mortgage, to the lender within 60 days of the registration of the mortgage, or within such other time period as instructed by the lender.

(15) The final report required by subrule (14) must be delivered within the times set out in that subrule even if the lawyer has paid funds to satisfy one or more prior encumbrances to ensure the priority of the mortgage as instructed and the lawyer has obtained an undertaking to register a discharge of the encumbrance or encumbrances but the discharge remains unregistered.

[New - February 2007]

2.03 CONFIDENTIALITY

Confidential Information

2.03 (1) A lawyer at all times shall hold in strict confidence all information concerning the business and affairs of the client acquired in the course of the professional relationship and shall not divulge any such information unless expressly or impliedly authorized by the client or required by law to do so.

Commentary

A lawyer cannot render effective professional service to the client unless there is full and unreserved communication between them. At the same time, the client must feel completely secure and entitled to proceed on the basis that, without any express request or stipulation on the client's part, matters disclosed to or discussed with the lawyer will be held in strict confidence.

This rule must be distinguished from the evidentiary rule of lawyer and client privilege concerning oral or documentary communications passing between the client and the lawyer. The ethical rule is wider and applies without regard to the nature or source of the information or the fact that others may share the knowledge.

A lawyer owes the duty of confidentiality to every client without exception and whether or not the client is a continuing or casual client. The duty survives the professional relationship and continues indefinitely after the lawyer has ceased to act for the client, whether or not differences have arisen between them.

Generally, the lawyer should not disclose having been consulted or retained by a particular person about a particular matter unless the nature of the matter requires such disclosure.

A lawyer should take care to avoid disclosure to one client of confidential information concerning or received from another client and should decline employment that might require such disclosure.

A lawyer should avoid indiscreet conversations, even with the lawyer's spouse or family, about a client's affairs and should shun any gossip about such things even though the client is not named or otherwise identified. Similarly, a lawyer should not repeat any gossip or information about the client's business or affairs that is overheard or recounted to the lawyer. Apart altogether from ethical considerations or questions of good taste, indiscreet shop-talk between lawyers, if overheard by third parties able to identify the matter being discussed, could result in prejudice to the client. Moreover, the respect of the listener for lawyers and the legal profession will probably be lessened.

Although the rule may not apply to facts that are public knowledge, nevertheless, the lawyer should guard against participating in or commenting on speculation concerning the client's affairs or business.

In some situations, the authority of the client to disclose may be implied. For example, some disclosure may be necessary in court proceedings, in a pleading or other court document. Also, it is implied that a lawyer may, unless the client directs otherwise, disclose the client's affairs to partners and associates in the law firm and, to the extent necessary, to non-legal staff, such as secretaries and filing clerks. But this implied authority to disclose places the lawyer under a duty to impress upon associates, employees, and students the importance of non-disclosure (both during their employment and afterwards) and requires the lawyer to take reasonable care to prevent their disclosing or using any information that the lawyer is bound to keep in confidence.

A lawyer may have an obligation to disclose information under subrule 4.06(3)(Security of Court Facilities). If client information is involved in those situations, the lawyer should be guided by the provisions of rule 2.03.

The rule prohibits disclosure of confidential information because confidentiality and loyalty are fundamental to the relationship between a lawyer and client and legal advice cannot be given and justice cannot be done unless clients have a large measure of freedom to discuss their affairs with their lawyers. However, there are some very exceptional situations identified in the following subrules where disclosure without the client's permission might be warranted because the lawyer is satisfied that truly serious harm of the types identified is imminent and cannot otherwise be prevented. These situations will be extremely rare, and, even in these situations, the lawyer should not disclose more information than is required.

Justified or Permitted Disclosure

(2) When required by law or by order of a tribunal of competent jurisdiction, a lawyer shall disclose confidential information, but the lawyer shall not disclose more information than is required.

(3) Where a lawyer believes upon reasonable grounds that there is an imminent risk to an identifiable person or group of death or serious bodily harm, including serious psychological harm that substantially interferes with health or well-being, the lawyer may disclose, pursuant to judicial order where practicable, confidential information where it is necessary to do so in order to prevent the death or harm, but shall not disclose more information than is required.

Commentary

A lawyer employed or retained to act for an organization, including a corporation, confronts a difficult problem about confidentiality when he or she becomes aware that the organization may commit a dishonest, fraudulent, criminal, or illegal act. This problem is sometimes described as the problem of whether the lawyer should "blow the whistle" on his or her employer or client. Although the *Rules of Professional Conduct* make it clear that the lawyer shall not knowingly assist or encourage any dishonesty, fraud, crime, or illegal conduct (rule 2.02 (5)) and provide a rule for how a lawyer should respond to conduct by an organization that was, is or may be dishonest, fraudulent, criminal, or illegal (rules 2.02 (5.1) and (5.2), it does not follow that the lawyer should disclose to the appropriate authorities an employer's or client's proposed misconduct. Rather, the general rule, as set out above, is that the lawyer shall hold the client's information in strict confidence, and this general rule is subject to only a few exceptions. Assuming the exceptions do not apply, there are, however, several steps that a lawyer should take when confronted with the difficult problem of proposed misconduct by an organization. The lawyer should recognise that his or her duties are owed to the organization and not to the officers, employees, or agents of the organization (rule 2.02 (1.1)) and the lawyer should comply with subrules 2.02 (5.1) and (5.2), which set out the steps the lawyer should take in response to proposed, past or continuing misconduct by the organization.

[Amended – March 2004]

(4) Where it is alleged that a lawyer or the lawyer's associates or employees are

(a) guilty of a criminal offence involving a client's affairs,

(b) civilly liable with respect to a matter involving a client's affairs, or

(c) guilty of malpractice or misconduct,

a lawyer may disclose confidential information in order to defend against the allegations, but the lawyer shall not disclose more information than is required.

(5) A lawyer may disclose confidential information in order to establish or collect the lawyer's fees, but the lawyer shall not disclose more information than is required.

Literary Works

(6) If a lawyer engages in literary works, such as a memoir or an autobiography, the lawyer shall not disclose confidential information without the client's or former client's consent.

Commentary

The fiduciary relationship between lawyer and client forbids the lawyer from using any confidential information covered by the ethical rule for the benefit of the lawyer or a third person or to the disadvantage of the client.

2.04 AVOIDANCE OF CONFLICTS OF INTEREST

Definition

2.04 (1) In this rule

A "conflict of interest" or a "conflicting interest" means an interest

(a) that would be likely to affect adversely a lawyer's judgment on behalf of, or loyalty to, a client or prospective client, or

(b) that a lawyer might be prompted to prefer to the interests of a client or prospective client.

Commentary

Conflicting interests include, but are not limited to, the financial interest of a lawyer or an associate of a lawyer, including that which may exist where lawyers have a financial interest in a firm of non-lawyers in an affiliation, and the duties and loyalties of a lawyer to any other client, including the obligation to communicate information. For example, there could be a conflict of interest if a lawyer, or a family member, or a law partner had a personal financial interest in the client's affairs or in the matter in which the lawyer is requested to act for the client, such as a partnership interest in some joint business venture with the client. The definition of conflict of interest, however, does not capture financial interests that do not compromise a lawyer's duties to the client. For example, a lawyer owning a small number of shares of a publicly traded corporation would not necessarily have a conflict of interest, because the holding may have no adverse influence on the lawyer's judgment or loyalty to the client.

Where a lawyer is acting for a friend or family member, the lawyer may have a conflict of interest because the personal relationship may interfere with the lawyer's duty to provide objective, disinterested professional advice to the client.

[Amended - May 2001, March 2004, October 2004]

Avoidance of Conflicts of Interest

(2) A lawyer shall not advise or represent more than one side of a dispute.

(3) A lawyer shall not act or continue to act in a matter when there is or is likely to be a conflicting interest unless, after disclosure adequate to make an informed decision, the client or prospective client consents.

Commentary

A client or the client's affairs may be seriously prejudiced unless the lawyer's judgment and freedom of action on the client's behalf are as free as possible from conflict of interest.

A lawyer should examine whether a conflict of interest exists not only from the outset but throughout the duration of a retainer because new circumstances or information may establish or reveal a conflict of interest.

As important as it is to the client that the lawyer's judgment and freedom of action on the client's behalf should not be subject to other interests, duties, or obligations, in practice this factor may not always be decisive. Instead, it may be only one of several factors that the client will weigh when deciding whether or not to give the consent referred to in the rule. Other factors might include, for example, the availability of another lawyer of comparable expertise and experience, the extra cost, delay and inconvenience involved in engaging another lawyer, and the latter's unfamiliarity with the client and the client's affairs. In some instances, each client's case may gather strength from joint representation. In the result, the client's interests may sometimes be better served by not engaging another lawyer, for example, when the client and another party to a commercial transaction are continuing clients of the same law firm but are regularly represented by different lawyers in that firm.

A conflict of interest may arise when a lawyer acts not only as a legal advisor but in another role for the client. For example, there is a dual role when a lawyer or his or her law firm acts for a public or private corporation and the lawyer serves as a director of the corporation. Lawyers may also serve these dual roles for partnerships, trusts, and other organizations. A dual role may raise a conflict of interest because it may affect the lawyer's independent judgment and fiduciary obligations in either or both roles, it may obscure legal advice from business and practical advice, it may invalidate the protection of lawyer and client privilege, and it has the potential of disqualifying the lawyer or the law firm from acting for the organization. Before accepting a dual role, a lawyer should consider these factors and discuss them with the client. The lawyer should also consider rule 6.04 (Outside Interests and Practice of Law).

If a lawyer has a sexual or intimate personal relationship with a client, this may conflict with the lawyer's duty to provide objective, disinterested professional advice to the client. Before accepting a retainer from or continuing a retainer with a person with whom the lawyer has such a relationship, a lawyer should consider the following factors:

a. The vulnerability of the client, both emotional and economic;

b. The fact that the lawyer and client relationship may create a power imbalance in favour of the lawyer or, in some circumstances, in favour of the client;

c. Whether the sexual or intimate personal relationship will jeopardize the client's right to have all information concerning the client's business and affairs held in strict confidence. For example, the existence of the relationship may obscure whether certain information was acquired in the course of the lawyer and client relationship;

d. Whether such a relationship may require the lawyer to act as a witness in the proceedings;

e. Whether such a relationship will interfere in any way with the lawyer's fiduciary obligations to the client, his or her ability to exercise independent professional judgment, or his or her ability to fulfill obligations owed as an officer of the court and to the administration of justice.

There is no conflict of interest if another lawyer of the firm who does not have a sexual or intimate personal relationship with the client is the lawyer handling the client's work.

While subrule 2.04(3) does not require that a lawyer advise the client to obtain independent legal advice about the conflicting interest, in some cases, especially those in which the client is not sophisticated or is vulnerable, the lawyer should recommend such advice to ensure that the client's consent is informed, genuine, and uncoerced.

[Amended – March 2004, October 2004]

Acting Against Client

(4) A lawyer who has acted for a client in a matter shall not thereafter act against the client or against persons who were involved in or associated with the client in that matter

(a) in the same matter,

(b) in any related matter, or

(c) save as provided by subrule (5), in any new matter, if the lawyer has obtained from the other retainer relevant confidential information unless the client and those involved in or associated with the client consent.

> Commentary
>
> It is not improper for the lawyer to act against a client in a fresh and independent matter wholly unrelated to any work the lawyer has previously done for that person and where previously obtained confidential information is irrelevant to that matter.

(5) Where a lawyer has acted for a former client and obtained confidential information relevant to a new matter, the lawyer's partner or associate may act in the new matter against the former client if

(a) the former client consents to the lawyer's partner or associate acting, or

(b) the law firm establishes that it is in the interests of justice that it act in the new matter, having regard to all relevant circumstances, including

(i) the adequacy and timing of the measures taken to ensure that no disclosure of the former client's confidential information to the partner or associate having carriage of the new matter will occur,

(ii) the extent of prejudice to any party,

(iii) the good faith of the parties,

(iv) the availability of suitable alternative counsel, and

(v) issues affecting the public interest.

> Commentary
>
> The term “client” is defined in rule 1.02 to include a client of the law firm of which the lawyer is a partner or associate, whether or not the lawyer handles the client's work. Therefore, if a member of a law firm has obtained from a former client confidential information that is relevant to a new matter, no member of the law firm may act against the former client in the new matter unless the requirements of subrule (5) have been satisfied. In its effect, subrule (5) extends with necessary modifications the rules and guidelines about conflicts arising from a lawyer transfer between law firms (rule 2.05) to the situation of a law firm acting against a former client.

Joint Retainer

(6) Except as provided in subrule (8.2), where a lawyer accepts employment from more than one client in a matter or transaction, the lawyer shall advise the clients that

(a) the lawyer has been asked to act for both or all of them,

(b) no information received in connection with the matter from one can be treated as confidential so far as any of the others are concerned, and

(c) if a conflict develops that cannot be resolved, the lawyer cannot continue to act for both or all of them and may have to withdraw completely.

[Amended – February 2007]

Commentary

Although this subrule does not require that, before accepting a joint retainer, a lawyer advise the client to obtain independent legal advice about the joint retainer, in some cases, especially those in which one of the clients is less sophisticated or more vulnerable than the other, the lawyer should recommend such advice to ensure that the client's consent to the joint retainer is informed, genuine, and uncoerced.

A lawyer who receives instructions from spouses or partners as defined in the *Substitute Decisions Act, 1992* S.O. 1992 c. 30 to prepare one or more wills for them based on their shared understanding of what is to be in each will should treat the matter as a joint retainer and comply with subrule (6). Further, at the outset of this joint retainer, the lawyer should advise the spouses or partners that if subsequently only one of them were to communicate new instructions, for example, instructions to change or revoke a will:

(a) the subsequent communication would be treated as a request for a new retainer and not as part of the joint retainer;

(b) in accordance with rule 2.03, the lawyer would be obliged to hold the subsequent communication in strict confidence and not disclose it to the other spouse or partner; but

(c) the lawyer would have a duty to decline the new retainer, unless;

(i) the spouses or partners had annulled their marriage, divorced, permanently ended their conjugal relationship, or permanently ended their close personal relationship, as the case may be;

(ii) the other spouse or partner had died; or

(iii) the other spouse or partner was informed of the subsequent communication and agreed to the lawyer acting on the new instructions.

After advising the spouses or partners in the manner described above, the lawyer should obtain their consent to act in accordance with subrule (8).

[Amended – February, 2005]

(6.1) Where a lawyer acts for both the borrower and the lender in a mortgage or loan transaction, the lawyer shall disclose to the borrower and the lender, in writing, before the advance or release of the mortgage or loan funds, all material information that is relevant to the transaction.

Commentary

What is material is to be determined objectively. Material information would be facts that would be perceived objectively as relevant by any reasonable lender or borrower. An example is a price escalation or "flip" where a property is re-transferred or re-sold on the same day or within a short time period for a significantly higher price. The duty to disclose arises even if the lender or the borrower does not ask for the specific information.

[New – February 2007]

(7) Except as provided in subrule (8.2), where a lawyer has a continuing relationship with a client for whom the lawyer acts regularly, before the lawyer accepts joint employment for that client and another client in a matter or transaction, the lawyer shall advise the other client of the continuing relationship and recommend that the client obtain independent legal advice about the joint retainer.

[Amended – February 2007]

Commentary

Although all the parties concerned may consent, a lawyer should avoid acting for more than one client when it is likely that an issue contentious between them will arise or their interests, rights, or obligations will diverge as the matter progresses.

(8) Except as provided in subrule (8.2), where a lawyer has advised the clients as provided under subrules (6) and (7) and the parties are content that the lawyer act, the lawyer shall obtain their consent.

[Amended – February 2007]

(8.1) In subrule (8.2), "lending client" means a client that is a bank, trust company, insurance company, credit union or finance company that lends money in the ordinary course of its business.

(8.2) If a lawyer is jointly retained by a client and by a lending client in respect of a mortgage or loan from the lending client to that client, including any guarantee of that mortgage or loan, the lending client's consent is deemed to exist upon the lawyer's receipt of written instructions from the lending client to act and the lawyer is not required to

(a) provide the advice described in subrule (6) to the lending client before accepting the employment,

(b) provide the advice described in subrule (7) if the lending client is the other client as described in that subrule, or

(c) obtain the consent of the lending client as described in subrule (8), including confirming the lending client's consent in writing, unless the lending client requires that its consent be reduced to writing.

Commentary

Subrules (8.1) and (8.2) are intended to simplify the advice and consent process between a lawyer and institutional lender clients. Such clients are generally sophisticated. Their acknowledgement of the terms of and consent to the joint retainer is usually confirmed in the documentation of the transaction (e.g. mortgage loan instructions) and the consent is generally deemed by such clients to exist when the lawyer is requested to act.

Subrule (8.2) applies to all loans where a lawyer is acting jointly for both the lending client and another client regardless of the purpose of the loan, including, without restriction, mortgage loans, business loans and personal loans. It also applies where there is a guarantee of such a loan.

[New – February 2007]

(9) Save as provided by subrule (10), where clients have consented to a joint retainer and an issue contentious between them or some of them arises, the lawyer shall

(a) not advise them on the contentious issue, and

(b) refer the clients to other lawyers, unless

(i) no legal advice is required, and

(ii) the clients are sophisticated,

in which case, the clients may settle the contentious issue by direct negotiation in which the lawyer does not participate.

Commentary

The rule does not prevent a lawyer from arbitrating or settling or attempting to arbitrate or settle, a dispute between two or more clients or former clients who are not under any legal disability and who wish to submit the dispute to the lawyer. Where, after the clients have consented to a joint retainer, an issue contentious between them or some of them arises, the lawyer is not necessarily precluded from advising them on non-contentious matters.

(10) Where clients consent to a joint retainer and also agree that if a contentious issue arises the lawyer may continue to advise one of them and a contentious issue does arise, the lawyer may advise the one client about the contentious matter and shall refer the other or others to another lawyer.

Affiliations Between Lawyers and Affiliated Entities

(10.1) Where there is an affiliation, before accepting a retainer to provide legal services to a client jointly with non-legal services of an affiliated entity, a lawyer shall disclose to the client

(a) any possible loss of solicitor and client privilege because of the involvement of the affiliated entity, including circumstances where a non-lawyer or non-lawyer staff of the affiliated entity provide services, including support services, in the lawyer's office,

(b) the lawyer's role in providing legal services and in providing non-legal services or in providing both legal and non-legal services, as the case may be,

(c) any financial, economic or other arrangements between the lawyer and the affiliated entity that may affect the independence of the lawyer's representation of the client, including whether the lawyer shares in the revenues, profits or cash flows of the affiliated entity; and

(d) agreements between the lawyer and the affiliated entity, such as agreements with respect to referral of clients between the lawyer and the affiliated entity, that may affect the independence of the lawyer's representation of the client.

(10.2) Where there is an affiliation, after making the disclosure as required by subrule (10.1), a lawyer shall obtain the client's consent before accepting a retainer under subrule (10.1).

(10.3) Where there is an affiliation, a lawyer shall establish a system to search for conflicts of interest of the affiliation.

Commentary

Lawyers practising in an affiliation are required to control the practice through which they deliver legal services to the public. They are also required to address conflicts of interest in respect of a proposed retainer by a client as if the lawyer's practice and the practice of the affiliated entity were one where the lawyers accept a retainer to provide legal services to that client jointly with non-legal services of the affiliated entity. The affiliation is subject to the same conflict of interest rules as apply to lawyers and law firms. This obligation may extend to inquiries of offices of affiliated entities outside of Ontario where those offices are treated economically as part of a single affiliated entity.

In reference to clause (a) of subrule (10.1), see also subsection 3(2) of By-Law 7.1 (Operational Obligations and Responsibilities).

[Amended – January 2008]

Prohibition Against Acting for Borrower and Lender

(11) Subject to subrule (12), a lawyer or two or more lawyers practising in partnership or association shall not act for or otherwise represent both lender and borrower in a mortgage or loan transaction.

(12) Provided that there is no violation of this rule, a lawyer may act for or otherwise represent both lender and borrower in a mortgage or loan transaction if

(a) the lawyer practises in a remote location where there are no other lawyers that either party could conveniently retain for the mortgage or loan transaction,

(b) the lender is selling real property to the borrower and the mortgage represents part of the purchase price,

(c) the lender is a bank, trust company, insurance company, credit union or finance company that lends money in the ordinary course of its business,

(d) the consideration for the mortgage or loan does not exceed $50,000, or

(e) the lender and borrower are not at "arm's length" as defined in the *Income Tax Act (Canada).*

[Amended - May 2001]

Multi-discipline Practice

(13) A lawyer in a multi-discipline practice shall ensure that non-licensee partners and associates observe this rule for the legal practice and for any other business or professional undertaking carried on by them outside the legal practice.

[Amended - June 2009]

Unrepresented Persons

(14) When a lawyer is dealing on a client's behalf with an unrepresented person, the lawyer shall

(a) urge the unrepresented person to obtain independent legal representation,

(b) take care to see that the unrepresented person is not proceeding under the impression that his or her interests will be protected by the lawyer, and

(c) make clear to the unrepresented person that the lawyer is acting exclusively in the interests of the client and accordingly his or her comments may be partisan.

Short-term limited legal services

(15) In this subrule and subrules (16) to (19)

"*pro bono* client" means a client to whom a lawyer provides short-term limited legal services;

"short-term limited legal services" means *pro bono* summary legal services provided by a lawyer to a client under the auspices of Pro Bono Law Ontario's Law Help Ontario program for matters in the Superior Court of Justice or in Small Claims Court, with the expectation by the lawyer and the client that the lawyer will not provide continuing legal representation in the matter.

(16) A lawyer engaged in the provision of short-term limited legal services may provide legal services to a *pro bono* client unless

(a) the lawyer knows or becomes aware that the interests of the *pro bono* client are directly adverse to the immediate interests of another current client of the lawyer, the lawyer's firm or Pro Bono Law Ontario; or

(b) the lawyer has or, while providing the short-term limited legal services, obtains confidential information relevant to a matter involving a current or former client of the lawyer, the lawyer's firm or Pro Bono Law Ontario whose interests are adverse to those of the *pro bono* client.

(17) A lawyer who is a partner, an associate, an employee or an employer of a lawyer providing short-term limited legal services to a *pro bono* client may act for other clients of the law firm whose interests are adverse to the *pro bono* client so long as adequate and timely measures are in place to ensure that no disclosure of the *pro bono* client's confidential information is made to the lawyer acting for the other clients.

(18) A lawyer who is unable to provide short-term limited legal services to a *pro bono* client because of the operation of subrule (16) (a) or (b) shall cease to provide short term limited legal services to the *pro bono* client as soon as the lawyer actually becomes aware of the adverse interest or as soon as he or she has or obtains the confidential information referred to in subrule (16) and the lawyer shall not seek the *pro bono* client's waiver of the conflict.

(19) In providing short-term limited legal services, a lawyer shall

(a) ensure, before providing the legal services, that the appropriate disclosure of the nature of the legal services has been made to the client; and

(b) determine whether the client may require additional legal services beyond the short-term limited legal services and if additional services are required or advisable, encourage the client to seek further legal assistance.

Commentary

Short term limited legal service programs are usually offered in circumstances in which it may be difficult to systematically screen for conflicts of interest in a timely way, despite the best efforts and existing practices and procedures of Pro Bono Law Ontario (PBLO) and the lawyers and law firms who provide these services. Performing a full conflicts screening in circumstances in which the *pro bono* services described in subrule (15) are being offered can be very challenging given the timelines, volume and logistics of the setting in which the services are provided. The time required to screen for conflicts may mean that qualifying individuals for whom these brief legal services are available are denied access to legal assistance.

Subrules (15) to (19) apply in circumstances in which the limited nature of the legal services being provided by a lawyer significantly reduces the risk of conflicts of interest with other matters being handled by the lawyer's firm. Accordingly, the lawyer is disqualified from acting for a client receiving short-term limited legal services only if the lawyer has actual knowledge of a conflict of interest between the *pro bono* client and an existing or former client of the lawyer, the lawyer's firm or PBLO. For example, a conflict of interest of which the lawyer has no actual knowledge but which is imputed to the lawyer because of the lawyer's membership in or association or employment with a firm would not preclude the lawyer from representing the client seeking short-term limited legal services.

The lawyer's knowledge would be based on the lawyer's reasonable recollection and information provided by the client in the ordinary course of the consultation and in the client's application to PBLO for legal assistance.

The personal disqualification of a lawyer participating in PBLO's program does not create a conflict for the other lawyers participating in the program, as the conflict is not imputed to them.

Confidential information obtained by a lawyer representing a *pro bono* client, as defined in subrule (15), will not be imputed to the lawyer's licensee partners, associates and employees or non-licensee partners or associates in a multi-discipline partnership. As such, these individuals may continue to act for another client adverse in interest to the *pro bono* client who is obtaining or has obtained short-term limited legal services, and may act in future for another client adverse in interest to the *pro bono* client who is obtaining or has obtained short-term limited legal services.

Appropriate screening measures must be in place to prevent disclosure of confidential information relating to the client to the lawyer's partners, associates, employees or employer (in the practice of law). Subrule (17) extends, with necessary modifications, the rules and guidelines about conflicts arising from a lawyer transfer between law firms (rule 2.05) to the situation of a law firm acting against a current client of the firm in providing short term limited legal services. Measures that the lawyer providing the short-term limited legal services should take to ensure the confidentiality of information of the client's information include:

- having no involvement in the representation of or any discussions with others in the firm about another client whose interests conflict with those of the *pro bono* client;
- identifying relevant files, if any, of the *pro bono* client and physically segregating access to them to those working on the file or who require access for specifically identified or approved reasons; and
- ensuring that the firm has distributed a written policy to all licensees, non-licensee partners and associates and support staff, explaining the screening measures that are in place.

Subrule (18) precludes a lawyer from obtaining a waiver in respect of conflicts of interest that arise in providing short-term legal services.

[New – April 22, 2010]

2.04.1 LAWYERS ACTING FOR TRANSFEROR AND TRANSFEREE IN TRANSFERS OF TITLE

2.04.1 (1) Subject to subrule (3), an individual lawyer shall not act for or otherwise represent both the transferor and the transferee in a transfer of title to real property.

(2) Subrule (1) does not prevent a law firm of two or more lawyers from acting for or otherwise representing a transferor and a transferee in a transfer of title to real property so long as the transferor and transferee are represented by different lawyers in the firm and there is no violation of rule 2.04.

(3) So long as there is no violation of rule 2.04, an individual lawyer may act for or otherwise represent both the transferor and the transferee in a transfer of title to real property if

(a) the Land Registration Reform Act permits the lawyer to sign the transfer on behalf of the transferor and the transferee,

(b) the transferor and transferee are "related persons" as defined in section 251 of the Income Tax Act (Canada), or

(c) the lawyer practices law in a remote location where there are no other lawyers that either the transferor or the transferee could without undue inconvenience retain for the transfer

[Effective March 31, 2008]

2.05 CONFLICTS FROM TRANSFER BETWEEN LAW FIRMS

Definitions

2.05 (1) In this rule

"client" includes anyone to whom a lawyer owes a duty of confidentiality, whether or not a solicitor-client relationship exists between them,

[Amended - June 2007]

"confidential information" means information obtained from a client that is not generally known to the public, and

> Commentary
>
> The duties imposed by this rule concerning confidential information should be distinguished from the general ethical duty to hold in strict confidence all information concerning the business and affairs of the client acquired in the course of the professional relationship, which duty applies without regard to the nature or source of the information or to the fact that others may share the knowledge.

"matter" means a case or client file but does not include general "know-how" and, in the case of a government lawyer, does not include policy advice unless the advice relates to a particular case.

Application of Rule

(2) This rule applies where a lawyer transfers from one law firm ("former law firm") to another ("new law firm"), and either the transferring lawyer or the new law firm is aware at the time of the transfer or later discovers that

(a) the new law firm represents a client in a matter that is the same as or related to a matter in which the former law firm represents its client ("former client"),

(b) the interests of those clients in that matter conflict, and

(c) the transferring lawyer actually possesses relevant information respecting that matter.

(3) Subrules (4) to (7) do not apply to a lawyer employed by the federal, a provincial, or a territorial Attorney General or Department of Justice who, after transferring from one department, ministry, or agency to another, continues to be employed by that Attorney General or Department of Justice.

Commentary

The purpose of the rule is to deal with actual knowledge. Imputed knowledge does not give rise to disqualification.

Lawyers and support staff - This rule is intended to regulate lawyers and articled students who transfer between law firms. It also imposes a general duty on lawyers to exercise due diligence in the supervision of non-lawyer staff, to ensure that they comply with the rule and with the duty not to disclose confidences of clients of the lawyer's firm and confidences of clients of other law firms in which the person has worked.

Government employees and in-house counsel - The definition of "law firm" includes one or more lawyers practising in a government, a Crown corporation, any other public body, and a corporation. Thus, the rule applies to lawyers transferring to or from government service and into or out of an in-house counsel position, but does not extend to purely internal transfers in which, after transfer, the employer remains the same.

Law firms with multiple offices - The rule treats as one "law firm" such entities as the various legal services units of a government, a corporation with separate regional legal departments, an inter-provincial law firm, and a legal aid program with many community law offices. The more autonomous each unit or office is, the easier it should be, in the event of a conflict, for the new firm to obtain the former client's consent or to establish that it is in the public interest that it continue to represent its client in the matter.

[Amended – June 2007]

Law Firm Disqualification

(4) Where the transferring lawyer actually possesses relevant information respecting the former client that is confidential and that, if disclosed to a member of the new law firm, may prejudice the former client, the new law firm shall cease its representation of its client in that matter unless

[Amended – June 2007]

(a) the former client consents to the new law firm's continued representation of its client, or

(b) the new law firm establishes that it is in the interests of justice that it act in the matter, having regard to all relevant circumstances, including,

(i) the adequacy and timing of the measures taken to ensure that no disclosure to any member of the new law firm of the former client's confidential information will occur,

(ii) the extent of prejudice to any party,

(iii) the good faith of the parties,

(iv) the availability of suitable alternative counsel, and

(v) issues affecting the public interest.

Commentary

The circumstances enumerated in subrule (4)(b) are drafted in broad terms to ensure that all relevant facts will be taken into account. While clauses (ii) to (iv) are self-explanatory, clause (v) addresses governmental concerns respecting issues of national security, cabinet confidences, and obligations incumbent on Attorneys General and their agents in the administration of justice.

(5) For greater certainty, subrule (4) is not intended to interfere with the discharge by an Attorney General or his or her counsel or agent (including those occupying the offices of Crown Attorney, Assistant Crown Attorney, or part-time Assistant Crown Attorney) of their constitutional and statutory duties and responsibilities.

(6) Where the transferring lawyer actually possesses relevant information respecting the former client but that information is not confidential information which, if disclosed to a member of the new law firm, may prejudice the former client,

(a) the lawyer shall execute an affidavit or solemn declaration to that effect, and

(b) the new law firm shall

(i) notify its client and the former client, or if the former client is represented in that matter by a lawyer, notify that lawyer of the relevant circumstances and its intended action under this rule, and

(ii) deliver to the persons referred to in (i) a copy of any affidavit or solemn declaration executed under (a).

[Amended - June 2007]

Transferring Lawyer Disqualification

(7) A transferring lawyer described in the opening clause of subrule (4) or (6) shall not, unless the former client consents,

(a) participate in any manner in the new law firm's representation of its client in that matter, or

(b) disclose any confidential information respecting the former client.

[Amended - June 2007]

(8) No member of the new law firm shall, unless the former client consents, discuss with a transferring lawyer described in the opening clause of subrule (4) or (6) the new law firm's representation of its client or the former law firm's representation of the former client in that matter.

[Amended - June 2007]

Determination of Compliance

(9) Anyone who has an interest in, or who represents a party in, a matter referred to in this rule may apply to a tribunal of competent jurisdiction for a determination of any aspect of this rule.

Due Diligence

(10) A lawyer shall exercise due diligence in ensuring that each member and employee of the lawyer's law firm, each non-lawyer partner and associate, and each other person whose services the lawyer has retained

[Amended - June 2007]

(a) complies with this rule, and

(b) does not disclose

(i) confidential information of clients of the firm, and

(ii) confidential information of clients of another law firm in which the person has worked.

Commentary

MATTERS TO CONSIDER

When a law firm considers hiring a lawyer or articled student ("transferring lawyer") from another law firm, the transferring lawyer and the new law firm need to determine, before the transfer, whether any conflicts of interest will be created. Conflicts can arise with respect to clients of the law firm that the transferring lawyer is leaving and with respect to clients of a firm in which the transferring lawyer worked at some earlier time. The transferring lawyer and the new law firm need to identify, first, all cases in which

(a) the new law firm represents a client in a matter that is the same as or related to a matter in respect of which the former law firm represents its client,

(b) the interests of these clients in that matter conflict, and

(c) the transferring lawyer actually possesses relevant information respecting that matter.

[Amended – June 2007]

The law firm must then determine whether, in each such case, the transferring lawyer actually possesses relevant information respecting the former client that is confidential and that, if disclosed to a member of the new law firm, may prejudice the former client. If this element exists, the new law firm is disqualified unless the former client consents or the new law firm establishes that its continued representation is in the interests of justice, based on relevant circumstances.

[Amended - June 2007]

In determining whether the transferring lawyer possesses confidential information, both the transferring lawyer and the new law firm need to be very careful to ensure that they do not, during the interview process itself, disclose client confidences.

MATTERS TO CONSIDER BEFORE HIRING A POTENTIAL TRANSFEREE

After completing the interview process and before hiring the transferring lawyer, the new law firm should determine whether a conflict exists.

A. Where a conflict does exist

If the new law firm concludes that the transferring lawyer does actually possess relevant information respecting a former client that is confidential and that, if disclosed to a member of the new law firm, may prejudice the former client if the transferring lawyer is hired, the new law firm will be prohibited from continuing to represent its client in the matter unless

(a) the new law firm obtains the former client's consent to its continued representation of its client in that matter, or

(b) the new law firm complies with subrule (4)(b), and, in determining whether continued representation is in the interests of justice, both clients' interests are the paramount consideration.

If the new law firm seeks the former client's consent to the new law firm continuing to act, it will in all likelihood be required to satisfy the former client that it has taken reasonable measures to ensure that no disclosure to any member of the new law firm of the former client's confidential information will occur. The former client's consent must be obtained before the transferring lawyer is hired.

Alternatively, if the new law firm applies under subrule (9) for a determination that it may continue to act, it bears the onus of establishing the matters referred to in subrule (4)(b). Ideally, this process should be completed before the transferring person is hired.

[Amended – June 2007]

B. Where no conflict exists

Although subrule 2.05(6) does not require that the notice required by that subrule be in writing, it would be prudent for the new law firm to confirm these matters in writing. Written notification eliminates any later dispute about whether notice has been given and about its timeliness and content.

The new law firm might, for example, seek the former client's consent to the transferring lawyer acting for the new law firm's client in the matter because, in the absence of such consent, the transferring lawyer may not act.

If the former client does not consent to the transferring lawyer acting, it would be prudent for the new law firm to take reasonable measures to ensure that no disclosure will occur to any member of the new law firm of the former client's confidential information. If such measures are taken, it will strengthen the new law firm's position if it is later determined that the transferring lawyer did in fact possess confidential information which, if disclosed, may prejudice the former client.

A transferring lawyer who possesses no such confidential information puts the former client on notice by executing an affidavit or solemn declaration and delivering it to the former client. A former client who disputes the allegation of no such confidential information may apply under subrule (9) for a determination of that issue.

C. Where the new law firm is not sure whether a conflict exists

There may be some cases where the new law firm is not sure whether the transferring lawyer actually possesses confidential information respecting a former client that, if disclosed to a member of the new law firm, may prejudice the former client. In such circumstances, it would be prudent for the new law firm to seek guidance from the Society before hiring the transferring lawyer.

REASONABLE MEASURES TO ENSURE NON-DISCLOSURE OF CONFIDENTIAL INFORMATION

As noted above, there are two circumstances in which the new law firm should consider the implementation of reasonable measures to ensure that no disclosure will occur to any member of the new law firm of the former client's confidential information:

(a) where the transferring lawyer actually possesses confidential information respecting a former client that, if disclosed to a member of the new law firm, may prejudice the former client, and

[Amended – June 2007]

(b) where the new law firm is not sure whether the transferring lawyer actually possesses such confidential information, but it wants to strengthen its position if it is later determined that the transferring lawyer did in fact possess such confidential information.

It is not possible to offer a set of "reasonable measures" that will be appropriate or adequate in every case. Instead, the new law firm that seeks to implement reasonable measures must exercise professional judgment in determining what steps must be taken "to ensure that no disclosure will occur to any member of the new law firm of the former client's confidential information."

In the case of law firms with multiple offices, the degree of autonomy possessed by each office will be an important factor in determining what constitutes "reasonable measures." For example, the various legal services units of a government, a corporation with separate regional legal departments, an inter-provincial law firm, or a legal aid program may be able to demonstrate that, because of its institutional structure, reporting relationships, function, nature of work, and geography, relatively fewer "measures" are necessary to ensure the non-disclosure of client confidences. If it can be shown that, because of factors such as the above, lawyers in separate units, offices, or departments do not "work together" with other lawyers in other units, offices or departments, this shall be taken into account in the determination of what screening measures are "reasonable."

The guidelines at the end of this Commentary, adapted from the Canadian Bar Association's Task Force report entitled Conflict of Interest Disqualification: Martin v. Gray and Screening Methods (February 1993), are intended as a checklist of relevant factors to be considered. Adoption of only some of the guidelines may be adequate in some cases, while adoption of them all may not be sufficient in others.

In cases where a transferring lawyer joining a government legal services unit or the legal department of a corporation actually possesses confidential information respecting a former client that, if disclosed to a member of the new "law firm," may prejudice the former client, the interests of the new client (Her Majesty or the corporation) must continue to be represented. Normally, this will be effected by instituting satisfactory screening measures, which could include referring the conduct of the matter to counsel in a different department, office or legal services unit. As each factual situation will be unique, flexibility will be required in the application of subrule (4)(b), particularly clause (v). Only in those situations where the entire firm must be disqualified pursuant to subrule (4) will it be necessary to refer conduct of the matter to outside counsel.

GUIDELINES

1. The screened lawyer should have no involvement in the new law firm's representation of its client.

[Amended – June 2007]

2. The screened lawyer should not discuss the current matter or any information relating to the representation of the former client (the two may be identical) with anyone else in the new law firm.

3. No member of the new law firm should discuss the current matter or the previous representation with the screened lawyer.

4. The current matter should be discussed only within the limited group that is working on the matter.

5. The files of the current client, including computer files, should be physically segregated from the new law firm's regular filing system, specifically identified, and accessible only to those lawyers and support staff in the new law firm who are working on the matter or who require access for other specifically identified and approved reasons.

6. No member of the new law firm should show the screened lawyer any documents relating to the current representation.

7. The measures taken by the new law firm to screen the transferring lawyer should be stated in a written policy explained to all lawyers and support staff within the firm, supported by an admonition that violation of the policy will result in sanctions, up to and including dismissal.

8. Undertakings should be provided by the appropriate law firm members setting out that they have adhered to and will continue to adhere to all elements of the screen.

9. The former client, or if the former client is represented in that matter by a lawyer, that lawyer, should be advised

(a) that the screened lawyer is now with the new law firm, which represents the current client, and

(b) of the measures adopted by the new law firm to ensure that there will be no disclosure of confidential information.

10. The screened lawyer's office or work station and that of the lawyer's support staff should be located away from the offices or work stations of lawyers and support staff working on the matter.

11. The screened lawyer should use associates and support staff different from those working on the current matter.

12. In the case of law firms with multiple offices, consideration should be given to referring conduct of the matter to counsel in another office.

[Amended – June 2007]

2.06 DOING BUSINESS WITH A CLIENT

Definitions

2.06 (1) In this rule

"related persons" means related persons as defined in the *Income Tax Act (Canada)* and "related person" has a corresponding meaning, and

"syndicated mortgage" means a mortgage having more than one investor.

Investment by Client where Lawyer has an Interest

(2) Subject to subrule (2.1), where a client intends to enter into a transaction with his or her lawyer or with a corporation or other entity in which the lawyer has an interest other than a corporation or other entity whose securities are publicly traded, the lawyer, before accepting any retainer

(a) shall disclose and explain the nature of the conflicting interest to the client or, in the case of a potential conflict, how and why it might develop later,

(b) shall recommend independent legal representation and shall require that the client receive independent legal advice, and

(c) where the client requests the lawyer to act, the lawyer shall obtain the client's written consent.

[Amended – May 2001]

(2.1) When a client intends to pay for legal services by transferring to his, her or its lawyer a share, participation or other interest in property or in an enterprise, other than a non-material interest in a publicly traded enterprise, the lawyer shall recommend but need not require that the client receive independent legal advice before accepting a retainer.

[New – May 2001; Amended – March 2004]

Commentary

If the lawyer does not choose to make disclosure of the conflicting interest or cannot do so without breaching a confidence, the lawyer must decline the retainer.

The lawyer should not uncritically accept the client's decision to have the lawyer act. It should be borne in mind that, if the lawyer accepts the retainer, the lawyer's first duty will be to the client. If the lawyer has any misgivings about being able to place the client's interests first, the retainer should be declined.

Generally, in disciplinary proceedings under this rule, the burden will rest upon the lawyer to show good faith, that adequate disclosure was made in the matter, and that the client's consent was obtained.

If the investment is by borrowing from the client, the transaction may fall within the requirements of subrules 2.06(4) or (6).

Certificate of Independent Legal Advice

(3) A lawyer retained to give independent legal advice shall, before any advance of funds has been made by the client,

(a) provide the client with a written certificate that the client has received independent legal advice, and

(b) obtain the client's signature on a copy of the certificate of independent legal advice and send the signed copy to the lawyer with whom the client proposes to transact business.

Borrowing from Clients

(4) A lawyer shall not borrow money from a client unless

(a) the client is a lending institution, financial institution, insurance company, trust company or any similar corporation whose business includes lending money to members of the public, or

(b) the client is a related person as defined by the Income Tax Act (Canada) and the lawyer is able to discharge the onus of proving that the client's interests were fully protected by the nature of the case and by independent legal advice or independent legal representation.

Commentary

The relationship between lawyer and client is a fiduciary one, and no conflict between the lawyer's own interest and the lawyer's duty to the client can be permitted.

Whether a person lending money to a lawyer on that person's own account or investing money in a security in which the lawyer has an interest is to be considered a client within this rule is to be determined having regard to all circumstances. If the circumstances are such that the lender or investor might reasonably feel entitled to look to the lawyer for guidance and advice in respect of the loan or investment, the lawyer will be considered bound by the same fiduciary obligation that attaches to a lawyer in dealings with a client.

(5) In any transaction, other than a transaction within the provisions of subrule (4), in which money is borrowed from a client by a lawyer's spouse or by a corporation, syndicate, or partnership in which either the lawyer or the lawyer's spouse has, or both of them together have, directly or indirectly, a substantial interest, the lawyer shall ensure that the client's interests are fully protected by the nature of the case and by independent legal representation.

Lawyers in Loan or Mortgage Transactions

(6) A lawyer engaged in the private practice of law in Ontario shall not directly, or indirectly through a corporation, syndicate, partnership, trust, or other entity in which the lawyer or a related person has a financial interest, other than an ownership interest of a corporation or other entity offering its securities to the public of less than five per cent (5%) of any class of securities

(a) hold a syndicated mortgage or loan in trust for investor clients unless each investor client receives

(i) a complete reporting letter on the transaction,

(ii) a trust declaration signed by the person in whose name the mortgage or any security instrument is registered, and

(iii) a copy of the duplicate registered mortgage or security instrument,

(b) arrange or recommend the participation of a client or other person as an investor in a syndicated mortgage or loan where the lawyer is an investor unless the lawyer can demonstrate that the client or other person had independent legal advice in making the investment, or

(c) sell mortgages or loans to, or arrange mortgages or loans for, clients or other persons except in accordance with the skill, competence, and integrity usually expected of a lawyer in dealing with clients.

Commentary

ACCEPTABLE MORTGAGE OR LOAN TRANSACTIONS

A lawyer may engage in the following mortgage or loan transactions in connection with the practice of law:

(a) a lawyer may invest in mortgages or loans personally or on behalf of a related person or a combination thereof,

(b) a lawyer may deal in mortgages or loans as an executor, administrator, committee, trustee of a testamentary or inter vivos trust established for purposes other than mortgage or loan investment or under a power of attorney given for purposes other than exclusively for mortgage or loan investment, and

(c) a lawyer may collect, on behalf of clients, mortgage or loan payments that are made payable in the name of the lawyer under a written direction to that effect given by the client to the mortgagor or borrower provided that such payments are deposited into the lawyer's trust account.

A lawyer may introduce a borrower (whether or not a client) to a lender (whether or not a client) and the lawyer may then act for either, and when subrule 2.04 (12) applies, the lawyer may act for both.

Disclosure

(7) Where a lawyer sells or arranges mortgages for clients or other persons, the lawyer shall disclose in writing to each client or other person the priority of the mortgage and all other information relevant to the transaction that is known to the lawyer that would be of concern to a proposed investor.

No Advertising

(8) A lawyer shall not promote, by advertising or otherwise, individual or joint investment by clients or other persons who have money to lend, in any mortgage in which a financial interest is held by the lawyer, a related person, or a corporation, syndicate, partnership, trust or other entity in which the lawyer or related person has a financial interest, other than an ownership interest of a corporation or other entity offering its securities to the public of less than five per cent (5%) of any class of securities.

Guarantees by a Lawyer

(9) Except as provided by subrule (10), a lawyer shall not guarantee personally, or otherwise provide security for, any indebtedness in respect of which a client is a borrower or lender.

(10) A lawyer may give a personal guarantee in the following circumstances:

(a) the lender is a lending institution, financial institution, insurance company, trust company or any similar corporation whose business includes lending money to members of the public, and the lender is directly or indirectly providing funds solely for the lawyer, the lawyer's spouse, parent, or child,

(b) the transaction is for the benefit of a non-profit or charitable institution where the lawyer as a member or supporter of such institution is asked, either individually or together with other members or supporters of the institution, to provide a guarantee, or

(c) the lawyer has entered into a business venture with a client and the lender requires personal guarantees from all participants in the venture as a matter of course and

(i) the lawyer has complied with rule 2.04 (Avoidance of Conflicts of Interest) and this rule (Doing Business with a Client), and

(ii) the lender and participants in the venture who are or were clients of the lawyer have received independent legal representation.

[Amended - June 2007]

2.07 PRESERVATION OF CLIENT'S PROPERTY

Preservation of Client's Property

2.07 (1) A lawyer shall care for a client's property as a careful and prudent owner would when dealing with like property and shall observe all relevant rules and law about the preservation of a client's property entrusted to a lawyer.

Commentary

The duties concerning safekeeping, preserving, and accounting for clients' monies and other property are set out in the by-laws made under the *Law Society Act*.

These duties are closely related to those regarding confidential information. The lawyer should keep the client's papers and other property out of sight as well as out of reach of those not entitled to see them and should, subject to any rights of lien, promptly return them to the client upon request or at the conclusion of the lawyer's retainer.

Notification of Receipt of Property

(2) A lawyer shall promptly notify the client of the receipt of any money or other property of the client, unless satisfied that the client is aware that they have come into the lawyer's custody.

Identifying Client's Property

(3) A lawyer shall clearly label and identify the client's property and place it in safekeeping distinguishable from the lawyer's own property.

(4) A lawyer shall maintain such records as necessary to identify a client's property that is in the lawyer's custody.

Accounting and Delivery

(5) A lawyer shall account promptly for a client's property that is in the lawyer's custody and upon request shall deliver it to the order of the client.

(6) Where a lawyer is unsure of the proper person to receive a client's property, the lawyer shall apply to a tribunal of competent jurisdiction for direction.

Commentary

The lawyer should be alert to claim on behalf of a client any privilege in respect of property seized or attempted to be seized by an external authority. In this regard, the lawyer should be familiar with the nature of the client's privilege and with such relevant statutory provisions as are found in the *Income Tax Act (Canada).*

2.08 FEES AND DISBURSEMENTS

Reasonable Fees and Disbursements

2.08 (1) A lawyer shall not charge or accept any amount for a fee or disbursement unless it is fair and reasonable and has been disclosed in a timely fashion.

(2) A lawyer shall not charge a client interest on an overdue account save as permitted by the *Solicitors Act* or as otherwise permitted by law.

Commentary

What is a fair and reasonable fee will depend upon such factors as

(a) the time and effort required and spent,

(b) the difficulty and importance of the matter,

(c) whether special skill or service has been required and provided,

(d) the amount involved or the value of the subject-matter,

(e) the results obtained,

(f) fees authorized by statute or regulation,

(g) special circumstances, such as the loss of other retainers, postponement of payment, uncertainty of reward, or urgency.

The fiduciary relationship between lawyer and client requires full disclosure in all financial dealings between them and prohibits the acceptance by the lawyer of any hidden fees. No fee, reward, costs, commission, interest, rebate, agency or forwarding allowance, or other compensation related to professional employment may be taken by the lawyer from anyone other than the client without full disclosure to and the consent of the client or, where the lawyer's fees are being paid by someone other than the client, such as a legal aid agency, a borrower, or a personal representative, without the consent of such agency or other person.

Breach of this rule and misunderstandings about fees and financial matters bring the legal profession into disrepute and reflect adversely upon the general administration of justice. A lawyer should try to avoid controversy with a client about fees and should be ready to explain the basis for the charges (especially if the client is unsophisticated or uninformed about how a fair and reasonable fee is determined). A lawyer should inform a client about his or her rights to have an account assessed under the *Solicitors Act*.

Where possible to do so, a lawyer should give the client a fair estimate of fees and disbursements, pointing out any uncertainties involved, so that the client may be able to make an informed decision. This is particularly important concerning fee charges or disbursements that the client might not reasonably be expected to anticipate. When something unusual or unforeseen occurs that may substantially affect the amount of a fee or disbursement, the lawyer should forestall misunderstandings or disputes by giving the client an immediate explanation.

It is in keeping with the best traditions of the legal profession to provide services pro bono and to reduce or waive a fee where there is hardship or poverty or the client or prospective client would otherwise be deprived of adequate legal advice or representation. A lawyer should provide public interest legal services and should support organizations that provide services to persons of limited means.

Contingency Fees and Contingency Fee Agreements

(3) Subject to subrule (1) except in family law or criminal or quasi-criminal matters, a lawyer may enter into a written agreement in accordance with the *Solicitors Act* and the regulations thereunder, that provides that the lawyer's fee is contingent, in whole or in part, on the successful disposition or completion of the matter for which the lawyer's services are to be provided.

[Amended – November 2002, October 2004]

Commentary

In determining the appropriate percentage or other basis of the contingency fee, the lawyer and the client should consider a number of factors, including the likelihood of success, the nature and complexity of the claim, the expense and risk of pursuing it, the amount of the expected recovery and who is to receive an award of costs. The lawyer and client may agree that in addition to the fee payable under the agreement, any amount arising as a result of an award of costs or costs obtained as a part of a settlement is to be paid to the lawyer, which agreement under the *Solicitors Act* must receive judicial approval. In such circumstances, a smaller percentage of the award than would otherwise be agreed upon for the contingency fee, after considering all relevant factors, will generally be appropriate. The test is whether the fee in all of the circumstances is fair and reasonable.

[New - October 2002, Amended October 2004]

Statement of Account

(4) In a statement of an account delivered to a client, a lawyer shall clearly and separately detail the amounts charged as fees and as disbursements.

Joint Retainer

(5) Where a lawyer is acting for two or more clients, the lawyer shall divide the fees and disbursements equitably between them, unless there is an agreement by the clients otherwise.

Division of Fees and Referral Fees

(6) Where the client consents, fees for a matter may be divided between licensees who are not in the same firm, provided that the fees are divided in proportion to the work done and the responsibilities assumed.

(7) Where a lawyer refers a matter to another licensee because of the expertise and ability of the other licensee to handle the matter and the referral was not made because of a conflict of interest, the referring lawyer may accept and the other licensee may pay a referral fee provided that

(a) the fee is reasonable and does not increase the total amount of the fee charged to the client, and

(b) the client is informed and consents.

(8) A lawyer shall not

(a) directly or indirectly share, split, or divide his or her fees with any person who is not a licensee, or

(b) give any financial or other reward to any person who is not a licensee for the referral of clients or client matters.

[Amended - April 2008]

Commentary

This rule does not prohibit an arrangement respecting the purchase and sale of a law practice when the consideration payable includes a percentage of revenues generated from the practice sold.

[New - May 2001]

Exception for Multi-discipline Practices and Interprovincial and International Law Firms

(9) Subrule (8) does not apply to

(a) multi-discipline practices of lawyer and non-licensee partners where the partnership agreement provides for the sharing of fees, cash flows or profits among members of the firm, and

(b) sharing of fees, cash flows or profits by lawyers who are

(i) members of an interprovincial law firm, or

(ii) members of a law partnership of Ontario and non-Canadian lawyers who otherwise comply with this rule.

[Amended – June 2009]

Commentary

An affiliation is different from a multi-discipline practice established in accordance with the by-laws under the *Law Society Act*, an interprovincial law partnership or a partnership between Ontario lawyers and foreign lawyers. An affiliation is subject to subrule 2.08(8). In particular, an affiliated entity is not permitted to share in the lawyer's revenues, cash flows or profits, either directly or indirectly through excessive inter-firm charges, for example, by charging inter-firm expenses above their fair market value.

[New - May 2001]

Appropriation of Funds

(10) The lawyer shall not appropriate any funds of the client held in trust or otherwise under the lawyer's control for or on account of fees except as permitted by the by-laws under the *Law Society Act*.

2.09 WITHDRAWAL FROM REPRESENTATION

Withdrawal from Representation

2.09 (1) A lawyer shall not withdraw from representation of a client except for good cause and upon notice to the client appropriate in the circumstances.

> Commentary
>
> Although the client has the right to terminate the lawyer-client relationship at will, the lawyer does not enjoy the same freedom of action. Having undertaken the representation of a client, the lawyer should complete the task as ably as possible unless there is justifiable cause for terminating the relationship.
>
> No hard and fast rules can be laid down about what will constitute reasonable notice before withdrawal. Where the matter is covered by statutory provisions or rules of court, these will govern. In other situations, the governing principle is that the lawyer should protect the client's interests to the best of the lawyer's ability and should not desert the client at a critical stage of a matter or at a time when withdrawal would put the client in a position of disadvantage or peril.

Optional Withdrawal

(2) Subject to the rules about criminal proceedings and the direction of the tribunal, where there has been a serious loss of confidence between the lawyer and the client, the lawyer may withdraw.

> Commentary
>
> A lawyer who is deceived by the client will have justifiable cause for withdrawal, and the refusal of the client to accept and act upon the lawyer's advice on a significant point might indicate a loss of confidence justifying withdrawal. However, the lawyer should not use the threat of withdrawal as a device to force a hasty decision by the client on a difficult question.

Non-payment of Fees

(3) Subject to the rules about criminal proceedings and the direction of the tribunal, where, after reasonable notice, the client fails to provide funds on account of disbursements or fees, a lawyer may withdraw unless serious prejudice to the client would result.

Withdrawal from Criminal Proceedings

(4) Where a lawyer has agreed to act in a criminal case and where the interval between a withdrawal and the trial of the case is sufficient to enable the client to obtain another licensee and to allow such other licensee adequate time for preparation, the lawyer who has agreed to act may withdraw because the client has not paid the agreed fee or for other adequate cause provided that the lawyer

[Amended – June 2007]

(a) notifies the client, preferably in writing, that the lawyer is withdrawing because the fees have not been paid or for other adequate cause,

(b) accounts to the client for any monies received on account of fees and disbursements,

(c) notifies Crown counsel in writing that the lawyer is no longer acting,

(d) in a case when the lawyer's name appears on the records of the court as acting for the accused, notifies the clerk or registrar of the appropriate court in writing that the lawyer is no longer acting.

Commentary

A lawyer who has withdrawn because of conflict with the client should not indicate in the notice addressed to the court or Crown counsel the cause of the conflict or make reference to any matter that would violate the privilege that exists between lawyer and client. The notice should merely state that the lawyer is no longer acting and has withdrawn.

(5) Where a lawyer has agreed to act in a criminal case and where the date set for trial is not far enough removed to enable the client to obtain another licensee or to enable another licensee to prepare adequately for trial and an adjournment of the trial date cannot be obtained without adversely affecting the client's interests, the lawyer who agreed to act may not withdraw because of non-payment of fees.

(6) Where the lawyer is justified in withdrawing from a criminal case for reasons other than non-payment of fees and there is not a sufficient interval between a notice to the client of the lawyer's intention to withdraw and the date when the case is to be tried to enable the client to obtain another licensee and to enable such licensee to prepare adequately for trial, the first lawyer, unless instructed otherwise by the client, should attempt to have the trial date adjourned and may withdraw from the case only with the permission of the court before which the case is to be tried.

[Amended – June 2007]

Commentary

Where circumstances arise that in the opinion of the lawyer require an application to the court for leave to withdraw, the lawyer should promptly inform Crown counsel and the court of the intention to apply for leave in order to avoid or minimize any inconvenience to the court and witnesses.

Mandatory Withdrawal

(7) Subject to the rules about criminal proceedings and the direction of the tribunal, a lawyer shall withdraw if

(a) discharged by the client,

(b) the lawyer is instructed by the client to do something inconsistent with the lawyer's duty to the tribunal and, following explanation, the client persists in such instructions,

(c) the client is guilty of dishonourable conduct in the proceedings or is taking a position solely to harass or maliciously injure another,

(d) it becomes clear that the lawyer's continued employment will lead to a breach of these rules,

(d.1) the lawyer is required to do so pursuant to subrules 2.02 (5.1) or (5.2) (dishonesty, fraud, etc. when client an organization), or

(e) the lawyer is not competent to handle the matter.

[Amended – March 2004]

Commentary

When a law firm is dissolved it will usually result in the termination of the lawyer-client relationship as between a particular client and one or more of the lawyers involved. In such cases, most clients will prefer to retain the services of the lawyer whom they regarded as being in charge of their business before the dissolution. However, the final decision rests with the client, and the lawyers who are no longer retained by that client should act in accordance with the principles here set out, and, in particular, should try to minimize expense and avoid prejudice to the client.

Manner of Withdrawal

(8) When a lawyer withdraws, the lawyer shall try to minimize expense and avoid prejudice to the client and shall do all that can reasonably be done to facilitate the orderly transfer of the matter to the successor legal practitioner.

(9) Upon discharge or withdrawal, a lawyer shall

(a) subject to the lawyer's right to a lien, deliver to or to the order of the client all papers and property to which the client is entitled,

(b) give the client all information that may be required in connection with the case or matter,

(c) account for all funds of the client then held or previously dealt with, including the refunding of any remuneration not earned during the representation,

(d) promptly render an account for outstanding fees and disbursements, and

(e) co-operate with the successor legal practitioner so as to minimize expense and avoid prejudice to the client.

[Amended – June 2009]

Commentary

The obligation to deliver papers and property is subject to a lawyer's right of lien. In the event of conflicting claims to such papers or property, the lawyer should make every effort to have the claimants settle the dispute.

A lawyer acting for several clients in a case or matter who ceases to act for one or more of them should co-operate with the successor legal practitioner or practitioners to the extent required by the rules and should seek to avoid any unseemly rivalry, whether real or apparent.

[Amended – June 2009]

Where upon the discharge or withdrawal of the lawyer, the question of a right of lien for unpaid fees and disbursements arises, the lawyer should have due regard to the effect of its enforcement upon the client's position. Generally speaking, the lawyer should not enforce the lien if to do so would prejudice materially the client's position in any uncompleted matter.

Duty of Successor Licensee

(10) Before agreeing to represent a client, a successor licensee shall be satisfied that the former licensee approves, has withdrawn, or has been discharged by the client.

[Amended – June 2007]

Commentary

It is quite proper for the successor licensee to urge the client to settle or take reasonable steps towards settling or securing any outstanding account of the former licensee, especially if the latter withdrew for good cause or was capriciously discharged. But if a trial or hearing is in progress or imminent or if the client would otherwise be prejudiced, the existence of an outstanding account should not be allowed to interfere with the successor licensee acting for the client.

[Amended – June 2007]

Rule 3 The Practice of Law

3.01 MAKING LEGAL SERVICES AVAILABLE

Making Services Available

3.01 (1) A lawyer shall make legal services available to the public in an efficient and convenient way.

Commentary

A lawyer may assist in making legal services available by participating in the Legal Aid Plan and lawyer referral services and by engaging in programmes of public information, education or advice concerning legal matters.

Right to Decline Representation - A lawyer may decline a particular representation (except when assigned as counsel by a tribunal), but that discretion should be exercised prudently, particularly if the probable result would be to make it difficult for a person to obtain legal advice or representation. Generally, a lawyer should not decline representation merely because a person seeking legal services or that person's cause is unpopular or notorious, or because powerful interests or allegations of misconduct or malfeasance are involved, or because of the lawyer's private opinion about the guilt of the accused. A lawyer declining representation should assist in obtaining the services of another licensee qualified in the particular field and able to act.

When a lawyer offers assistance to a client or prospective client in finding another licensee, the assistance should be given willingly and, except where a referral fee is permitted by rule 2.08(7), without charge.

Restrictions

(2) In offering legal services, a lawyer shall not use means

(a) that are false or misleading,

(b) that amount to coercion, duress, or harassment,

(c) that take advantage of a person who is vulnerable or who has suffered a traumatic experience and has not yet had a chance to recover,

(d) that are intended to influence a person who has retained another lawyer for a particular matter to change his or her lawyer for that matter, unless the change is initiated by the person or the other lawyer, or

(e) that otherwise bring the profession or the administration of justice into disrepute.

Commentary

A person who is vulnerable or who has suffered a traumatic experience and has not yet had a chance to recover may need the professional assistance of a lawyer, and this rule does not prevent a lawyer from offering his or her assistance to such a person. Rather, the rule prohibits the lawyer from using unconscionable or exploitive means that bring the profession or the administration of justice into disrepute.

3.02 MARKETING

Marketing Legal Services

3.02 (1) In this Rule, "marketing" includes advertisements and other similar communications in various media as well as firm names (including trade names), letterhead, business cards and logos.

(2) A lawyer may market legal services if the marketing

(a) is demonstrably true, accurate and verifiable,

(b) is neither misleading, confusing, or deceptive, nor likely to mislead, confuse or deceive, and

(c) is in the best interests of the public and is consistent with a high standard of professionalism.

Commentary

Examples of marketing that may contravene this rule include:

a. stating an amount of money that the lawyer has recovered for a client or referring to the lawyer's degree of success in past cases, unless such statement is accompanied by a further statement that past results are not necessarily indicative of future results and that the amount recovered and other litigation outcomes will vary according to the facts in individual cases;

b. suggesting qualitative superiority to other lawyers;

c. raising expectations unjustifiably;

d. suggesting or implying the lawyer is aggressive;

e. disparaging or demeaning other persons, groups, organizations or institutions;

f. taking advantage of a vulnerable person or group;

g. using testimonials or endorsements which contain emotional appeals.

Advertising of Fees

(3) A lawyer may advertise fees charged by the lawyer for legal services if

(a) the advertising is reasonably precise as to the services offered for each fee quoted,

(b) the advertising states whether other amounts, such as disbursements and taxes, will be charged in addition to the fee, and

(c) the lawyer adheres to the advertised fee.

3.03 ADVERTISING NATURE OF PRACTICE

Certified Specialist

3.03 (1) A lawyer may advertise that the lawyer is a specialist in a specified field only if the lawyer has been so certified by the Society.

Commentary

Lawyer's advertisements may be designed to provide information to assist a potential client to choose a lawyer who has the appropriate skills and knowledge for the client's particular legal matter.

In accordance with s. 20(1) of the Society's By-law 15 on Certified Specialists, the lawyer who is not a certified specialist is not permitted to use any designation from which a person might reasonably conclude that the lawyer is a certified specialist.

In a case where a firm practises in more than one jurisdiction, some of which certify or recognize specialization, an advertisement by such a firm which makes reference to the status of a firm member as a specialist, in media circulated concurrently in the other jurisdiction(s) and the certifying jurisdiction, shall not be considered as offending this rule if the certifying authority or organization is identified.

A lawyer may advertise areas of practice, including preferred areas of practice or that his or her practice is restricted to a certain area of law. An advertisement may also include a description of the lawyer's or law firm's proficiency or experience in an area of law. In all cases, the representations made must be accurate (that is, demonstrably true) and must not be misleading.

3.04 Interprovincial Law Firms

Interprovincial Law Firms

3.04 (1) Lawyers may enter into agreements with lawyers in other Canadian jurisdictions to form an interprovincial law firm, so long as they comply with the requirements of this rule.

Requirements

(2) A lawyer who is a member of an interprovincial law firm and qualified to practise in Ontario shall comply with all the requirements of the Society.

(3) A lawyer who is a member of an interprovincial law firm and qualified to practise in Ontario shall ensure that the books, records, and accounts pertaining to the practice in Ontario are available in Ontario on demand by the Society's auditors or their designated agents.

(4) A lawyer who is a member of an interprovincial law firm and qualified to practise in Ontario shall ensure that his or her partners, associates, or employees who are not qualified to practise in Ontario are not held out as and do not represent themselves as qualified to practise in Ontario.

[Amended - November 2008]

Rule 4 Relationship to the Administration of Justice

4.01 THE LAWYER AS ADVOCATE

Advocacy

4.01 (1) When acting as an advocate, a lawyer shall represent the client resolutely and honourably within the limits of the law while treating the tribunal with candour, fairness, courtesy, and respect.

Commentary

The lawyer has a duty to the client to raise fearlessly every issue, advance every argument, and ask every question, however distasteful, which the lawyer thinks will help the client's case and to endeavour to obtain for the client the benefit of every remedy and defence authorized by law. The lawyer must discharge this duty by fair and honourable means, without illegality and in a manner that is consistent with the lawyer's duty to treat the tribunal with candour, fairness, courtesy and respect and in a way that promotes the parties' right to a fair hearing where justice can be done. Maintaining dignity, decorum, and courtesy in the courtroom is not an empty formality because, unless order is maintained, rights cannot be protected.

This rule applies to the lawyer as advocate, and therefore extends not only to court proceedings but also to appearances and proceedings before boards, administrative tribunals, arbitrators, mediators, and others who resolve disputes, regardless of their function or the informality of their procedures.

Role in Adversary Proceedings - In adversary proceedings the lawyer's function as advocate is openly and necessarily partisan. Accordingly, the lawyer is not obliged (save as required by law or under these rules and subject to the duties of a prosecutor set out below) to assist an adversary or advance matters derogatory to the client's case.

In adversary proceedings that will likely affect the health, welfare, or security of a child, a lawyer should advise the client to take into account the best interests of the child, where this can be done without prejudicing the legitimate interests of the client.

When acting as an advocate, a lawyer should refrain from expressing the lawyer's personal opinions on the merits of a client's case.

When opposing interests are not represented, for example, in without notice or uncontested matters or in other situations where the full proof and argument inherent in the adversary system cannot be achieved, the lawyer must take particular care to be accurate, candid, and comprehensive in presenting the client's case so as to ensure that the tribunal is not misled.

Duty as Defence Counsel - When defending an accused person, a lawyer's duty is to protect the client as far as possible from being convicted except by a tribunal of competent jurisdiction and upon legal evidence sufficient to support a conviction for the offence with which the client is charged. Accordingly, and notwithstanding the lawyer's private opinion on credibility or the merits, a lawyer may properly rely on any evidence or defences including so-called technicalities not known to be false or fraudulent.

Admissions made by the accused to a lawyer may impose strict limitations on the conduct of the defence, and the accused should be made aware of this. For example, if the accused clearly admits to the lawyer the factual and mental elements necessary to constitute the offence, the lawyer, if convinced that the admissions are true and voluntary, may properly take objection to the jurisdiction of the court, or to the form of the indictment, or to the admissibility or sufficiency of the evidence, but must not suggest that some other person committed the offence or call any evidence which, by reason of the admissions, the lawyer believes to be false. Nor may the lawyer set up an affirmative case inconsistent with such admissions, for example, by calling evidence in support of an alibi intended to show that the accused could not have done or, in fact, has not done the act. Such admissions will also impose a limit on the extent to which the lawyer may attack the evidence for the prosecution. The lawyer is entitled to test the evidence given by each individual witness for the prosecution and argue that the evidence taken as a whole is insufficient to amount to proof that the accused is guilty of the offence charged, but the lawyer should go no further than that.

The lawyer should never waive or abandon the client's legal rights, for example, an available defence under a statute of limitations, without the client's informed consent.

In civil matters, it is desirable that the lawyer should avoid and discourage the client from resorting to frivolous or vexatious objections, or from attempts to gain advantage from slips or oversights not going to the merits, or from tactics that will merely delay or harass the other side. Such practices can readily bring the administration of justice and the legal profession into disrepute.

In civil proceedings, the lawyer has a duty not to mislead the tribunal about the position of the client in the adversary process. Thus, a lawyer representing a party to litigation who has made an agreement or is party to an agreement made before or during the trial by which a plaintiff is guaranteed recovery by one or more parties notwithstanding the judgment of the court, should immediately reveal the existence and particulars of the agreement to the court and to all parties to the proceedings.

(2) When acting as an advocate, a lawyer shall not

(a) abuse the process of the tribunal by instituting or prosecuting proceedings which, although legal in themselves, are clearly motivated by malice on the part of the client and are brought solely for the purpose of injuring the other party,

(b) knowingly assist or permit the client to do anything that the lawyer considers to be dishonest or dishonourable,

(c) appear before a judicial officer when the lawyer, the lawyer's associates or the client have business or personal relationships with the officer that give rise to or might reasonably appear to give rise to pressure, influence, or inducement affecting the impartiality of the officer,

(d) endeavour or allow anyone else to endeavour, directly or indirectly, to influence the decision or action of a tribunal or any of its officials in any case or matter by any means other than open persuasion as an advocate,

(e) knowingly attempt to deceive a tribunal or influence the course of justice by offering false evidence, misstating facts or law, presenting or relying upon a false or deceptive affidavit, suppressing what ought to be disclosed, or otherwise assisting in any fraud, crime, or illegal conduct,

(f) knowingly misstate the contents of a document, the testimony of a witness, the substance of an argument, or the provisions of a statute or like authority,

(g) knowingly assert as true a fact when its truth cannot reasonably be supported by the evidence or as a matter of which notice may be taken by the tribunal,

(h) deliberately refrain from informing the tribunal of any binding authority that the lawyer considers to be directly on point and that has not been mentioned by an opponent,

(i) dissuade a witness from giving evidence or advise a witness to be absent,

(j) knowingly permit a witness or party to be presented in a false or misleading way or to impersonate another,

(k) needlessly abuse, hector, or harass a witness,

(l) when representing a complainant or potential complainant, attempt to gain a benefit for the complainant by threatening the laying of a criminal charge or by offering to seek or to procure the withdrawal of a criminal charge, and

(m) needlessly inconvenience a witness.

Commentary

A lawyer representing an accused or potential accused may communicate with a complainant or potential complainant, for example, to obtain factual information, to arrange for restitution or an apology from the accused, or to defend or settle any civil claims between the accused and the complainant. However, where the complainant or potential complaint is vulnerable, the lawyer must take care not to take unfair or improper advantage of the circumstances. Where the complainant or potential complainant is unrepresented, the lawyer should be governed by the rules about unrepresented persons and make it clear that the lawyer is acting exclusively in the interests of the accused or potential accused and, accordingly, the lawyer's comments may be partisan. When communicating with an unrepresented complainant or potential complainant, it is prudent to have a witness present.

Duty as Prosecutor

(3) When acting as a prosecutor, a lawyer shall act for the public and the administration of justice resolutely and honourably within the limits of the law while treating the tribunal with candour, fairness, courtesy, and respect.

Commentary

When engaged as a prosecutor, the lawyer's prime duty is not to seek to convict but to see that justice is done through a fair trial on the merits. The prosecutor exercises a public function involving much discretion and power and must act fairly and dispassionately. The prosecutor should not do anything that might prevent the accused from being represented by counsel or communicating with counsel and, to the extent required by law and accepted practice, should make timely disclosure to defence counsel or directly to an unrepresented accused of all relevant and known facts and witnesses, whether tending to show guilt or innocence.

Discovery Obligations

(4) Where the rules of a tribunal require the parties to produce documents or attend on examinations for discovery, a lawyer, when acting as an advocate

(a) shall explain to his or her client

(i) the necessity of making full disclosure of all documents relating to any matter in issue, and

(ii) the duty to answer to the best of his or her knowledge, information, and belief, any proper question relating to any issue in the action or made discoverable by the rules of court or the rules of the tribunal,

(b) shall assist the client in fulfilling his or her obligations to make full disclosure, and

(c) shall not make frivolous requests for the production of documents or make frivolous demands for information at the examination for discovery.

Disclosure of Error or Omission

(5) A lawyer who has unknowingly done or failed to do something that if done or omitted knowingly would have been in breach of this rule and who discovers it, shall, subject to rule 2.03 (Confidentiality), disclose the error or omission and do all that can reasonably be done in the circumstances to rectify it.

Commentary

If the client desires that a course be taken that would involve a breach of this rule, the lawyer must refuse and do everything reasonably possible to prevent it. If that cannot be done the lawyer should, subject to rule 2.09 (Withdrawal from Representation), withdraw or seek leave to do so.

Courtesy

(6) A lawyer shall be courteous, civil, and act in good faith to the tribunal and with all persons with whom the lawyer has dealings in the course of litigation.

> Commentary
>
> Legal contempt of court and the professional obligation outlined here are not identical, and a consistent pattern of rude, provocative, or disruptive conduct by the lawyer, even though unpunished as contempt, might well merit discipline.

Undertakings

(7) A lawyer shall strictly and scrupulously carry out an undertaking given to the tribunal or to another legal practitioner in the course of litigation.

[Amended – June 2009]

> Commentary
>
> Unless clearly qualified, the lawyer's undertaking is a personal promise and responsibility.

Agreement on Guilty Plea

(8) Before a charge is laid or at any time after a charge is laid, a lawyer for an accused or potential accused may discuss with the prosecutor the possible disposition of the case, unless the client instructs otherwise.

(9) Where, following investigation,

(a) a lawyer for an accused or potential accused advises his or her client about the prospects for an acquittal or finding of guilt,

(b) the lawyer advises the client of the implications and possible consequences of a guilty plea and particularly of the sentencing authority and discretion of the court, including the fact that the court is not bound by any agreement about a guilty plea,

(c) the client voluntarily is prepared to admit the necessary factual and mental elements of the offence charged, and

(d) the client voluntarily instructs the lawyer to enter into an agreement as to a guilty plea,

the lawyer may enter into an agreement with the prosecutor about a guilty plea.

Commentary

The public interest in the proper administration of justice should not be sacrificed in the interest of expediency.

4.02 THE LAWYER AS WITNESS

Submission of Affidavit

4.02 (1) Subject to any contrary provisions of the law or the discretion of the tribunal before which a lawyer is appearing, a lawyer who appears as advocate shall not submit his or her own affidavit to the tribunal.

Submission of Testimony

(2) Subject to any contrary provisions of the law or the discretion of the tribunal before which a lawyer is appearing, a lawyer who appears as advocate shall not testify before the tribunal unless permitted to do so by the rules of court or the rules of procedure of the tribunal, or unless the matter is purely formal or uncontroverted.

Commentary

A lawyer should not express personal opinions or beliefs or assert as a fact anything that is properly subject to legal proof, cross-examination, or challenge. The lawyer should not in effect appear as an unsworn witness or put the lawyer's own credibility in issue. The lawyer who is a necessary witness should testify and entrust the conduct of the case to another lawyer. There are no restrictions on the advocate's right to cross-examine another lawyer, however, and the lawyer who does appear as a witness should not expect to receive special treatment because of professional status.

Appeals

(3) A lawyer who is a witness in proceedings shall not appear as advocate in any appeal from the decision in those proceedings.

4.03 INTERVIEWING WITNESSES

Interviewing Witnesses

4.03 Subject to the rules on communication with a represented party set out in subrules 6.03(7),(8) and (9), a lawyer may seek information from any potential witness, whether under subpoena or not, but the lawyer shall disclose the lawyer's interest and take care not to subvert or suppress any evidence or procure the witness to stay out of the way.

[Amended – November 2007]

4.04 COMMUNICATION WITH WITNESSES GIVING EVIDENCE

Communication with Witnesses Giving Evidence

4.04 Subject to the direction of the tribunal, the lawyer shall observe the following rules respecting communication with witnesses giving evidence:

(a) during examination-in-chief, the examining lawyer may discuss with the witness any matter that has not been covered in the examination up to that point,

(b) during examination-in-chief by another legal practitioner of a witness who is unsympathetic to the lawyer's cause, the lawyer not conducting the examination-in-chief may discuss the evidence with the witness,

(c) between completion of examination-in-chief and commencement of cross-examination of the lawyer's own witness, the lawyer ought not to discuss the evidence given in chief or relating to any matter introduced or touched on during the examination-in-chief,

(d) during cross-examination by an opposing legal practitioner, the witness's own lawyer ought not to have any conversation with the witness about the witness's evidence or any issue in the proceeding,

(e) between completion of cross-examination and commencement of re-examination, the lawyer who is going to re-examine the witness ought not to have any discussion about evidence that will be dealt with on re-examination,

(f) during cross-examination by the lawyer of a witness unsympathetic to the cross-examiner's cause, the lawyer may discuss the witness's evidence with the witness,

(g) during cross-examination by the lawyer of a witness who is sympathetic to that lawyer's cause, any conversations ought to be restricted in the same way as communications during examination-in-chief of one's own witness, and

(h) during re-examination of a witness called by an opposing legal practitioner, if the witness is sympathetic to the lawyer's cause the lawyer ought not to discuss the evidence to be given by that witness during re-examination. The lawyer may, however, properly discuss the evidence with a witness who is adverse in interest.

[Amended – June 2009]

Commentary

If any question arises whether the lawyer's behaviour may be in violation of this rule, it will often be appropriate to obtain the consent of the opposing legal practitioner or leave of the tribunal before engaging in conversations that may be considered improper.

This rule applies with necessary modifications to examinations out of court.

[Amended – June 2009]

4.05 RELATIONS WITH JURORS

Communications Before Trial

4.05 (1) When acting as an advocate, before the trial of a case, a lawyer shall not communicate with or cause another to communicate with anyone that the lawyer knows to be a member of the jury panel for that trial.

Commentary

A lawyer may investigate a prospective juror to ascertain any basis for challenge, provided that the lawyer does not directly or indirectly communicate with the juror or with any member of the juror's family. But a lawyer should not conduct or cause another, by financial support or otherwise, to conduct a vexatious or harassing investigation of either a member of the jury panel or a juror.

Disclosure of Information

(2) When acting as an advocate, a lawyer shall disclose to the judge and opposing counsel any information of which the lawyer is aware that a juror or prospective juror

(a) has or may have an interest, direct or indirect, in the outcome of the case,

(b) is acquainted with or connected in any manner with the presiding judge, any counsel or any litigant, or

(c) is acquainted with or connected in any manner with any person who has appeared or who is expected to appear as a witness,

unless the judge and opposing counsel have previously been made aware of the information.

(3) A lawyer should promptly disclose to the court any information that the lawyer has about improper conduct by a member of a jury panel or by a juror toward another member of the jury panel, another juror, or to the members of a juror's family.

Communication During Trial

(4) Except as permitted by law, when acting as an advocate, a lawyer shall not during a trial of a case communicate with or cause another to communicate with any member of the jury.

(5) A lawyer who is not connected with a case before the court shall not communicate with or cause another to communicate with any member of the jury about the case.

Commentary

The restrictions on communications with a juror or potential juror should also apply to communications with or investigations of members of his or her family.

4.06 THE LAWYER AND THE ADMINISTRATION OF JUSTICE

Encouraging Respect for the Administration of Justice

4.06 (1) A lawyer shall encourage public respect for and try to improve the administration of justice.

Commentary

The obligation outlined in the rule is not restricted to the lawyer's professional activities but is a general responsibility resulting from the lawyer's position in the community. A lawyer's responsibilities are greater than those of a private citizen. A lawyer should take care not to weaken or destroy public confidence in legal institutions or authorities by irresponsible allegations. The lawyer in public life should be particularly careful in this regard because the mere fact of being a lawyer will lend weight and credibility to public statements. Yet for the same reason, a lawyer should not hesitate to speak out against an injustice.

The admission to and continuance in the practice of law implies on the part of a lawyer a basic commitment to the concept of equal justice for all within an open, ordered, and impartial system. However, judicial institutions will not function effectively unless they command the respect of the public, and because of changes in human affairs and imperfections in human institutions, constant efforts must be made to improve the administration of justice and thereby maintain public respect for it.

Criticizing Tribunals - Although proceedings and decisions of tribunals are properly subject to scrutiny and criticism by all members of the public, including lawyers, judges and members of tribunals are often prohibited by law or custom from defending themselves. Their inability to do so imposes special responsibilities upon lawyers. First, a lawyer should avoid criticism that is petty, intemperate, or unsupported by a *bona fide* belief in its real merit, bearing in mind that in the eyes of the public, professional knowledge lends weight to the lawyer's judgments or criticism. Second, if a lawyer has been involved in the proceedings, there is the risk that any criticism may be, or may appear to be, partisan rather than objective. Third, where a tribunal is the object of unjust criticism, a lawyer, as a participant in the administration of justice, is uniquely able to and should support the tribunal, both because its members cannot defend themselves and because in doing so the lawyer is contributing to greater public understanding of and therefore respect for the legal system.

A lawyer, by training, opportunity, and experience is in a position to observe the workings and discover the strengths and weaknesses of laws, legal institutions, and public authorities. A lawyer should, therefore, lead in seeking improvements in the legal system, but any criticisms and proposals should be *bona fide* and reasoned.

Seeking Legislative or Administrative Changes

(2) A lawyer who seeks legislative or administrative changes shall disclose the interest being advanced, whether the lawyer's interest, the client's interest, or the public interest.

Commentary

The lawyer may advocate legislative or administrative changes on behalf of a client although not personally agreeing with them, but the lawyer who purports to act in the public interest should espouse only those changes that the lawyer conscientiously believes to be in the public interest.

Security of Court Facilities

(3) A lawyer who has reasonable grounds for believing that a dangerous situation is likely to develop at a court facility shall inform the local police force and give particulars.

Commentary

Where possible, the lawyer should suggest solutions to the anticipated problem such as (a) the necessity for further security, and (b) that judgment ought to be reserved.

Where possible, the lawyer should also notify other lawyers who are known to be involved in proceedings at the court facility where the dangerous situation is likely to develop. Beyond providing a warning of danger, this notice is desirable because it may allow them to suggest security measures that do not interfere with an accused's or a party's right to a fair trial.

If client information is involved in those situations, the lawyer should be guided by the provisions of rule 2.03 (Confidentiality).

4.07 LAWYERS AS MEDIATORS

Role of Mediator

4.07 A lawyer who acts as a mediator shall, at the outset of the mediation, ensure that the parties to it understand fully that

(a) the lawyer is not acting as a lawyer for either party but, as mediator, is acting to assist the parties to resolve the matters in issue, and

(b) although communications pertaining to and arising out of the mediation process may be covered by some other common law privilege, they will not be covered by the solicitor-client privilege.

Commentary

In acting as a mediator, generally a lawyer should not give legal advice as opposed to legal information to the parties during the mediation process.

Generally, neither the lawyer-mediator nor a partner or associate of the lawyer-mediator should render legal representation or give legal advice to either party to the mediation, bearing in mind the provisions of rule 2.04 (Avoidance of Conflicts of Interest) and its commentaries and the common law authorities.

Generally a lawyer-mediator should suggest and encourage the parties to seek the advice of separate counsel before and during the mediation process if they have not already done so.

Where in the mediation process the lawyer-mediator prepares a draft contract for the consideration of the parties, the lawyer-mediator should expressly advise and encourage them to seek separate independent legal representation concerning the draft contract.

Rule 5 Relationship to Students, Employees, and Others

5.01 SUPERVISION

Application

5.01 (1) In this rule, a non-lawyer does not include an articled student.

Direct Supervision required

(2) A lawyer shall in accordance with the By-Laws

(a) assume complete professional responsibility for his or her practice of law, and

(b) shall directly supervise non-lawyers to whom particular tasks and functions are assigned.

Commentary

By-Law 7.1 governs the circumstances in which a lawyer may assign certain tasks and functions to a non-lawyer within a law practice. Where a non-lawyer is competent to do work under the supervision of a lawyer, a lawyer may assign work to the non-lawyer. The non-lawyer must be directly supervised by the lawyer. A lawyer is required to review the non-lawyer's work at frequent intervals to ensure its proper and timely completion.

A lawyer may permit a non-lawyer to perform tasks assigned and supervised by the lawyer as long as the lawyer maintains a direct relationship with the client or, if the lawyer is in a community legal clinic funded by Legal Aid Ontario, as long as the lawyer maintains a direct supervisory relationship with each client's case in accordance with the supervision requirements of Legal Aid Ontario and assumes full professional responsibility for the work.

A lawyer who practices alone or operates a branch or part-time office should ensure that all matters requiring a lawyer's professional skill and judgment are dealt with by a lawyer qualified to do the work and that legal advice is not given by unauthorized persons, whether in the lawyer's name or otherwise.

A lawyer should ensure that the non-lawyer is identified as such when communicating orally or in writing with clients, licensees, public officials, or with the public generally whether within or outside the offices of the law practice.

The following examples, which are not exhaustive, illustrate situations where it may be appropriate to assign work to non-lawyers subject to direct supervision.

Real Estate – A lawyer may permit a non-lawyer to attend to all matters of routine administration, assist in more complex transactions, draft statements of account and routine documents and correspondence and attend to registrations. The lawyer must not assign to a non-lawyer the ultimate responsibility for review of a title search report or of documents before signing or for review and signing of a letter of requisition, review and signing of a title opinion or review and signing of a reporting letter to the client.

In real estate transactions using the system for the electronic registration of title documents ("e-reg" TM), only a lawyer may sign for completeness of any document that requires compliance with law statements.

Corporate and Commercial – A lawyer may permit a non-lawyer to attend to all matters of routine administration and to assist in more complex matters and to draft routine documents and correspondence relating to corporate, commercial, and securities matters such as drafting corporate minutes and documents pursuant to corporation statutes, security instruments, security registration documents and contracts of all kinds, closing documents and statements of account, and to attend on filings.

Wills, Trusts and Estates – A lawyer may permit a non-lawyer to attend to all matters of routine administration, to assist in more complex matters, to collect information, draft routine documents and correspondence, to prepare income tax returns, to calculate such taxes, to draft executors' accounts and statements of account, and to attend to filings.

[New- November 2007]

Electronic Registration of Title Documents

(3) When a lawyer has a personalized specially encrypted diskette to access the system for the electronic registration of title documents ("e-reg" TM), the lawyer

(a) shall not permit others, including a non-lawyer employee, to use the lawyer's diskette, and

(b) shall not disclose his or her personalized e-reg TM pass phrase to others.

(4) When a non-lawyer employed by a lawyer has a personalized specially encrypted diskette to access the system for the electronic registration of title documents, the lawyer shall ensure that the non-lawyer

(a) does not permit others to use the diskette, and

(b) does not disclose his or her personalized e-reg TM pass phrase to others.

Commentary

The implementation across Ontario of a system for the electronic registration of title documents imposes special responsibilities on lawyers and others using the system. Each person in a law office who accesses the e-reg ™ system must have a personalized specially encrypted diskette and personalized e-reg ™ pass phrase. The integrity and security of the system is achieved, in part, by its maintaining a record of those using the system for any transactions. Moreover, under the system, only lawyers entitled to practise law may make certain prescribed statements. Statements professing compliance with law without registration of supporting documents may be made only by lawyers in good standing. Only lawyers entitled to practise law may approve electronic documents containing these statements. It is, therefore, important that lawyers should maintain and ensure the security and the exclusively personal use of the personalized specially encrypted diskette used to access the system and the personalized electronic registration pass phrase. When in a real estate practice it is permissible for a lawyer to delegate responsibilities to a non-lawyer who has a personalized specially encrypted diskette and a personalized electronic registration pass phrase, the lawyer should ensure that the non-lawyer maintains and understands the importance of maintaining the security of the personalized specially encrypted diskette and the pass phrase.

In real estate transactions using the e-reg ™ system, a lawyer who approves the electronic registration of title documents by a non-lawyer is responsible for the content of any document that contains the electronic signature of the non-lawyer.

[Amended – November 2007]

Title Insurance

(5) A lawyer shall not permit a non-lawyer to

(a) provide advice to the client concerning any insurance, including title insurance, without supervision,

(b) present insurance options or information regarding premiums to the client without supervision,

(c) recommend one insurance product over another without supervision, and

(d) give legal opinions regarding the insurance coverage obtained.

[New - March 31, 2008]

Signing E-Reg™ Documents

(6) A lawyer who electronically signs a document using the system for the electronic registration of title documents – e-reg™ – assumes complete professional responsibility for the document.

[New - March 31, 2008]

5.02 STUDENTS

Recruitment Procedures

5.02 (1) A lawyer shall observe the procedures of the Society about the recruitment of articling students and the engagement of summer students.

Duties of Principal

(2) A lawyer acting as a principal to a student shall provide the student with meaningful training and exposure to and involvement in work that will provide the student with knowledge and experience of the practical aspects of the law, together with an appreciation of the traditions and ethics of the profession.

Duties of Articling Student

(3) An articling student shall act in good faith in fulfilling and discharging all the commitments and obligations arising from the articling experience.

5.03 SEXUAL HARASSMENT

Definition

5.03 (1) In this rule, sexual harassment is one incident or a series of incidents involving unwelcome sexual advances, requests for sexual favours, or other verbal or physical conduct of a sexual nature

(a) when such conduct might reasonably be expected to cause insecurity, discomfort, offence, or humiliation to the recipient(s) of the conduct,

(b) when submission to such conduct is made implicitly or explicitly a condition for the provision of professional services,

(c) when submission to such conduct is made implicitly or explicitly a condition of employment,

(d) when submission to or rejection of such conduct is used as a basis for any employment decision (including, but not limited to, allocation of files, matters of promotion, raise in salary, job security, and benefits affecting the employee), or

(e) when such conduct has the purpose or the effect of interfering with a person's work performance or creating an intimidating, hostile, or offensive work environment.

Commentary

Types of behaviour that constitute sexual harassment include, but are not limited to,

(a) sexist jokes causing embarrassment or offence, or that are by their nature clearly embarrassing or offensive,

[Amended - January 2009]

(b) leering,

(c) the display of sexually offensive material,

(d) sexually degrading words used to describe a person,

(e) derogatory or degrading remarks directed towards members of one sex or one's sexual orientation,

(f) sexually suggestive or obscene comments or gestures,

(g) unwelcome inquiries or comments about a person's sex life,

(h) unwelcome sexual flirtations, advances, or propositions,

(i) persistent unwanted contact or attention after the end of a consensual relationship,

(j) requests for sexual favours,

(k) unwanted touching,

(l) verbal abuse or threats, and

(m) sexual assault.

Sexual harassment can occur in the form of behaviour by men towards women, between men, between women, or by women towards men.

Prohibition on Sexual Harassment

(2) A lawyer shall not sexually harass a colleague, a staff member, a client, or any other person.

5.04 DISCRIMINATION

Special Responsibility

5.04 (1) A lawyer has a special responsibility to respect the requirements of human rights laws in force in Ontario and, specifically, to honour the obligation not to discriminate on the grounds of race, ancestry, place of origin, colour, ethnic origin, citizenship, creed, sex, sexual orientation, age, record of offences (as defined in the Ontario Human Rights Code), marital status, family status, or disability with respect to professional employment of other lawyers, articled students, or any other person or in professional dealings with other licensees or any other person.

[Amended – June 2007]

Commentary

The Society acknowledges the diversity of the community of Ontario in which lawyers serve and expects them to respect the dignity and worth of all persons and to treat all persons equally without discrimination.

This rule sets out the special role of the profession to recognize and protect the dignity of individuals and the diversity of the community in Ontario.

Rule 5.04 will be interpreted according to the provisions of the Ontario Human Rights Code and related case law.

The Ontario Human Rights Code defines a number of grounds of discrimination listed in rule 5.04. For example,

Age is defined as an age that is eighteen years or more.

[Amended - January 2009]

Disability is broadly defined in s. 10 of the Code to include both physical and mental disabilities.

[Amended - January 2009]

Family status is defined as the status of being in a parent-and-child relationship.

Marital status is defined as the status of being married, single, widowed, divorced, or separated and includes the status of living with a person in a conjugal relationship outside marriage.

[Amended - January 2009]

Record of offences is defined such that a prospective employer may not discriminate on the basis of a pardoned criminal offence (a pardon must have been granted under the Criminal Records Act (Canada) and not revoked) or provincial offences.

The right to equal treatment without discrimination because of sex includes the right to equal treatment without discrimination because a woman is or may become pregnant.

There is no statutory definition of discrimination. Supreme Court of Canada jurisprudence defines discrimination as including

(a) Differentiation on prohibited grounds that creates a disadvantage. Lawyers who refuse to hire employees of a particular race, sex, creed, sexual orientation, etc. would be differentiating on the basis of prohibited grounds.

[Amended - January 2009]

(b) Adverse effect discrimination. An action or policy that is not intended to be discriminatory can result in an adverse effect that is discriminatory. If the application of a seemingly "neutral" rule or policy creates an adverse effect on a group protected by rule 5.04, there is a duty to accommodate. For example, while a requirement that all articling students have a driver's licence to permit them to travel wherever their job requires may seem reasonable, that requirement should only be imposed if driving a vehicle is an essential requirement for the position. Such a requirement may have the effect of excluding from employment persons with disabilities that prevent them from obtaining a licence.

[Amended - January 2009]

Human rights law in Ontario includes as discrimination, conduct which, though not intended to discriminate, has an adverse impact on individuals or groups on the basis of the prohibited grounds. The Ontario Human Rights Code requires that the affected individuals or groups must be accommodated unless to do so would cause undue hardship.

A lawyer should take reasonable steps to prevent or stop discrimination by any staff or agent who is subject to the lawyer's direction or control.

Ontario human rights law excepts from discrimination special programs designed to relieve disadvantage for individuals or groups identified on the basis of the grounds noted in the Code.

In addition to prohibiting discrimination, rule 5.04 prohibits harassment on the ground of race, ancestry, place of origin, colour, ethnic origin, citizenship, creed, sex, sexual orientation, age, record of offences, marital status, family status, or disability. Harassment by superiors, colleagues, and co-workers is also prohibited.

[Amended - January 2009]

Harassment is defined as "engaging in a course of vexatious comment or conduct that is known or ought reasonably to be known to be unwelcome" on the basis of any ground set out in rule 5.04. This could include, for example, repeatedly subjecting a client or colleague to jokes based on race or creed.

Services

(2) A lawyer shall ensure that no one is denied services or receives inferior service on the basis of the grounds set out in this rule.

Employment Practices

(3) A lawyer shall ensure that his or her employment practices do not offend this rule.

Commentary

Discrimination in employment or in the provision of services not only fails to meet professional standards, it also violates the Ontario Human Rights Code and related equity legislation.

In advertising a job vacancy, an employer may not indicate qualifications by a prohibited ground of discrimination. However, where discrimination on a particular ground is permitted because of an exception under the Ontario Human Rights Code, such questions may be raised at an interview. For example, if an employer has an anti-nepotism policy, the employer may inquire about the applicant's possible relationship to another employee as that employee's spouse, child or parent. This is in contrast to questions about applicant's marital status by itself. Since marital status has no relevance to employment within a law firm, questions about marital status should not be asked.

[Amended - January 2009]

An employer should consider the effect of seemingly "neutral" rules. Some rules, while applied to everyone, can bar entry to the firm or pose additional hardships on employees of one sex or of a particular creed, ethnic origin, marital or family status, or on those who have (or develop) disabilities. For example, a law office may have a written or unwritten dress code. It would be necessary to revise the dress code if it does not already accept that a head covering worn for religious reasons must be considered part of acceptable business attire. The maintenance of a rule with a discriminatory effect breaches rule 5.04 unless changing or eliminating the rule would cause undue hardship.

If an applicant cannot perform all or part of an essential job requirement because of a personal characteristic listed in the Ontario Human Rights Code, the employer has a duty to accommodate. Only if the applicant cannot do the essential task with reasonable accommodation may the employer refuse to hire on this basis. A range of appropriate accommodation measures may be considered. An accommodation is considered reasonable unless it would cause undue hardship.

The Supreme Court of Canada has confirmed that what is required is equality of result, not just of form. Differentiation can result in inequality, but so too can the application of the same rule to everyone, without regard for personal characteristics and circumstances. Equality of result requires the accommodation of differences that arise from the personal characteristics cited in rule 5.04.

The nature of accommodation as well as the extent to which the duty to accommodate might apply in any individual case are developing areas of human rights law. However, the following principles are well established.

If a rule, requirement, or expectation creates difficulty for an individual because of factors related to the personal characteristics noted in rule 5.04, the following obligations arise:

The rule, requirement or expectation must be examined to determine whether it is "reasonable and *bona fide*." If the rule, requirement, or expectation is not imposed in good faith and is not strongly and logically connected to a business necessity, it cannot be maintained. There must be objectively verifiable evidence linking the rule, requirement, or expectation with the operation of the business.

If the rule, requirement, or expectation is imposed in good faith and is strongly logically connected to a business necessity, the next step is to consider whether the individual who is disadvantaged by the rule can be accommodated.

The duty to accommodate operates as both a positive obligation and as a limit to obligation. Accommodation must be offered to the point of undue hardship. Some hardship must be tolerated to promote equality; however, if the hardship occasioned by the particular accommodation at issue is "undue," that accommodation need not be made.

Rule 6 Relationship to the Society and Other Lawyers

6.01 RESPONSIBILITY TO THE PROFESSION GENERALLY

Integrity

6.01 (1) A lawyer shall conduct himself or herself in such a way as to maintain the integrity of the profession.

> Commentary
>
> Integrity is the fundamental quality of any person who seeks to practise as a lawyer. If a client has any doubt about his or her lawyer's trustworthiness, the essential element in the true lawyer-client relationship will be missing. If integrity is lacking, the lawyer's usefulness to the client and reputation within the profession will be destroyed regardless of how competent the lawyer may be.
>
> Public confidence in the administration of justice and in the legal profession may be eroded by a lawyer's irresponsible conduct. Accordingly, a lawyer's conduct should reflect credit on the legal profession, inspire the confidence, respect and trust of clients and the community, and avoid even the appearance of impropriety.
>
> *[Amended – June 2007]*

Meeting Financial Obligations

(2) A lawyer shall promptly meet financial obligations incurred in the course of practice on behalf of clients unless, before incurring such an obligation, the lawyer clearly indicates in writing to the person to whom it is to be owed that it is not to be a personal obligation.

[Amended - January 2009]

> Commentary
>
> In order to maintain the honour of the Bar, lawyers have a professional duty (quite apart from any legal liability) to meet financial obligations incurred, assumed, or undertaken on behalf of clients unless, the lawyer clearly indicates otherwise in advance.
>
> *[Amended - January 2009]*
>
> When a lawyer retains a consultant, expert, or other professional, the lawyer should clarify the terms of the retainer in writing, including specifying the fees, the nature of the services to be provided, and the person responsible for payment. If the lawyer is not responsible for the payment of the fees, the lawyer should help in making satisfactory arrangements for payment if it is reasonably possible to do so.

If there is a change of lawyer, the lawyer who originally retained a consultant, expert, or other professional should advise him or her about the change and provide the name, address, telephone number, fax number, and e-mail address of the new lawyer.

Duty to Report Misconduct

(3) A lawyer shall report to the Society, unless to do so would be unlawful or would involve a breach of solicitor-client privilege,

(a) the misappropriation or misapplication of trust monies,

(b) the abandonment of a law or legal services practice,

(c) participation in serious criminal activity related to a licensee's practice,

(d) the mental instability of a licensee of such a serious nature that the licensee's clients are likely to be severely prejudiced, and

(e) any other situation where a licensee's clients are likely to be severely prejudiced.

[Amended – June 2007]

Commentary

Unless a licensee who departs from proper professional conduct is checked at an early stage, loss or damage to clients or others may ensue. Evidence of minor breaches may, on investigation, disclose a more serious situation or may indicate the commencement of a course of conduct that may lead to serious breaches in the future. It is, therefore, proper (unless it is privileged or otherwise unlawful) for a lawyer to report to the Society any instance involving a breach of these rules or the rules governing paralegals. If a lawyer is in any doubt whether a report should be made, the lawyer should consider seeking the advice of the Society directly or indirectly (e.g., through another lawyer).

Nothing in this paragraph is meant to interfere with the traditional solicitor-client relationship. In all cases the report must be made *bona fide* without malice or ulterior motive.

[Amended – June 2007]

Often, instances of improper conduct arise from emotional, mental, or family disturbances or substance abuse. Lawyers who suffer from such problems should be encouraged to seek assistance as early as possible. The Society supports the Ontario Lawyers' Assistance Program (OLAP), and other support groups in their commitment to the provision of confidential counselling. Therefore, lawyers acting in the capacity of counsellors for OLAP and other support groups will not be called by the Society or by any investigation committee to testify at any conduct, capacity, or competence hearing without the consent of the lawyer from whom the information was received. Notwithstanding the above, a lawyer counselling another lawyer has an ethical obligation to report to the Society upon learning that the lawyer being assisted is engaging in or may in the future engage in serious misconduct or criminal activity related to the lawyer's practice. The Society cannot countenance such conduct regardless of a lawyer's attempts at rehabilitation.

[Amended - October 2006]

Encouraging Client to Report Dishonest Conduct

(4) A lawyer shall attempt to persuade a client who has a claim against an apparently dishonest licensee to report the facts to the Society before pursuing private remedies.

(5) If the client refuses to report his or her claim against an apparently dishonest licensee to the Society, the lawyer shall inform the client of the policy of the Compensation Fund and shall obtain instructions in writing to proceed with the client's claim without notice to the Society.

(6) A lawyer shall inform a client of the provision of the *Criminal Code of Canada* dealing with the concealment of an indictable offence in return for an agreement to obtain valuable consideration (section 141).

(7) If the client wishes to pursue a private agreement with the apparently dishonest lawyer, the lawyer shall not continue to act if the agreement constitutes a breach of section 141 of the *Criminal Code of Canada.*

[Amended – June 2007]

Duty to Report Certain Offences

(8) If a lawyer is charged with an offence described in By-law 8 of the Society, he or she shall inform the Society of the charge and of its disposition in accordance with the By-law.

[Amended – June 2007]

Commentary

By-law 8 relates to the reporting of serious criminal charges under the *Criminal Code* and charges under other Acts that bring into question the honesty of a lawyer or that relate to a lawyer's practice of law. Such a charge may be a red flag that clients may need protection. The Society must be in a position to determine what, if any, action is required by it if a lawyer is charged with an offence described in By-law 8 and what, if any, action is required if the lawyer is found guilty.

[Amended - June 2007]

6.02 RESPONSIBILITY TO THE SOCIETY

Communications from the Society

6.02 A lawyer shall reply promptly to any communication from the Society.

6.03 RESPONSIBILITY TO LAWYERS AND OTHERS

Courtesy and Good Faith

6.03 (1) A lawyer shall be courteous, civil, and act in good faith with all persons with whom the lawyer has dealings in the course of his or her practice.

Commentary

The public interest demands that matters entrusted to a lawyer be dealt with effectively and expeditiously, and fair and courteous dealing on the part of each lawyer engaged in a matter will contribute materially to this end. The lawyer who behaves otherwise does a disservice to the client, and neglect of the rule will impair the ability of lawyers to perform their function properly.

Any ill feeling that may exist or be engendered between clients, particularly during litigation, should never be allowed to influence lawyers in their conduct and demeanour toward other legal practitioners or the parties. The presence of personal animosity between legal practitioners involved in a matter may cause their judgment to be clouded by emotional factors and hinder the proper resolution of the matter. Personal remarks or personally abusive tactics interfere with the orderly administration of justice and have no place in our legal system.

A lawyer should avoid ill-considered or uninformed criticism of the competence, conduct, advice, or charges of other legal practitioners, but should be prepared, when requested, to advise and represent a client in a complaint involving another legal practitioner.

[Amended – June 2009]

(2) A lawyer shall agree to reasonable requests concerning trial dates, adjournments, the waiver of procedural formalities, and similar matters that do not prejudice the rights of the client.

(3) A lawyer shall avoid sharp practice and shall not take advantage of or act without fair warning upon slips, irregularities, or mistakes on the part of other legal practitioners not going to the merits or involving the sacrifice of a client's rights.

(4) A lawyer shall not use a tape recorder or other device to record a conversation between the lawyer and a client or another legal practitioner, even if lawful, without first informing the other person of the intention to do so.

[Amended - June 2009]

Communications

(5) A lawyer shall not in the course of professional practice send correspondence or otherwise communicate to a client, another legal practitioner, or any other person in a manner that is abusive, offensive, or otherwise inconsistent with the proper tone of a professional communication from a lawyer.

(6) A lawyer shall answer with reasonable promptness all professional letters and communications from other legal practitioners that require an answer, and a lawyer shall be punctual in fulfilling all commitments.

Communications with a represented person

(7) Subject to subrules (7.1) and (8), if a person is represented by a legal practitioner in respect of a matter, a lawyer shall not, except through or with the consent of the legal practitioner, *[Amended – September 2011]*

(a) approach or communicate or deal with the person on the matter, or

(b) attempt to negotiate or compromise the matter directly with the person.

[Amended – June 2009]

(7.1) Subject to subrule (8), if a person is receiving legal services from a legal practitioner under a limited scope retainer on a particular matter, a lawyer may, without the consent of the legal practitioner, approach, communicate or deal directly with the person on the matter, unless the lawyer receives written notice of the limited nature of the legal services being provided by the legal practitioner and the approach, communication or dealing falls within the scope of the limited scope retainer.

[New – September 2011]

Second Opinions

(8) A lawyer who is not otherwise interested in a matter may give a second opinion to a person who is represented by a legal practitioner with respect to that matter.

[Amended - June 2009]

Commentary

Subrule (7) applies to communications with any person, whether or not a party to a formal adjudicative proceeding, contract, or negotiation, who is represented by a legal practitioner concerning the matter to which the communication relates. A lawyer may communicate with a represented person concerning matters outside the representation. This subrule does not prevent parties to a matter from communicating directly with each other.

The prohibition on communications with a represented person applies only where the lawyer knows that the person is represented in the matter to be discussed. This means that the lawyer has actual knowledge of the fact of the representation, but actual knowledge may be inferred from the circumstances. This inference may arise where there is substantial reason to believe that the person with whom communication is sought is represented in the matter to be discussed. Thus, a lawyer cannot evade the requirement of obtaining the consent of the other legal practitioner by closing his or her eyes to the obvious.

Where notice as described in subrule (7.1) has been provided to a lawyer for an opposing party, the lawyer is required to communicate with the legal practitioner who is representing the person under a limited scope retainer, but only to the extent of the matter or matters within the scope of the retainer as identified by the legal practitioner. The lawyer may communicate with the person on matters outside of the limited scope retainer.

[New – September 2011]

Subrule (8) deals with circumstances in which a client may wish to obtain a second opinion from another lawyer. While a lawyer should not hesitate to provide a second opinion, the obligation to be competent and to render competent services requires that the opinion be based on sufficient information. In the case of a second opinion, such information may include facts that can be obtained only through consultation with the first legal practitioner involved. The lawyer should advise the client accordingly, and if necessary consult the first legal practitioner unless the client instructs otherwise.

[Amended - June 2009]

Communications with a represented corporation or organization

(9) A lawyer retained to act on a matter involving a corporation or organization that is represented by a legal practitioner in respect of that matter shall not, without the legal practitioner's consent or unless otherwise authorized or required by law, communicate, facilitate communication with or deal with a person

(a) who is a director or officer, or another person who is authorized to act on behalf of the corporation or organization,

(b) who is likely involved in decision-making for the corporation or organization or who provides advice in relation to the particular matter,

(c) whose act or omission may be binding on or imputed to the corporation or organization for the purposes of its liability, or

(d) who supervises, directs or regularly consults with the legal practitioner and who makes decisions based on the legal practitioner's advice.

(9.1) If a person described in subrule (9) (a), (b), (c) or (d) is represented in the matter by a legal practitioner, the consent of the legal practitioner is sufficient to allow a lawyer to communicate, facilitate communication with or deal with the person.

(9.2) In subrule (9), "organization" includes a partnership, limited partnership, association, union, fund, trust, co-operative, unincorporated association, sole proprietorship and a government department, agency, or regulatory body.

Commentary

The purpose of subrules 6.03 (9), (9.1) and (9.2) is to protect the lawyer-client relationship of corporations and other organizations by specifying persons with whom a lawyer may not communicate, facilitate communication or deal if the lawyer represents a client in a matter involving a corporation or organization and the corporation or organization is represented by a legal practitioner. They apply to litigation as well as to transactional and other non-litigious matters. A lawyer may communicate with a person in a corporation or other organization, other than those referred to in subrule (9), even if the corporation or organization is represented by a legal practitioner. These subrules are intended to advance the public policy of promoting efficient discovery and favours the revelation of the truth by addressing the circumstances in which a corporation or organization is allowed to prevent the disclosure of relevant evidence. They are not intended to protect a corporation or organization from the revelation of prejudicial facts.

Generally, subrule 6.03 (9) precludes contact only with those actively involved in a matter. For example, in a litigation matter, it does not preclude contact with mere witnesses. Further, communications with persons within the corporation or organization are not barred merely by virtue of the possibility that their information might constitute "admissions" in the evidentiary sense. To proscribe contact with any person within a corporation or organization on the basis that he or she may make a statement that might be admitted in evidence against the corporation or organization would be overly protective of the corporation or organization and too restrictive of an opposing counsel's ability to contact and interview potential witnesses. Fairness does not require the presence of a corporation's or organization's legal practitioner whenever a person within the corporation or organization may make a statement admissible in evidence against it.

Subrule 6.03 (9) prohibits communications by a lawyer for another person or entity concerning the matter in question with persons likely involved in the decision-making process about the matter. These individuals are so closely identified with the interests of the corporation or organization as to be indistinguishable from it. They would have the authority to commit the corporation or organization to a position with regard to the subject matter of the representation. This person would have such authority as a corporate officer or because for some other reason the law cloaks him or her with authority, including making decisions affecting the outcome of the matter, including litigation decisions, or because his or her duties include answering the type of inquiries posed. These individuals include those to whom the organization's legal practitioner looks for decisions with respect to the matter.

Thus, subject to the exceptions set out in it, subrule 6.03 (9) would prohibit contact with those persons who exercise managerial responsibility in the matter, who are alleged to have committed the wrongful acts at issue in the litigation, or who have authority on behalf of the corporation to make decisions about the course of the litigation.
A lawyer is not prohibited from communicating with a person in a litigation matter unless the person's act or omission is believed, on reasonable grounds, to be so central and obvious to a determination of liability that the person's conduct may be imputed to the corporation or organization. If it is not reasonably likely that the person is an active participant for liability purposes or a decision-maker respecting the outcome of the matter, nothing in subrule 6.03 (9) precludes informal contact with such a person.

An individual who regularly consults with the corporation's or organization's legal practitioner concerning a matter will not necessarily be a person who also directs the legal practitioner. In some large corporations and organizations, some management personnel may direct or control counsel for some matters but not others. The mere fact that a person holds a management position does not trigger the protections of the rule.

A person who is simply interviewed or questioned by a corporation's or organization's legal practitioner about a matter to gather factual information does not "regularly consult" with the legal practitioner. While a person's duties within a corporation or organization may include answering litigation-related inquiries, this rule does not prohibit an inquiry of this person by opposing counsel that is related to the person's knowledge of the historical aspects leading up to the alleged injury or damage which give rise to the subject matter of the representation.

The prohibition on communications with a represented corporation or organization applies only where the lawyer knows that the entity is represented in the matter to be discussed. This means that the lawyer has actual knowledge of the fact of the representation, but actual knowledge may be inferred from the circumstances. This inference may arise where it is reasonable to believe that the entity with whom communication is sought is represented in the matter to be discussed. Thus, a lawyer cannot evade the requirement of obtaining the consent of counsel by closing his or her eyes to the obvious.

Subrule 6.03 (9) does not prevent a lawyer from communicating with employees or agents concerning matters outside the representation.

As a practical matter, to avoid eliciting privileged or confidential information and ensure that the communications are proper, the lawyer should identify himself or herself as representing an interested party in the matter when approaching a potential witness or other person in the corporation or organization. The lawyer should also advise the person whom he or she is hoping to interview that they are free to decline to respond. See also rule 4.03 (Interviewing Witnesses).

A lawyer representing a corporation or other organization may also be retained to represent employees of the corporation or organization. In such circumstances, the lawyer must comply with the requirements of rule 2.04 (Avoidance of Conflicts of Interest), and particularly subrules 2.04(6) through (10). A lawyer must not represent that he or she acts for an employee of a client, unless the requirements of rule 2.04 have been complied with, and must not be retained by an employee solely for the purpose of sheltering factual information from another party.
If the representation by the legal practitioner described in subrule (9.1) is only with respect to the personal interests of the individual, consent of the corporation's or organization's counsel would be required with respect to the corporation's or organization's interests.

Unions – Subrule 6.03 (9) is not intended to prohibit a lawyer for a union from contacting employees of a represented corporation or organization in circumstances where proper representation of the union's interests requires communication with certain employees who are the holders of information. For example, a lawyer retained by a union with respect to a termination grievance in which the union alleges that the employer, who is represented, has breached the collective agreement, is not prohibited from contacting employees who may have information on the termination or events leading up to the termination.

Similarly, a management-side labour lawyer would not offend the subrule if the lawyer contacted an employee who is a member of a bargaining unit represented by a legal practitioner.

Governments –The concept of the individual who may "bind the organization" may not apply in the government context in the same way as in the corporate environment. For government departments, ministries and similar groups, the rule is intended to cover individuals who participate in a significant way in decision-making or who provide advice in relation to a particular matter.

In government, because of its complexity and despite its hierarchy, it may not always be clear to whom a lawyer is authorized to communicate on a particular matter and who is involved in the decision-making process. The roles of these individuals may not be discrete, as different officials at different levels in different departments provide advice and recommendations. For example, in a contract negotiation, employees from one ministry may be directly involved, but those from another ministry may also have sensitive information relevant to the matter that may require protection under subrule 6.03 (9).

In addition, the legal branch at the particular ministry is usually considered to always be "retained". There may be circumstances where the only appropriate action is to contact the legal branch. In all cases, appropriate judgment must be exercised

In general, the subrule is not intended to:

a. constrain lawyers who wish to contact government officials for a discussion of policy or similar matters on behalf of a client;

b. affect access to information requests under such legislation as the *Freedom of Information and Protection of Privacy Act* (Ontario) or the federal *Access to Information Act,* including situations where a litigant has named the provincial or federal Crown, respectively, as a defendant; or

c. affect the exercise of the duties of public servants under the *Public Service of Ontario Act, 2006* with respect to disclosure of information.

Municipalities – Similar to government, in the municipal context, it is recognized that no one individual has the authority to bind the municipality. Each councillor is representative of the entire council for the purposes of decision-making. Subrule 6.03 (9), for example, would not permit the lawyer for an applicant on a controversial planning matter that is before the Ontario Municipal Board to contact individual members of council on the matter without the consent of the municipal solicitor.

The subrule is not intended to:

a. prevent lawyers appearing before council on a client's behalf and making representations to a public meeting held pursuant to the *Planning Act;*

b. affect access to information requests under such legislation as the *Municipal Freedom of Information and Protection of Privacy Act,* including situations where a litigant has named the municipality as a defendant; or

c. restrain communications by persons having dealings or negotiations, including lobbying, with municipalities with the elected representatives (councillors) or municipal staff.

[Amended – November 2010]

Undertakings

(10) A lawyer shall not give an undertaking that cannot be fulfilled and shall fulfill every undertaking given.

Commentary

Undertakings should be written or confirmed in writing and should be absolutely unambiguous in their terms. If a lawyer giving an undertaking does not intend to accept personal responsibility, this should be stated clearly in the undertaking itself. In the absence of such a statement, the person to whom the undertaking is given is entitled to expect that the lawyer giving it will honour it personally. The use of such words as "on behalf of my client"or "on behalf of the vendor" does not relieve the lawyer giving the undertaking of personal responsibility.

In real estate transactions using the system for the electronic registration of title documents ("e-reg" TM), the lawyers acting for the parties (with their consent) will sign and be bound by a Document Registration Agreement that will contain undertakings. When entering into a Document Registration Agreement, a lawyer should have regard to and strictly comply with his or her obligations under subrule (10).

[Amended - November 2007]

6.04 OUTSIDE INTERESTS AND THE PRACTICE OF LAW

Maintaining Professional Integrity and Judgment

6.04 (1) A lawyer who engages in another profession, business, or occupation concurrently with the practice of law shall not allow such outside interest to jeopardize the lawyer's professional integrity, independence, or competence.

(2) A lawyer shall not allow involvement in an outside interest to impair the exercise of the lawyer's independent judgment on behalf of a client.

Commentary

The term "outside interest" covers the widest possible range of activities and includes activities that may overlap or be connected with the practice of law such as engaging in the mortgage business, acting as a director of a client corporation, or writing on legal subjects, as well as activities not so connected such as, for example, a career in business, politics, broadcasting or the performing arts. In each case the question of whether and to what extent the lawyer may be permitted to engage in the outside interest will be subject to any applicable law or rule of the Society.

Where the outside interest is not related to the legal services being performed for clients, ethical considerations will usually not arise unless the lawyer's conduct might bring the lawyer or the profession into disrepute or impair the lawyer's competence as, for example, where the outside interest might occupy so much time that clients' interests would suffer because of inattention or lack of preparation.

6.05 THE LAWYER IN PUBLIC OFFICE

Standard of Conduct

6.05 (1) A lawyer who holds public office shall, in the discharge of official duties, adhere to standards of conduct as high as those that these rules require of a lawyer engaged in the practice of law.

Commentary

The rule applies to a lawyer who is elected or appointed to a legislative or administrative office at any level of government, regardless of whether the lawyer attained the office because of professional qualifications. Because such a lawyer is in the public eye, the legal profession can more readily be brought into disrepute by a failure to observe its ethical standards.

Generally, the Society will not be concerned with the way in which a lawyer holding public office carries out official responsibilities, but conduct in office that reflects adversely upon the lawyer's integrity or professional competence may be the subject of disciplinary action.

Conflict of Interest

(2) A lawyer who holds public office shall not allow professional or personal interests to conflict with the proper discharge of official duties.

Commentary

The lawyer holding part-time public office must not accept any private legal business where duty to the client will, or may, conflict with official duties. If some unforeseen conflict arises, the lawyer should terminate the professional relationship, explaining to the client that official duties must prevail. The lawyer who holds a full-time public office will not be faced with this sort of conflict but must nevertheless guard against allowing independent judgment in the discharge of official duties to be influenced either by the lawyer's own interest, that of some person closely related to or associated with the lawyer, that of former or prospective clients, or former or prospective partners or associates.

> Subject to any special rules applicable to the particular public office, the lawyer holding the office who sees that there is a possibility of a conflict of interest should declare the possible conflict at the earliest opportunity, and not take part in any consideration, discussion or vote concerning the matter in question.

(3) If there may be a conflict of interest, a lawyer who holds or who held public office shall not represent clients or advise them in contentious cases that the lawyer has been concerned with in an official capacity.

Appearances before Official Bodies

(4) Subject to the rules of the official body, when a lawyer or any of his or her partners or associates is a member of an official body, the lawyer shall not appear professionally before that body.

> Commentary
>
> Subject to the rules of the official body, a partner or associate may appear professionally before a committee of the official body if the partner or associate is not a member of that committee, provided that in respect of matters in which the partner or associate appears, the lawyer does not sit on the committee, take part in the discussions of the committee's recommendations, or vote upon them.

Conduct after Leaving Public Office

(5) A lawyer who has left public office shall not act for a client in connection with any matter for which the lawyer had substantial responsibility before leaving public office.

> Commentary
>
> It would not be improper for the lawyer to act professionally in the matter on behalf of the public body in question.
>
> A lawyer who has acquired confidential information by virtue of holding public office should keep the information confidential and not divulge or use it, notwithstanding that the lawyer has ceased to hold such office.

6.06 PUBLIC APPEARANCES AND PUBLIC STATEMENTS

Communication with the Public

6.06 (1) Provided that there is no infringement of the lawyer's obligations to the client, the profession, the courts, or the administration of justice, a lawyer may communicate information to the media and may make public appearances and statements.

Commentary

Lawyers in their public appearances and public statements should conduct themselves in the same manner as with their clients, their fellow legal practitioners, and tribunals. Dealings with the media are simply an extension of the lawyer's conduct in a professional capacity. The mere fact that a lawyer's appearance is outside of a courtroom, a tribunal, or the lawyer's office does not excuse conduct that would otherwise be considered improper.

A lawyer's duty to the client demands that, before making a public statement concerning the client's affairs, the lawyer must first be satisfied that any communication is in the best interests of the client and within the scope of the retainer.

Public communications about a client's affairs should not be used for the purpose of publicizing the lawyer and should be free from any suggestion that the lawyer's real purpose is self-promotion or self-aggrandizement.

Given the variety of cases that can arise in the legal system, particularly in civil, criminal, and administrative proceedings, it is impossible to set down guidelines that would anticipate every possible circumstance. Circumstances will arise where the lawyer should have no contact with the media and other cases where the lawyer is under a specific duty to contact the media to properly serve the client - the latter situation will arise more often in the context of administrative boards and tribunals where a particular tribunal is an instrument of government policy and hence is susceptible to public opinion.

A lawyer is often involved in a non-legal setting where contact is made with the media about publicizing such things as fund-raising, expansion of hospitals or universities, programs of public institutions or political organizations, or in acting as a spokesperson for organizations that, in turn, represent particular racial, religious, or other special interest groups. This is a well-established and completely proper role for the lawyer to play in view of the obvious contribution it makes to the community.

A lawyer is often called upon to comment publicly on the effectiveness of existing statutory or legal remedies, on the effect of particular legislation or decided cases, or to offer an opinion about cases that have been instituted or are about to be instituted. This, too, is an important role the lawyer can play to assist the public in understanding legal issues.

[Amended – June 2009]

A lawyer is often involved as advocate for interest groups whose objective is to bring about changes in legislation, governmental policy, or even a heightened public awareness about certain issues. This is also an important role that the lawyer can be called upon to play.

Lawyers should be aware that when they make a public appearance or give a statement they will ordinarily have no control over any editing that may follow or the context in which the appearance or statement may be used, or under what headline it may appear.

Interference with Right to Fair Trial or Hearing

(2) A lawyer shall not communicate information to the media or make public statements about a matter before a tribunal if the lawyer knows or ought to know that the information or statement will have a substantial likelihood of materially prejudicing a party's right to a fair trial or hearing.

Commentary

Fair trials and hearings are fundamental to a free and democratic society. It is important that the public, including the media, be informed about cases before courts and tribunals. The administration of justice benefits from public scrutiny. It is also important that a person's, particularly an accused person's, right to a fair trial or hearing not be impaired by inappropriate public statements made before the case has concluded.

6.07 PREVENTING UNAUTHORIZED PRACTICE

Preventing Unauthorized Practice

6.07 (1) A lawyer shall assist in preventing the unauthorized practice of law and the unauthorized provision of legal services.

[Amended – June 2007]

Commentary

Statutory provisions against the practice of law and provision of legal services by unauthorized persons are for the protection of the public. Unauthorized persons may have technical or personal ability, but they are immune from control, regulation, and, in the case of misconduct, from discipline by the Society. Moreover, the client of a lawyer who is authorized to practise has the protection and benefit of the lawyer-client privilege, the lawyer's duty of secrecy, the professional standard of care that the law requires of lawyers, and the authority that the courts exercise over them. Other safeguards include professional liability insurance, rights with respect to the assessment of bills, rules respecting the handling of trust monies, and requirements for the maintenance of compensation funds.

Working With or Employing Unauthorized Persons

(2) Without the express approval of a committee of Convocation appointed for the purpose, a lawyer shall not retain, occupy office space with, use the services of, partner or associate with, or employ in any capacity having to do with the practice of law or provision of legal services any person who, in Ontario or elsewhere, has been disbarred and struck off the Rolls, has had his or her license to practise law or to provide legal services revoked, has been suspended, has had his or her license to practise law or to provide legal services suspended, has undertaken not to practise law or to provide legal services, or who has been involved in disciplinary action and been permitted to resign or to surrender his or her license to practise law or to provide legal services, and has not had his or her license restored.

[Amended – January 2008]

Practice by Suspended Lawyers Prohibited

(3) A lawyer whose license to practise law is suspended shall comply with the requirements of the By-laws and shall not

(a) practice law

(b) represent or hold himself or herself out as a person entitled to practise law, or

(c) represent or hold himself or herself out as a person entitled to provide legal services.

[New – January 2008]

Commentary

Part II of By-Law 7.1 (Operational Obligations and Responsibilities) and Part II.1 of By-Law 9 (Financial Transactions and Records) set out the obligations of a lawyer whose license to practise law is suspended.

[Amended - May 2008]

Undertakings Not to Practise Law

(4) A lawyer who gives an undertaking to the Law Society not to practise law shall not,

(a) practise law,

(b) represent or hold himself or herself out as a person entitled to practise law, or

(c) represent or hold himself or herself out as a person entitled to provide legal services.

[New – January 2008]

Undertakings to Practise Law Subject to Restrictions

(5) A lawyer who gives an undertaking to the Law Society to restrict his or her practise shall comply with the undertaking.

[New – January 2008]

6.08 RETIRED JUDGES RETURNING TO PRACTICE

Definitions

6.08 (1) In this rule, "retired appellate judge" means a lawyer

(a) who was formerly a judge of the Supreme Court of Canada, the Court of Appeal for Ontario, or the Federal Court of Appeal,

[Amended - January 2009]

(b) who has retired, resigned, or been removed from the Bench, and

(c) who has returned to practice.

(2) In this rule, "retired judge" means a lawyer

(a) who was formerly a judge of the Federal Court, the Tax Court of Canada, the Supreme Court of Ontario, Trial Division, a County or District Court, the Ontario Court of Justice, or the Superior Court of Justice,

[Amended - January 2009]

(b) who has retired, resigned, or been removed from the Bench, and

(c) who has returned to practice.

Appearance as Counsel

(3) A retired appellate judge shall not appear as counsel or advocate in any court, or in chambers, or before any administrative board or tribunal without the express approval of a committee of Convocation appointed for the purpose. This approval may only be granted in exceptional circumstances and may be restricted as the committee of Convocation sees fit.

(4) A retired judge shall not appear as counsel or advocate

(a) before the court on which the judge served or any lower court, and

(b) before any administrative board or tribunal over which the court on which the judge served exercised an appellate or judicial review jurisdiction

for a period of two years from the date of his or her retirement, resignation, or removal, without the express approval of a committee of Convocation, appointed for the purpose, which approval may only be granted in exceptional circumstances and may be restricted as the committee of Convocation sees fit.

6.09 ERRORS AND OMISSIONS

Informing Client of Error or Omission

6.09 (1) When, in connection with a matter for which a lawyer is responsible, the lawyer discovers an error or omission that is or may be damaging to the client and that cannot be rectified readily, the lawyer shall

(a) promptly inform the client of the error or omission being careful not to prejudice any rights of indemnity that either of them may have under an insurance, client's protection or indemnity plan, or otherwise,

(b) recommend that the client obtain legal advice elsewhere concerning any rights the client may have arising from the error or omission, and

(c) advise the client that in the circumstances, the lawyer may no longer be able to act for the client.

Notice of Claim

(2) A lawyer shall give prompt notice of any circumstance that the lawyer may reasonably expect to give rise to a claim to an insurer or other indemnitor so that the client's protection from that source will not be prejudiced.

Commentary

Compulsory insurance imposes obligations on a lawyer, but these obligations must not impair the relationship and duties of the lawyer to the client. The insurer's rights must be preserved. There may well be occasions when a lawyer believes that certain actions or the failure to take action have made the lawyer liable for damages to the client when, in reality, no liability exists. Further, in every case a careful assessment will have to be made of the client's damages arising from the lawyer's negligence. Many factors will have to be taken into account in assessing the client's claim and damages. As soon as a lawyer becomes aware that an error or omission may have occurred, that may reasonably be expected to involve liability to the client for professional negligence, the lawyer should take the following steps.

[Amended - January 2009]

1. Immediately arrange an interview with the client and advise the client that an error or omission may have occurred, that may form the basis of a claim by the client against the lawyer.

2. Advise the client to obtain an opinion from an independent lawyer and that, in the circumstances, the first lawyer might no longer be able to act for the client.

3. Subject to rule 2.03 (Confidentiality), inform the insurer of the facts of the situation.

4. Co-operate fully and as expeditiously as possible with the insurer in the investigation and eventual settlement of the claim.

5. Make arrangements to pay that portion of the client's claim that is not covered by the insurance immediately upon completion of the settlement of the client’s claim. This would include payment of the deductible under a policy of insurance in accordance with By-Law 6 (Professional Liability Insurance).

[Amended - January 2009]

Co-operation

(3) When a claim of professional negligence is made against a lawyer, he or she shall assist and co-operate with the insurer or other indemnitor to the extent necessary to enable the claim to be dealt with promptly.

Responding to Client's Claim

(4) If a lawyer is not indemnified for a client's errors and omissions claim or to the extent that the indemnity may not fully cover the claim, the lawyer shall expeditiously deal with the claim and shall not take unfair advantage that would defeat or impair the client's claim.

(5) In cases where liability is clear and the insurer or other indemnitor is prepared to pay its portion of the claim, a lawyer has a duty to pay the balance.

6.10 RESPONSIBILITY IN MULTI-DISCIPLINE PRACTICES

Compliance with these Rules

6.10 A lawyer in a multi-discipline practice shall ensure that non-licensee partners and associates comply with these rules and all ethical principles that govern a lawyer in the discharge of his or her professional obligations.

[Amended - June 2009]

6.11 DISCIPLINE

Disciplinary Authority

6.11 (1) A lawyer is subject to the disciplinary authority of the Society regardless of where the lawyer's conduct occurs.

Professional Misconduct

(2) The Society may discipline a lawyer for professional misconduct.

Conduct Unbecoming a Lawyer

(3) The Society may discipline a lawyer for conduct unbecoming a lawyer.

Law Society of Upper Canada

By-Laws 6.1, 7.1, 8, and 9

BY-LAW 6.1

January 29, 2009
Amended: October 29, 2009
Revoked and Replaced: October 28, 2010
Amended: November 9, 2010 (editorial changes)
April 28, 2011

CONTINUING PROFESSIONAL DEVELOPMENT

Continuing professional development requirement

1. (1) Beginning January 1, 2011, the following licensees shall complete the number of hours of eligible activities each year required under subsection (2):

1. A licensee who is required to pay the full amount of the annual fee under subsection 2 (2) of By-Law 5 [Annual Fee].

2. A licensee who is exempt from payment of the full amount of the annual fee under section 3.1 of By-Law 5 [Annual Fee].

3. A licensee who is exempt from payment of the annual fee under subsection 4 (1) of By-Law 5 [Annual Fee] and who practises law as described therein.

4. A licensee who is exempt from payment of the annual fee under subsection 4 (6) of By-law 5 [Annual Fee] and who practises law in Ontario as a barrister and solicitor.

Number of required hours per year

(2) Each year, a licensee to whom subsection (1) applies shall complete one hour of eligible activities for each calendar month in the year during which for any amount of time the licensee practises law in Ontario as a barrister and solicitor or provides legal services in Ontario, of the total of which hours at least twenty-five percent shall consist of eligible activities that are accredited by the Society covering ethics, professionalism or practice management topics.

Exemption from or reduction in required number of hours

(3) On application by a licensee, in any year, the Society may, for that year, exempt the licensee from the requirement under subsection (1) or reduce the number of hours of eligible activities that the licensee is required to complete under subsection (2).

No carry-over

(4) A licensee may not carry over from one year to any other year any hours of eligible activities that the licensee completes in the one year.

Application

(5) Section 1 does not apply to a licensee for the period of time during which section 2 applies to the licensee.

New licensees: twenty-four hour requirement

2. (1) A licensee who after May 31, 2010 is licensed to practise law in Ontario as a barrister and solicitor or licensed to provide legal services in Ontario shall complete twenty-four hours of eligible activities that are accredited by the Society, of which at least twenty-five percent shall consist of eligible activities that are accredited by the Society covering ethics, professionalism or practice management topics, within a period of twenty-four months.

Twenty-four month period

(2) The twenty-four month period mentioned in subsection (1),

(a) begins on the day on which the licensee is paying the full amount of the annual fee under subsection 2 (2) of By-Law 5 [Annual Fee] and that is on or after the first day of January of the year immediately following the day on which the licensee is licensed; and

(b) includes only those whole or part calendar months during which the licensee pays the full amount of the annual fee under subsection 2 (2) of By-Law 5 [Annual Fee].

Exemption from or reduction in required number of hours

(3) On application by a licensee, the Society may exempt the licensee from the requirement under subsection (1) or reduce the number of hours of eligible activities that the licensee is required to complete under subsection (1).

Eligible activities completed prior to January 1

(4) Where the start of the twenty-four month period described in subsection (2) is January 1 of the year immediately following the day on which a licensee is licensed and where, for the period of time commencing on the day immediately following the day on which the licensee is licensed and ending on December 31 of the year in which the licensee is licensed, the licensee pays the full amount of the annual fee, the licensee may include, in the required number of hours of eligible activities accredited by the Society to be completed by the licensee under subsection (1), any hours of eligible activities that are accredited by the Society that the licensee completes after he or she is licensed but before the start of the twenty-four month period.

No carry-over

(5) Except as permitted under subsection (4), a licensee may not carry over from one year to any other year any hours of eligible activities that are accredited by the Society that the licensee completes in the one year.

Number of hours completed in year: determining compliance with subs. (1)

(6) Subject to subsection (7), in any year, if a licensee completes more hours of eligible activities that are accredited by the Society than the number of whole or part calendar months in that year during which the licensee pays the full amount of the annual fee under subsection 2 (2) of By-Law 5 [Annual Fee], for the purposes of determining compliance with subsection (1), the licensee shall be deemed to have completed a number of hours of eligible activities that are accredited by the Society that is equal to the number of whole or part calendar months in that year during which the licensee pays the full amount of the annual fee under subsection 2 (2) of By-Law 5 [Annual Fee].

Same

(7) In the first year immediately following the day on which a licensee is licensed, if subsection (4) applies to the licensee and the licensee has completed more hours of eligible activities that are accredited by the Society than the number of whole or part calendar months in the first year during which the licensee pays the full amount of the annual fee under subsection 2 (2) of By-Law 5 [Annual Fee], for the purposes of determining compliance with subsection (1), the licensee shall be deemed to have completed a number of hours of eligible activities that are accredited by the Society that is equal to the lesser of,

(a) the total of the number of whole or part calendar months in that year during which the licensee pays the full amount of the annual fee under subsection 2 (2) of By-Law 5 [Annual Fee] and the number of hours of eligible activities that are accredited by the Society that are completed by the licensee in the circumstances mentioned in subsection (4); and

(b) the total of the number of hours of eligible activities that are accredited by the Society that are completed by the licensee in the first year and the number of hours or eligible activities that are accredited by the Society that are completed by the licensee in the circumstances mentioned in subsection (4).

Application

(8) This section does not apply to a licensee who, on the day on which he or she is licensed to practise law in Ontario as a barrister and solicitor, has practised law in Canada outside Ontario for a period of time exceeding twenty-four months.

Interpretation: “eligible activity”

3. For the purposes of sections 1 and 2, an "eligible activity" is an activity that serves to maintain or enhance a licensee's professional knowledge, skills, attitudes or ethics as determined by the Society.

Reporting: licensees to whom s. 1 applies

4. (1) Every licensee to whom section 1 applies shall file a report with the Society, by December 31 of each year, in respect of the eligible activities completed by the licensee in each year.

Reporting: licensees to whom s. 2 applies

(2) Every licensee to whom section 2 applies shall file a report with the Society, by December 31 of each year, commencing with the year immediately following the day on which the licensee is licensed, in respect of the eligible activities completed by the licensee in each year.

Eligible activities included under subs. 2 (4)

(3) A licensee to whom subsection 2 (4) applies shall report the eligible activities mentioned in that subsection in the first year in which the licensee is required under subsection (2) to file a report with the Society in respect of eligible activities completed by the licensee in that year.

Form, format and manner of filing

(4) The report required under subsection (1) or subsection (2) shall be in a form provided, and in an electronic format specified, by the Society and shall be filed electronically as permitted by the Society.

Documents required to be kept

5. (1) A licensee shall keep all documents substantiating the licensee's completion of the eligible activities reported by him or her in a year until December 31 of the year following the year in which the activities were reported.

Providing documents to Society

(2) If requested by the Society to do so, a licensee shall provide to the Society all documents kept by the licensee under subsection (1).

Requirement to provide information

6. (1) The Society may require a licensee to whom section 1 or section 2 applies to provide to it specific information about the licensee's completion of the required number of hours of eligible activities.

Notice of requirement

(2) The Society shall notify a licensee in writing of the requirement to provide information under subsection (1) and shall send to the licensee a detailed list of the information to be provided by him or her.

Time for providing information

(3) Subject to subsection (4), the licensee shall provide to the Society the specific information required of him or her not later than ten days after the date specified on the notice of the requirement to provide information.

Extension of time for providing information

(4) On the request of the licensee, the Society may extend the time within which the licensee is required to provide to the Society the specific information required of him or her.

Request for extension of time

(5) A request to the Society to extend time under subsection (4) shall be made by the licensee in writing and by not later than the day by which the licensee is required under subsection (3) to provide information to the Society.

Additional authority to require information

(6) The Society's authority to require a licensee to provide information contained in this section is in addition to, and does not limit, the Society's authority to require a licensee to provide information contained elsewhere in this By-Law, in any other by-law or in the Act.

BY-LAW 7.1

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January 29, 2009
January 29, 2009 (editorial changes)
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November 10, 2010 (editorial changes)

OPERATIONAL OBLIGATIONS AND RESPONSIBILITIES

PART I

SUPERVISION OF ASSIGNED TASKS AND FUNCTIONS

Interpretation

1. (1) In this Part,

"non-licensee" means an individual who,

(a) in the case of the assignment of tasks and functions by a person licensed to practise law in Ontario as a barrister and solicitor, is not a person licensed to practise law in Ontario as a barrister and solicitor and, in the case of the assignment of tasks and functions by a person licensed to provide legal services in Ontario, is not a licensee,

(b) is engaged by a licensee to provide her or his services to the licensee, and

(c) expressly agrees with the licensee that the licensee shall have effective control over the individual's provision of services to the licensee;

"catastrophic impairment" means a catastrophic impairment within the meaning of the *Statutory Accident Benefits Schedule*;

"claim" means a claim for statutory accident benefits within the meaning of the *Insurance Act*;

"impairment" means an impairment within the meaning of the *Statutory Accident Benefits Schedule*;

"law firm" means a law firm within the meaning of section 29 of By-Law 4 [Licensing], except the reference to clause 61.0.1 (a) in that definition shall be read as a reference to clauses 61.0.1 (a) and (c);

"*Statutory Accident Benefits Schedule*" means the *Statutory Accident Benefits Schedule* within the meaning of the *Insurance Act.*

Interpretation: "effective control"

(2) For the purposes of subsection (1), a licensee has effective control over an individual's provision of services to the licensee when the licensee may, without the agreement of the individual, take any action necessary to ensure that the licensee complies with the *Law Society Act*, the by-laws, the Society's rules of professional conduct and the Society's policies and guidelines.

Application: provision of legal services by student

2. (1) This Part does not apply to the provision of legal services by a student under the supervision of a licensee pursuant to subsection 34 (1) of By-Law 4.

Application: provision of legal services by law student

(2) This Part, subject to necessary modifications, does apply to the provision of legal services by a law student under the supervision of a licensee pursuant to subsection 34 (2) or (3) of By-Law 4.

Assignment of tasks, functions: general

3. (1) Subject to subsection (2), a licensee may, in accordance with this Part, assign to a non-licensee tasks and functions in connection with the licensee's practice of law or provision of legal services in relation to the affairs of the licensee's client.

Assignment of tasks, functions: affiliation

(2) A licensee who is affiliated with an entity under By-Law 7 may, in accordance with this Part, assign to the entity or its staff, tasks and functions in connection with the licensee's practice of law or provision of legal services in relation to the affairs of the licensee's client only if the client consents to the licensee doing so.

Assignment of tasks, function: direct supervision required

4. (1) A licensee shall assume complete professional responsibility for her or his practice of law or provision of legal services in relation to the affairs of the licensee's clients and shall directly supervise any non-licensee to whom are assigned particular tasks and functions in

connection with the licensee's practice of law or provision of legal services in relation to the affairs of each client.

(2) Without limiting the generality of subsection (1),

(a) the licensee shall not permit a non-licensee to accept a client on the licensee's behalf;

(b) the licensee shall maintain a direct relationship with each client throughout the licensee's retainer;

(c) the licensee shall assign to a non-licensee only tasks and functions that the non-licensee is competent to perform;

(d) the licensee shall ensure that a non-licensee does not act without the licensee's instruction;

(e) the licensee shall review a non-licensee's performance of the tasks and functions assigned to her or him at frequent intervals;

(f) the licensee shall ensure that the tasks and functions assigned to a non-licensee are performed properly and in a timely manner;

(g) the licensee shall assume responsibility for all tasks and functions performed by a non-licensee, including all documents prepared by the non-licensee; and

(h) the licensee shall ensure that a non-licensee does not, at any time, act finally in respect of the affairs of the licensee's client.

Assignment of tasks, functions: prior express instruction and authorization required

5. (1) A licensee shall give a non-licensee express instruction and authorization prior to permitting the non-licensee,

(a) to give or accept an undertaking on behalf of the licensee;

(b) to act on behalf of the licensee in respect of a scheduling or other related routine administrative matter before an adjudicative body; or

(c) to take instructions from the licensee's client.

Assignment of tasks, functions: prior consent and approval

(2) A licensee shall obtain a client's consent to permit a non-licensee to conduct routine negotiations with third parties in relation to the affairs of the licensee's client and shall approve the results of the negotiations before any action is taken following from the negotiations.

Assignment of tasks, functions: mediation of ancillary issues relating to catastrophic impairment claims

5.1 (1) Despite clause 6 (1) (c), a licensee who holds a Class L1 licence may permit a non-licensee who holds a Class P1 licence to participate in mediation of ancillary issues relating to a claim of an individual who has or appears to have a catastrophic impairment, but only if the non-licensee is employed by the licensee or by the law firm of which the licensee is a member.

(2) For the purposes of subsection (1), ancillary issues do not include issues relating to the determination of whether an impairment is a catastrophic impairment.

Tasks and functions that may not be assigned: general

6. (1) A licensee shall not permit a non-licensee,

(a) to give the licensee's client legal advice;

(b) to act on behalf of a person in a proceeding before an adjudicative body, other than on behalf of the licensee in accordance with subsection 5 (1), unless the non-licensee is authorized under the *Law Society Act* to do so;

(c) to conduct negotiations with third parties, other than in accordance with subsection 5 (2);

(d) to sign correspondence, other than correspondence of a routine administrative nature; or

(e) to forward to the licensee's client any document, other than a routine document, that has not been previously reviewed by the licensee.

Tasks and functions that may not be assigned by Class L1 licensee

(2) A licensee who holds a Class L1 licence shall not permit a non-licensee to use the licensee's personalized specially encrypted diskette in order to access the system for the electronic registration of title documents.

Collection letters

7. A licensee shall not permit a collection letter to be sent to any person unless,

(a) the letter is in relation to the affairs of the licensee's client;

(b) the letter is prepared by the licensee or by a non-licensee under the direct supervision of the licensee;

(c) if the letter is prepared by a non-licensee under the direct supervision of the licensee, the letter is reviewed and approved by the licensee prior to it being sent;

(d) the letter is on the licensee's business letterhead; and

(e) the letter is signed by the licensee.

PART II

OBLIGATIONS RESULTING FROM SUSPENSION

Interpretation

8. In this Part,

"existing client" means,

(a) a person who is a client of a suspended licensee when a suspension order is made against the licensee, or

(b) a person who becomes a client of the suspended licensee after the suspension order is made but before the suspension begins;

"former client" means a person who was a client of a suspended licensee before a suspension order was made against the licensee but who was not a client when the order was made;

"prospective client" means a person who seeks to retain a suspended licensee after the suspension order is made the licensee but before the suspension begins;

"suspended licensee" means a licensee who is the subject of a suspension order;

"suspension order" means an order made under the Act suspending a licensee's licence to practise law in Ontario as a barrister and solicitor or to provide legal services in Ontario, regardless of whether the suspension begins when the order is made or thereafter.

Notice requirements before suspension begins

9. (1) A suspended licensee shall before the suspension begins, but not later than the date on which the suspension begins,

(a) notify every existing client, on whose matters the work will not be completed by the suspended licensee before the suspension begins, of the suspension order and that,

(i) the suspended licensee will be unable to complete the work,

(ii) the client will need to retain another licensee to complete the work, and

(iii) the suspended licensee, subject to any rights that the suspended licensee may have over the client's file, will transfer the file to the licensee, if any, retained by the client to complete the work or will return the file to the client; and

(b) notify every existing client and former client for whom the suspended licensee performs or has performed the work described in subsection 14 (1) of the name and contact information of the licensee to whom the suspended licensee has given possession of the client's documents and files.

Compliance with subclauses (1) (a) (i) to (iii) not required

(2) A suspended licensee is not required to comply with the notice requirements mentioned in subclauses (1) (a) (i) to (iii) if the only work remaining to be completed on the client's matter is work mentioned in section 12 or 13, but, in such a case, the suspended licensee shall, before the suspension begins**,** notify the client of the name and contact information of the licensee retained by the suspended licensee to complete the work.

Notice requirements: during suspension

10. A suspended licensee shall, during the suspension,

(a) notify all persons who contact the suspended licensee's place of business of the suspension order; and

(b) notify any existing client or former client who contacts the suspended licensee's place of business of the name and contact information of another licensee who has been given possession of the clients' documents and files.

Notice requirements: prospective clients

11. A suspended licensee, at the time a prospective client seeks to retain the suspended licensee, shall notify the prospective client of the suspension order.

Work remaining on file: final report to client

12. If, on the date the suspension begins, the only work remaining for a suspended licensee to complete on a client's matter is a final report to the client, the suspended licensee shall, before the suspension begins, retain another licensee, who is authorized to do so, to review the client's file and to complete and send the final report to the client.

Work remaining on file: fulfillment of undertakings

13. If, on the date the suspension begins, the only work remaining for a suspended licensee to complete on a client's matter is the fulfillment of one or more undertakings given by the

suspended licensee, the suspended licensee shall retain another licensee or person, who is authorized to do so, to take all steps necessary to fulfill the undertakings.

Additional requirements: preparation of will, power of attorney, corporate records

14. (1) This section applies to a suspended licensee who performs or has performed any of the following work for a client:

1. Preparation of a will.

2. Preparation of a power of attorney.

3. Preparation of, or preparation and continued maintenance of, corporate records.

Requirement re original documents

(2) A suspended licensee shall, before the suspension begins**,**

(a) return to the client all original documents; or

(b) transfer the client's file, including all original documents, to another licensee who is authorized to perform any requisite work.

Real estate law: direction re Teranet access disk

15. A suspended licensee who has access to the Teranet system shall, on or before the date the suspension begins, complete and file with the Society, in a form provided by the Society, a direction authorizing the Society to take all steps necessary to cancel the suspended licensee's Teranet access disk for the period of the suspension.

Return of photo identification card

16. A suspended licensee shall, on or before the date the suspension begins, return to the Society any photo identification card issued to her or him by the Society.

Students

17. A suspended licensee, who has accepted a person into service under articles of clerkship where the period of service includes any or all of the period of the suspension, shall, before the suspension begins,

(a) notify the person of the suspension order and that the suspended licensee will not be able to retain the person in service under articles of clerkship after the suspension begins;

(b) arrange for another licensee, who is authorized and approved by the Society to do so, to accept the person into service under articles of clerkship after the suspension begins; and

(c) arrange with the Society for the person's service under articles of clerkship to be transferred from the suspended licensee to the other licensee effective the date on which the suspension begins.

Report to Society on compliance

18. A suspended licensee shall, not later than thirty days after the suspension begins, complete and file with the Society, in a form provided by the Society, a report confirming and providing details of the suspended licensee's compliance with this Part.

Permission to be exempt from requirement

19. A suspended licensee may apply in writing to the Society for an exemption from or a modification of a requirement mentioned in this Part, and the Society may exempt the suspended licensee from or modify the requirement, subject to such terms and conditions as the Society may impose.

PART III

CLIENT IDENTIFICATION AND VERIFICATION

Definitions

20. In this Part,

"electronic funds transfer" means the transfer of funds from one financial institution or financial entity to another initiated by the transmission, through any electronic, magnetic or optical device, telephone instrument or computer, of instructions for the transfer of funds, where the record of the transfer includes a reference number, the name of the financial institution or financial entity sending the funds, the name of the financial institution or financial entity receiving the funds, the date of the transfer of the funds, the amount of funds transferred, the currency of the funds transferred, the name of the holder of the account from which the funds transferred are drawn and the name of the holder of the account to which the funds transferred are deposited;

"financial entity" means a financial entity headquartered and operating in a country that is a member of the Financial Action Task Force on Money Laundering;

"financial institution" means,

(a) a bank to which the *Bank Act* (Canada) applies,

(b) an authorized foreign bank within the meaning of section 2 of the *Bank Act* (Canada) in respect of its business in Canada,

(c) a cooperative credit society, savings and credit union, credit union or caisse populaire that is regulated by an Act of a province or territory of Canada,

(d) an association that is regulated by the *Cooperative Credit Associations Act* (Canada),

(e) a company to which the *Trust and Loan Companies Act* (Canada) applies,

(f) a loan or trust corporation regulated by an Act of a province or territory of Canada,

(g) a ministry, department or agent of the government of Canada or of a province or territory of Canada if the ministry, department or agent accepts deposit liabilities in the course of providing financial services to the public, or

(h) a subsidiary of an entity mentioned in clauses (a) to (g) where the financial statements of the subsidiary are consolidated with the financial statements of the entity;

"funds" means cash, currency, securities, negotiable instruments and other financial instruments that indicate a person's title or interest in them;

"lawyer" means an individual who is authorized to practise law in a province or territory of Canada outside Ontario;

"organization" means a body corporate, partnership, fund, trust, co-operative or an unincorporated association;

"proceeding" means a proceeding before an adjudicative body;

"public body" means,

(a) a ministry, department or agent of the government of Canada or of a province or territory of Canada,

(b) a municipality incorporated by or under an Act of a province or territory of Canada, including a city, town, village, metropolitan or regional municipality, township, district, county, rural municipality, any other incorporated municipal body and an agent of any of them,

(c) a local board of a municipality incorporated by or under an Act of a province or territory of Canada, including any local board as defined in the *Municipal Act* and any similar body incorporated under the law of another province or territory,

(d) an organization that operates a public hospital and that is designated by the Minister of National Revenue as a hospital authority under the *Excise Tax Act* (Canada) or an agent of the organization,

(e) a body incorporated by or under an Act of Canada or of a province or territory of Canada for a public purpose, or

(f) a subsidiary of an entity mentioned in clauses (a) to (e) where the financial statements of the subsidiary are consolidated with the financial statements of the entity;

"reporting issuer" means,

(a) a reporting issuer within the meaning of an Act of a province or territory of Canada in respect of the securities law of the province or territory,

(b) a corporation whose shares are traded on a stock exchange designated under section 262 of the *Income Tax Act* (Canada) and that operates in a country that is a member of the Financial Action Task Force on Money Laundering, or

(c) a subsidiary of an entity mentioned in clause (a) or (b) where the financial statements of the subsidiary are consolidated with the financial statements of the entity;

"securities dealer" means a person authorized under an Act of a province or territory of Canada to engage in the business of dealing in securities or any other financial instruments or to provide portfolio management or investment advising services.

Application of Part

21. This Part applies only to matters in respect of which a licensee is retained to provide her or his professional services after this Part comes into force regardless of whether the client is a new or existing client.

Application of client identification and verification requirements

22. (1) Subject to subsections (2), (3) and (4), a licensee shall,

(a) when the licensee is retained to provide her or his professional services to a client, comply with the client identification requirements set out in subsection 23 (1); and

(b) when the licensee engages in or gives instructions in respect of the receiving, paying or transferring of funds,

(i) comply with the client identification requirements set out in subsection 23 (2), and

(ii) comply with the client verification requirements set out in subsection 23 (4).

Exemption re certain licensees

(2) A licensee is not required to comply with the client identification and verification requirements set out in section 23 if,

(a) the licensee is engaged in the activities described in subsection (1) on behalf of her or his employer;

(b) the licensee is engaged in the activities described in subsection (1) as agent for another licensee or a lawyer who has already complied with the client identification and verification requirements set out in section 23;

(c) the licensee is engaged in the activities described in subsection (1) for a client referred to the licensee by another licensee or a lawyer who has already complied with the client identification and verification requirements set out in section 23; or

(d) the licensee is engaged in the activities described in subsection (1), other than the activities described in clause (1) (b), as a duty counsel under the *Legal Aid Services Act,1998*, as a duty counsel providing professional services through a duty counsel program operated by a not-for-profit organization or as a provider of legal aid services through the provision of summary advice under the *Legal Aid Services Act, 1998*.

Exemptions re certain funds

(3) A licensee is not required to comply with the client identification requirements set out in subsection 23 (2) or the client verification requirements set out in subsection 23(4) in respect of funds,

(a) paid to or received from a financial institution, public body or reporting issuer;

(b) received from the trust account of another licensee or a lawyer;

(c) received from a peace officer, law enforcement agency or other public official acting in an official capacity;

(d) paid or received pursuant to a court order;

(e) paid to pay a fine or penalty;

(f) paid or received as a settlement in a proceeding;

(g) paid or received for professional fees, disbursements, expenses or bail; or

(h) paid, received or transferred by electronic funds transfer.

Exemptions re certain clients

(4) A licensee is not required to comply with the client identification requirements set out in subsection 23 (2) or the client verification requirements set out in subsection 23 (4) in respect of any of the following clients:

1. A financial institution.

2. A public body.

3. A reporting issuer.

Client identification

23. (l) When a licensee is retained to provide her or his professional services to a client, the licensee shall obtain the following information about the client:

1. The client's full name.

2. The client's business address and business telephone number, if applicable.

3. If the client is an individual, the client's home address and home telephone number.

4. If the client is an organization, other than a financial institution, public body or reporting issuer, the organization's incorporation or business identification number and the place of issue of its incorporation or business identification number, if applicable.

5. If the client is an individual, the client's occupation or occupations.

6. If the client is an organization, other than a financial institution, public body or reporting issuer, the general nature of the type of business or businesses or activity or activities engaged in by the client.

7. If the client is an organization, the name, position and contact information for each individual who gives instructions with respect to the matter for which the licensee is retained.

8. If the client is acting for or representing a third party, information about the third party as set out in paragraphs 1 to 7, as applicable.

Same

(2) When a licensee is engaged in the activities described in clause 22 (1) (b) and the client or any third party that the client is acting for or representing is an organization, in addition to complying with the client identification requirements set out in subsection (1), the licensee shall make reasonable efforts to obtain the following information about the client and the third party:

1. The name and occupation or occupations of each director of the organization, other than an organization that is a securities dealer.

2. The name, address and occupation or occupations of each person who owns twenty-five percent or more of the organization or of the shares of the organization.

Client identification, identification by others in licensee's firm

(2.1) A licensee complies with the identification requirements set out in subsections (1) and (2) if an employee of the licensee's firm or another licensee who practises law or provides legal services through the licensee's firm, acting on behalf of the licensee, complies with the requirements.

Client identification, previous identification

(3) A licensee complies with the identification requirements set out in subsection (2) if the licensee or another individual acting on behalf of the licensee under subsection (2.1) has previously complied with the identification requirements and has also previously complied with the verification requirements set out in subsection (4) in respect of the organization.

Client verification requirements

(4) When a licensee is engaged in the activities described in clause 22 (1) (b), the licensee shall take reasonable steps to verify the identity of the client and any third party that the client is acting for or representing using what the licensee reasonably considers to be reliable, independent source documents, data or information.

Timing of verification, individuals

(5) A licensee shall verify the identity of an individual mentioned in subsection (1), including an individual mentioned in paragraph 7, immediately after first engaging in the activities described in clause 22 (1) (b).

Timing of verification, organizations

(6) A licensee shall verify the identity of an organization mentioned in subsection (1) by not later than 60 days after first engaging in the activities described in clause 22 (1) (b).

Examples of independent source documents

(7) The following are examples of independent source documents for the purposes of subsection (4):

1. If the client or third party is an individual, an original government issued identification that is valid and has not expired, including a driver's licence, birth certificate, provincial or territorial health card (if such use of the card is not prohibited by the applicable provincial or territorial law), passport or similar record.

2. If the client or third party is an organization such as a corporation or society that is created or registered pursuant to legislative authority, a written confirmation from a government registry as to the existence, name and address of the organization, which includes the names of the organization's directors, if applicable, such as,

   i. a certificate of corporate status issued by a public body,

   ii. a copy obtained from a public body of a record that the organization is required to file annually under applicable legislation, or

   iii. a copy of a similar record obtained from a public body that confirms the organization's existence.

3. If the client or third party is an organization other than a corporation or society, such as a trust or partnership which is not registered in any government registry, a copy of the organization's constating documents, such as a trust or partnership agreement, articles of association or any other similar record that confirms its existence as an organization.

Client verification, non-face-to-face

(8) When a licensee is engaged in the activities described in clause 22 (1) (b) and the licensee is not receiving instructions from an individual face-to-face, the licensee complies with the verification requirements set out in subsection (4) if the licensee obtains an attestation from a person described in subsection (9) that the person has seen the appropriate independent source documents.

Persons from whom attestations may be accepted

(9) For the purposes of section (8), a licensee may obtain an attestation from the following persons:

1. If the client whose identity is being verified is present in Canada,

   i. a person entitled to administer oaths and affirmations in Canada, or

   ii. any of the following persons:

      A. a dentist,

      B. a physician,

      C. a chiropractor,

      D. a judge,

      E. a magistrate or a justice of the peace,

      F. a lawyer,

      G. a licensee (in Ontario)

      H. a notary (in Quebec),

      I. a notary public,

      J. an optometrist,

      K. a pharmacist,

      L. an accountant,

      M. a professional engineer,

      N. a veterinarian,

      O. a police officer,

      P. a nurse,

      Q. a school principal.

2. If the client whose identity is being verified is not present in Canada, a person acting on behalf of the licensee under clause (11) (b).

Attestation, form

(10) For the purposes of subsection (8), an attestation shall be endorsed on a legible photocopy of the document and shall include,

(a) the name, occupation and address of the person providing the attestation;

(b) the signature of the person providing the attestation; and

(c) the type and number of the document seen by the person providing the attestation.

Client verification, use of agent, *etc.*

(11) A licensee complies with the verification requirements set out in subsection (4) if,

(a) an employee of the licensee's firm or another licensee who practises law or provides legal services through the licensee's firm, acting on behalf of the licensee, complies with the requirements; or

(b) an individual who is not an individual mentioned in clause (a), acting on behalf of the licensee, complies with the requirements, provided that the licensee and the individual, prior to the individual acting on behalf of the licensee, enter into a written agreement specifying the steps that the individual will be taking on behalf of the licensee to comply with the verification requirements.

Client verification, previous verification

(12) A licensee complies with the verification requirements set out in subsection (4),

(a) in the case of an individual mentioned in subsection (1), if the licensee has previously complied with the verification requirements set out in subsection (4) in respect of the individual and recognizes the individual; and

(b) in the case of an organization mentioned in subsection (1), the licensee or an individual acting on behalf of the licensee under subsection (11) has previously complied with the identification requirements set out in subsection (2) and the verification requirements set out in subsection (4) in respect of the organization.

Copies to be obtained

(13) The licensee shall obtain a copy of every document used to verify the identity of any individual or organization for the purposes of subsection (4), including a copy of every document used by an individual acting on behalf of the licensee under subsection (11).

Record retention

(14) The licensee shall retain a record of the information obtained for the purposes of subsections (1) and (2) and copies of all documents received for the purposes of subsection (4) for the longer of,

(a) the duration of the licensee and client relationship and for as long as is necessary for the purpose of providing service to the client; and

(b) a period of at least six years following completion of the work for which the licensee was retained.

Criminal activity, duty to withdraw at time of taking information

24. If a licensee, in the course of complying with the client identification or verification requirements set out in section 23, knows or ought to know that he or she is or would be assisting a client in fraud or other illegal conduct, the licensee shall,

(a) immediately cease to and not further engage in any activities that would assist the client in fraud or other illegal conduct; and

(b) if the licensee is unable to comply with clause (a), withdraw from the provision of the licensee's professional services to the client.

Commencement

25. This Part comes into force on December 31, 2008.

PART IV

WITHDRAWAL OF SERVICES

Application of Part

26. This Part applies to all matters in respect of which a licensee is retained to provide her or his professional services to a client, including matters in respect of which the licensee was retained before this Part came into force and matters in respect of which the licensee is retained after that time regardless of whether the client is a new or existing client.

Criminal activity, duty to withdraw after being retained

27. If a licensee while retained by a client knows or ought to know that he or she is or would be assisting the client in fraud or other illegal conduct, the licensee shall,

(a) immediately cease to and not further engage in any activities that would assist the client in fraud or other illegal conduct; and

(b) if the licensee is unable to comply with clause (a), withdraw from the provision of the licensee's professional services to the client.

BY-LAW 8

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REPORTING AND FILING REQUIREMENTS

PART I

REPORTING REQUIREMENTS

BANKRUPTCY OR INSOLVENCY OF LICENSEE

Notice of bankruptcy or insolvency

1. A licensee shall immediately notify the Society whenever any of the following events occurs:

    1. The licensee receives notice of or is served with a petition for a receiving order against him or her filed in court under subsection 43 (1) of the *Bankruptcy and Insolvency Act* (Canada).

    2. The licensee makes an assignment of all his or her property for the general benefit of his or her creditors under section 49 of the *Bankruptcy and Insolvency Act* (Canada).

OFFENCES

Requirement to report offences: licensees

2. (1) Every licensee shall inform the Society in writing of,

    (a) a charge that the licensee committed,

(i) an indictable offence under the *Criminal Code* (Canada),

(ii) an offence under the *Controlled Drugs and Substances Act* (Canada),

(iii) an offence under the *Income Tax Act* (Canada) or under an Act of the legislature of a province or territory of Canada in respect of the income tax law of the province or territory, where the charge alleges, explicitly or implicitly, dishonesty on the part of the licensee or relates in any way to the professional business of the licensee,

(iv) an offence under an Act of the legislature of a province or territory of Canada in respect of the securities law of the province or territory, where the charge alleges, explicitly or implicitly, dishonesty on the part of the licensee or relates in any way to the professional business of the licensee, or

(v) an offence under another Act of Parliament, or under another Act of the legislature of a province or territory of Canada, where the charge alleges, explicitly or implicitly, dishonesty on the part of the licensee or relates in any way to the professional business of the licensee; and

(b) the disposition of a charge mentioned in clause (a).

Requirement to report: private prosecution

(2) Despite subsection (1), a licensee is only required to inform the Society of a charge contained in an information laid under section 504 of the *Criminal Code* (Canada), other than an information referred to in subsection 507 (1) of the *Criminal Code* (Canada), and of the disposition of the charge, if the charge results in a finding of guilt or a conviction.

Time of report

(3) A licensee shall report a charge as soon as reasonably practicable after he or she receives notice of the charge and shall report the disposition of a charge as soon as reasonably practicable after he or she receives notice of the disposition.

Same

(4) In the circumstances mentioned in subsection (2), a licensee shall report a charge and the disposition of the charge as soon as reasonably practicable after he or she receives notice of the disposition.

Interpretation: “indictable offence”

(5) In this section, “indictable offence” excludes an offence for which an offender is punishable only by summary conviction but includes,

(a) an offence for which an offender may be prosecuted only by indictment; and

(b) an offence for which an offender may be prosecuted by indictment or is punishable by summary conviction, at the instance of the prosecution.

INFORMATION: GENERAL

Requirement to provide various information

3. (1) The Society may require a licensee to provide to the Society the following information:

1. Personal identification information, including the licensee’s legal and assumed names.

2. Personal contact information.

3. Business contact information.

4. Information with respect to the licensee’s professional business, including,

   i. information about whether the licensee is practising law in Ontario as a barrister and solicitor or providing legal services in Ontario,

   ii. information with respect to where and in what capacity the licensee is practising law or providing legal services,

   iii. information with respect to the licensee’s handling of money and other property,

   iv. information with respect to the licensee’s storage of client files,

   v. information with respect to the licensee’s storage of wills and powers of attorney, and

   vi. information with respect to the licensee’s storage of corporate records, including minute books and seals.

Interpretation: personal and business contact information

(2) For the purposes of subsection (1),

(a) personal contact information includes,

(i) home address,

(ii) home telephone number,

(iii) home facsimile number, and

(iv) home e-mail address; and

(b) business contact information includes,

(i) business address,

(ii) business telephone number,

(iii) business facsimile number, and

(iv) business e-mail address.

Notice of requirement

(3) The Society shall notify a licensee in writing of the requirement to provide information under subsection (1) and shall send to the licensee a detailed list of the information to be provided by him or her.

Time for providing information

(4) Subject to subsection (5), the licensee shall provide to the Society the specific information required of him or her not later than ten days after the date specified on the notice of the requirement to provide information.

Extension of time for providing information

(5) On the request of the licensee, the Society may extend the time within which the licensee is required to provide to the Society the specific information required of him or her.

Request for extension of time

(6) A request to the Society to extend time under subsection (5) shall be made by the licensee in writing and by not later than the day by which the licensee is required under subsection (4) to provide information to the Society.

Additional authority to provide information

(7) The Society's authority to require a licensee to provide information contained in this section is in addition to, and does not limit, the Society's authority to require a licensee to provide information contained elsewhere in this By-Law, in any other by-law or in the Act.

REPORTING CHANGES

Requirement to report changes

4. (1) A licensee shall notify the Society in writing immediately after any change in the following information, previously provided by the licensee to the Society either before or after the coming into force of this section:

1. The licensee's legal and assumed names.

2. The licensee's personal contact information.

3. The licensee's business contact information.

4. Information with respect to whether the licensee is practising law in Ontario as a barrister and solicitor or providing legal services in Ontario.

5. Information with respect to the location and account number of any account at a chartered bank, provincial savings office, credit union or a league to which the *Credit Unions and Caisses Populaires Act, 1994* applies into which the licensee pays or paid money received in trust for a client.

Interpretation: personal and business contact information

(2) For the purposes of subsection (1),

(a) personal contact information includes,

(i) home address,

(ii) home telephone number,

(iii) home facsimile number, and

(iv) home e-mail address; and

(b) business contact information includes,

(i) business address,

(ii) business telephone number,

(iii) business facsimile number, and

(iv) business e-mail address.

Information required

(3) The notice required under subsection (1) shall include details of the change and the effective date of the change.

Documents, explanations

(4) The licensee shall provide to the Society such documents and explanations with respect to any change in the information mentioned in subsection (1) as the Society may require.

PART II

FILING REQUIREMENTS

ANNUAL REPORT

Requirement to file annual report

5. (1) Every licensee shall file a report with the Society, by March 31 of each year, in respect of,

(a) the licensee's professional business during the preceding year; and

(b) the licensee's other activities during the preceding year related to the licensee's practice of law or provision of legal services.

Form, format and manner of filing

(2) The report required under subsection (1) shall be in a form provided, and in an electronic format specified, by the Society and shall be filed electronically as permitted by the Society.

Same

(2.1) Despite subsection (2), on application by a licensee, in any year, the Society may, for that year, permit the licensee to file the report required under subsection (1) in a format other than the specified electronic format and in a manner other than electronically as permitted and a licensee who files the report required under subsection (1) in the format and manner as permitted by the Society under this subsection shall be deemed to have complied with the format and manner of filing requirements set out in subsection (2).

Exemption from requirement to file annual report

(3) The following licensees may apply to the Society for an exemption from the requirement to file a report under subsection (1):

1. A licensee who holds a Class L1 licence who is over sixty-five years of age and who,

   i. does not practise law in Ontario,

   ii. is not an estate trustee,

   iii. is not a trustee of an *inter vivos* trust, and

   iv. does not act as an attorney under a power of attorney for property given by a client or former client.

2. A licensee who holds a Class P1 licence who is over sixty-five years of age and who does not provide legal services in Ontario.

3. A licensee who is incapacitated within the meaning of the Act.

Application by licensee's representative

(4) The Society may permit any person on behalf of a licensee to make an application under subsection (3).

Application form

(5) An application under subsection (3) shall be in a form provided by the Society.

Documents and explanations

(6) For the purposes of assisting the Society to consider an application under subsection (3), the licensee or the person applying on behalf of the licensee shall provide to the Society such documents and explanations as may be required.

Consideration of application

(7) The Society shall consider every application made under subsection (3) and if satisfied that the licensee is eligible for an exemption under paragraph 1 or 2 of subsection (3), the Society shall approve the application.

Duration of exemption

(8) A licensee whose application is approved is exempt from the requirement to file a report under subsection (1) in respect of the year in which the application is approved and in respect of every year thereafter if the licensee remains eligible for the exemption throughout the entire year.

Period of default

6. For the purpose of clause 47 (1) (a) of the Act, the period of default for failure to complete or file a report required under section 5 is 120 days after the day the report is required to be filed.

Requirement to file public accountant's report

7. (1) The Society may require any licensee who is required to file a report under subsection 5 (1) to file, in addition to the report required under that subsection, a report of a public accountant relating to the matters in respect of which the licensee is required to file a report with the Society under subsection 5 (1).

Contents of report and time for filing

(2) The Society shall specify the matters to be included in the report and the time within which it must be filed with the Society.

Licensee's obligation to provide access to files, *etc*.

(3) For the purpose of permitting the public accountant to complete the report, the licensee shall,

(a) grant to the public accountant full access, without restriction, to all files maintained by the licensee;

(b) produce to the public accountant all financial records and other evidence and documents which the public accountant may require; and

(c) provide to the public accountant such explanations as the public accountant may require.

Authority to confirm independently particulars of transactions

(4) For the purpose of permitting the public accountant to complete the report, the public accountant may confirm independently the particulars of any transaction recorded in the files.

Cost

(5) The cost of preparing the report required under subsection (1), including the cost of retaining a public accountant, shall be paid for by the licensee.

Public accountant's duty of confidentiality

(6) When retaining a public accountant to complete a report required under this section, a licensee shall ensure that the public accountant is bound not to disclose any information that comes to his or her knowledge as a result of activities undertaken to complete the report, but the public accountant shall not be prohibited from disclosing information to the Society as required under this Part.

Period of default

8. (1) For the purpose of clause 47 (1) (a) of the Act, the period of default for failure to file a report of a public accountant in accordance with section 7 is 60 days after the day the report is required to be filed.

Reinstatement of licensee

(2) If a licensee's licence has been suspended under clause 47 (1) (a) of the Act for failure to file a report of a public accountant in accordance with section 7, for the purpose of subsection 47 (2) of the Act, the licensee shall file the report.

Failure to file public accountant's report: investigation

9. (1) If a licensee fails to file the report of a public accountant in accordance with section 7, the Society may require an investigation of the licensee's financial records to be made by a person designated by it, who need not be a public accountant, for the purpose of obtaining the information that would have been provided in the report.

Investigation: application of subss. 7 (3) and (4)

(2) Subsections 7 (3) and (4) apply with necessary modifications to the investigation under this section.

Confidentiality

(3) A person designated to investigate a licensee's financial records under this section shall not disclose any information that comes to his or her knowledge as a result of the investigation except as required in connection with the administration of the Act or the by-laws.

Cost

(4) The cost of the investigation under this section shall be paid for by the licensee.

PART III

REGISTER

Contents of register

10. (1) In addition to the information mentioned in subsection 27.1 (2) of the Act, the register that the Society is required to establish and maintain under section 27.1 of the Act shall contain the following information:

1. The assumed names, if any, of each licensee.

2. An indication of every time period that the licensee practises law in Ontario as a barrister and solicitor or provides legal services in Ontario.

3. For each time period that a licensee practises law in Ontario as a barrister and solicitor or provides legal services in Ontario,

   i. where and in what capacity the licensee practises law or provides legal services, and

   ii. the licensee's business contact information, including address, telephone number, facsimile number and e-mail address.

4. For each time period that a licensee does not practise law in Ontario as a barrister and solicitor or provide legal services in Ontario,

   i. if the licensee is otherwise working, the licensee's business contact information, including address, telephone number, facsimile number and e-mail address, or

   ii. if the licensee is not otherwise working, information as to how a licensee

may be contacted by former clients.

5. For a licensee who is deceased, the name and contact information, if any, of the licensee's estate trustee.

Availability to public

(2) The Society shall make the register available for public inspection in one or more of the following ways:

1. By establishing and maintaining a directory of licensees containing some or all of the information contained in the register on the Society's website.

2. By publishing a print directory of licensees containing some or all of the information contained in the register.

3. By establishing and maintaining a telephone line, open during the Society's normal business hours, for answering inquiries about contents of the register with respect to any licensee.

BY-LAW 9

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FINANCIAL TRANSACTIONS AND RECORDS

PART I

INTERPRETATION

Interpretation

1. (1) In this By-Law,

"arm's length" has the same meaning given it in the *Income Tax Act* (Canada);

"cash" means current coin within the meaning of the *Currency Act* (Canada), notes intended for circulation in Canada issued by the Bank of Canada pursuant to the *Bank of Canada Act* and current coin or banks notes of countries other than Canada;

"charge" has the same meaning given it in the *Land Registration Reform Act*;

"client" means a person or group of persons from whom or on whose behalf a licensee receives money or other property;

"firm of licensees" means,

(a) a partnership of licensees and all licensees employed by the partnership,

(b) a professional corporation established for the purpose of practising law in Ontario and all licensees employed by the professional corporation,

(c) a professional corporation established for the purpose of providing legal services in Ontario and all licensees employed by the professional corporation, or

(d) a professional corporation established for the purpose of practising law and providing legal services in Ontario and all licensees employed by the professional corporation;

"holiday" means,

(a) any Saturday or Sunday;

(b) New Year's Day, and where New Year's Day falls on a Saturday or Sunday, the following Monday;

(c) Family Day

(d) Good Friday;

(e) Easter Monday;

(f) Victoria Day;

(g) Canada Day, and where Canada Day falls on a Saturday or Sunday, the following Monday;

(h) Civic Holiday;

(i) Labour Day;

(j) Thanksgiving Day;

(k) Remembrance Day, and where Remembrance Day falls on a Saturday or Sunday, the following Monday;

(l) Christmas Day, and where Christmas Day falls on a Saturday or Sunday, the following Monday and Tuesday, and where Christmas Day falls on a Friday, the following Monday;

(m) Boxing Day; and

(n) any special holiday proclaimed by the Governor General or the Lieutenant Governor;

"lender" means a person who is making a loan that is secured or to be secured by a charge, including a charge to be held in trust directly or indirectly through a related person or

corporation;

“licensee” includes a firm of licensees;

“money” includes cash, cheques, drafts, credit card sales slips, post office orders and express and bank money orders;

“related” has the same meaning given it in the *Income Tax Act* (Canada);

“Teranet” means Teranet Inc., a corporation incorporated under the *Business Corporations Act*, acting as agent for the Ministry of Consumer and Business Services.

Time for doing an act expires on a holiday

(2) Except where a contrary intention appears, if the time for doing an act expires on a holiday, the act may be done on the next day that is not a holiday.

When deemed in trust

(3) For the purposes of subsections 9 (1), (2) and (3) and section 14, cash, cheques negotiable by the licensee, cheques drawn by the licensee on the licensee’s trust account and credit card sales slips in the possession and control of the licensee shall be deemed from the time the licensee receives such possession and control to be money held in a trust account if the cash, cheques or credit card sales slips, as the case may be, are deposited in the trust account not later than the following banking day.

PART II

HANDLING OF MONEY BY BANKRUPT LICENSEE

Handling of money by bankrupt licensee

2. (1) Subject to subsections (2) and (3), a licensee who is bankrupt within the meaning of the *Bankruptcy and Insolvency Act* (Canada) shall not receive from or on behalf of a person or group of persons any money or other property and shall not otherwise handle money or other property that is held in trust for a person or group of persons.

Exception

(2) A licensee who is bankrupt within the meaning of the *Bankruptcy and Insolvency Act* (Canada) may receive from or on behalf of a person or group of persons money,

(a) in payment of fees for services performed by the licensee for the person or group; or

(b) in reimbursement for money properly expended, or for expenses properly incurred, on behalf of the person or group.

Same

(3) A licensee who is bankrupt within the meaning of the *Bankruptcy and Insolvency Act* (Canada) may apply in writing to the Society for permission to receive from or on behalf of a person or group of persons any money or other property, other than as permitted under subsection (2), or for permission to handle money or other property that is held in trust for a person or group of persons, and the Society may permit the licensee to do so, subject to such terms and conditions as the Society may impose.

PART II.1

HANDLING OF MONEY BY LICENSEE WHOSE LICENCE IS SUSPENDED

Interpretation

2.1 In this Part,

"suspended licensee" means a licensee who is the subject of a suspension order;

"suspension order" means an order made under the Act suspending a licensee's licence to practise law in Ontario as a barrister and solicitor or to provide legal services in Ontario, regardless of whether the suspension begins when the order is made or thereafter.

Handling of money by suspended licensee

2.2 (1) Subject to subsection (2) and section 2.3, a suspended licensee shall not, during the suspension receive from or on behalf of a person or group of persons any money or other property and shall not otherwise handle money or other property that is held in trust for a person or group of persons.

Exception

(2) A suspended licensee may receive from or on behalf of a person or group of persons money,

(a) in payment of fees for services performed by the suspended licensee for the person or group; or

(b) in reimbursement for money properly expended, or for expenses properly incurred, on behalf of the person or group.

Trust account

2.3 (1) A suspended licensee shall, within 30 days of the beginning of the suspension,

(a) withdraw from every trust account kept in the name of the suspended licensee, or in the name of the firm of licensees of which the suspended licensee is a partner or by which the suspended licensee is employed, and, as required, pay to the appropriate person,

(i) money properly required for payment to a person on behalf of a client,

(ii) money required to reimburse the suspended licensee for money properly expended, or for expenses properly incurred, on behalf of a client,

(iii) money required for or toward payment of fees for services performed by the suspended licensee, and

(iv) all other money that belongs to the suspended licensee or to a person other than a client;

(b) after complying with clause (a), withdraw from every trust account kept in the name of the suspended licensee, or in the name of the firm of licensees of which the suspended licensee is a partner or by which the suspended licensee is employed, all money belonging to a client and pay the money to,

(i) the client,

(ii) another licensee to whom the client has directed the suspended licensee to make payment, or

(iii) another licensee who has agreed with the suspended licensee to accept payment in the event that the suspended licensee is unable to comply with subclause (i) or (ii); and

(c) after complying with clauses (a) and (b),

(i) close every trust account that was kept in the name of the suspended

licensee, and

(ii) cancel or cause to be cancelled the suspended licensee's signing authority on every trust account that was kept in the name of the firm of licensees of which the suspended licensee is a partner or by which the suspended licensee is employed.

Compliance with clause (1) (b) not required

(2) A suspended licensee is not required to comply with clause (1) (b) if the client's file is transferred, in accordance with Part IV of By-Law 7.1, to another licensee in the firm of licensees of which the suspended licensee is a partner or by which the suspended licensee is employed.

Application of sections of Part IV

(3) Subsection 9 (3) and sections 10, 11 and 12 apply to the withdrawal of money from a trust account under this section.

Report to Society on compliance

(4) A suspended licensee shall, not later than thirty days after the suspension begins, complete and file with the Society, in a form provided by the Society, a report confirming and providing details of the suspended licensee's compliance with this section.

Permission to be exempt from requirement

2.4 A suspended licensee may apply in writing to the Society for an exemption from or a modification of a requirement mentioned in this Part, and the Society may exempt the suspended licensee from or modify the requirement, subject to such terms and conditions as the Society may impose.

PART III

CASH TRANSACTIONS

Definition

3. In this Part,

"funds" means cash, currency, securities and negotiable instruments or other financial instruments that indicate the person's title or interest in them;

"public body" means,

(a) a department or agent of Her Majesty in right of Canada or of a province;

(b) an incorporated city, metropolitan authority, town, township, village, county, district, rural municipality or other incorporated municipal body or an agent of any of them; and

(c) an organization that operates a public hospital and that is designated by the Minister of National Revenue as a hospital under the *Excise Tax Act* (Canada) or agent of the organization.

Cash received

4. (1) A licensee shall not receive or accept from a person, in respect of any one client file, cash in an aggregate amount of 7,500 or more Canadian dollars.

Foreign currency

(2) For the purposes of this section, when a licensee receives or accepts from a person cash in a foreign currency the licensee shall be deemed to have received or accepted the cash converted into Canadian dollars at,

(a) the official conversion rate of the Bank of Canada for the foreign currency as published in the Bank of Canada's Daily Noon Rates that is in effect at the time the licensee receives or accepts the cash; or

(b) if the day on which the licensee receives or accepts cash is a holiday, the official conversion rate of the Bank of Canada in effect on the most recent business day preceding the day on which the licensee receives or accepts the cash.

Application

5. Section 4 applies when, in respect of a client file, a licensee engages in or gives instructions in respect of the following activities:

1. The licensee receives or pays funds.

2. The licensee purchases or sells securities, real properties or business assets or entities.

3. The licensee transfers funds by any means.

Exceptions

6. Despite section 5, section 4 does not apply when the licensee,

(a) receives cash from a public body, an authorized foreign bank within the meaning of section 2 of the *Bank Act* (Canada) in respect of its business in Canada or a bank to which the *Bank Act* (Canada) applies, a cooperative credit society, savings and credit union or caisse populaire that is regulated by a provincial Act, an association that is regulated by the *Cooperative Credit Associations Act* (Canada), a company to which the *Trust and Loan Companies Act* (Canada) applies, a trust company or loan company regulated by a provincial Act or a department or agent of Her Majesty in right of Canada or of a province where the department or agent accepts deposit liabilities in the course of providing financial services to the public;

(b) receives cash from a peace officer, law enforcement agency or other agent of the Crown acting in an official capacity;

(c) receives cash pursuant to an order of a tribunal;

(d) receives cash to pay a fine or penalty; or

(e) receives cash for fees, disbursements, expenses or bail provided that any refund out of such receipts is also made in cash.

PART IV

TRUST ACCOUNT

TRUST ACCOUNT TRANSACTIONS

Money received in trust for client

7. (1) Subject to section 8, every licensee who receives money in trust for a client shall immediately pay the money into an account at a chartered bank, provincial savings office, credit union or a league to which the *Credit Unions and Caisses Populaires Act, 1994* applies or registered trust corporation, to be kept in the name of the licensee, or in the name of the firm of licensees of which the licensee is a partner, through which the licensee practises law or provides

legal services or by which the licensee is employed, and designated as a trust account.

Interpretation

(2) For the purposes of subsection (1), a licensee receives money in trust for a client if the licensee receives from a person,

(a) money that belongs in whole or in part to a client;

(b) money that is to be held on behalf of a client;

(c) money that is to be held on a client=s direction or order;

(d) money that is advanced to the licensee on account of fees for services not yet rendered; or

(e) money that is advanced to the licensee on account of disbursements not yet made.

Money to be paid into trust account

(3) In addition to the money required under subsection (1) to be paid into a trust account, a licensee shall pay the following money into a trust account:

1. Money that may by inadvertence have been drawn from a trust account in contravention of section 9.

2. Money paid to a licensee that belongs in part to a client and in part to the licensee where it is not practical to split the payment of the money.

Money to be paid into trust account: money received before licence issued

(3.1) If a licensee who holds a Class P1 licence receives from a person, prior to being issued the licence, money for services yet to be rendered to a client and the licensee does not perform the services for the client by May 2, 2010, the licensee shall on May 3, 2010 pay the money into a trust account.

Withdrawal of money from trust account

(4) A licensee who pays into a trust account money described in paragraph 2 of subsection (3) shall as soon as practical withdraw from the trust account the amount of the money that belongs to him or her.

One or more trust accounts

(5) A licensee may keep one or more trust accounts.

Money not to be paid into trust account

8. (1) A licensee is not required to pay into a trust account money which he or she receives in trust for a client if,

(a) the client requests the licensee in writing not to pay the money into a trust account;

(b) the licensee pays the money into an account to be kept in the name of the client, a person named by the client or an agent of the client; or

(c) the licensee pays the money immediately upon receiving it to the client or to a person on behalf of the client in accordance with ordinary business practices.

Same

(2) A licensee shall not pay into a trust account the following money:

1. Money that belongs entirely to the licensee or to another licensee of the firm of licensees of which the licensee is a partner, through which the licensee practises law or provides legal services or by which the licensee is employed, including an amount received as a general retainer for which the licensee is not required either to account or to provide services.

2. Money that is received by the licensee as payment of fees for services for which a billing has been delivered, as payment of fees for services already performed for which a billing will be delivered immediately after the money is received or as reimbursement for disbursements made or expenses incurred by the licensee on behalf of a client.

Record keeping requirements

(3) A licensee who, in accordance with subsection (1), does not pay into a trust account money which he or she receives in trust for a client shall include all handling of such money in the records required to be maintained under Part V.

Withdrawal of money from trust account

9. (1) A licensee may withdraw from a trust account only the following money:

1. Money properly required for payment to a client or to a person on behalf of a client.

2. Money required to reimburse the licensee for money properly expended on behalf of a client or for expenses properly incurred on behalf of a client.

3. Money properly required for or toward payment of fees for services performed by the licensee for which a billing has been delivered.

4. Money that is directly transferred into another trust account and held on behalf of a client.

5. Money that under this Part should not have been paid into a trust account but was through inadvertence paid into a trust account.

Permission to withdraw other money

(2) A licensee may withdraw from a trust account money other than the money mentioned in subsection (1) if he or she has been authorized to do so by the Society.

Limit on amount withdrawn from trust account

(3) A licensee shall not at any time with respect to a client withdraw from a trust account under this section more money than is held on behalf of that client in that trust account at that time.

Manner in which certain money may be withdrawn from trust account

10. A licensee shall withdraw money from a trust account under paragraph 2 or 3 of subsection 9 (1) only,

(a) by a cheque drawn in favour of the licensee;

(b) by a transfer to a bank account that is kept in the name of the licensee and is not a trust account; or

(c) by electronic transfer.

Withdrawal by cheque

11. A cheque drawn on a trust account shall not be,

(a) made payable either to cash or to bearer; or

(b) signed by a person who is not a licensee except in exceptional circumstances and except when the person has signing authority on the trust account on which a cheque will be drawn and is bonded in an amount at least equal to the maximum balance on deposit during the immediately preceding fiscal year of the licensee in all the trust accounts on which signing authority has been delegated to the person.

Withdrawal by electronic transfer

12. (1) Money withdrawn from a trust account by electronic transfer shall be withdrawn only in accordance with this section.

When money may be withdrawn

(2) Money shall not be withdrawn from a trust account by electronic transfer unless the following conditions are met:

1. The electronic transfer system used by the licensee must be one that does not permit an electronic transfer of funds unless,

   i. one person, using a password or access code, enters into the system the data describing the details of the transfer, and

   ii. another person, using another password or access code, enters into the system the data authorizing the financial institution to carry out the transfer.

2. The electronic transfer system used by the licensee must be one that will produce, not later than the close of the banking day immediately after the day on which the electronic transfer of funds is authorized, a confirmation from the financial institution confirming that the data describing the details of the transfer and authorizing the financial institution to carry out the transfer were received.

3. The confirmation required by paragraph 2 must contain,

   i. the number of the trust account from which money is drawn,

   ii. the name, branch name and address of the financial institution where the account to which money is transferred is kept,

   iii. the name of the person or entity in whose name the account to which money is transferred is kept,

iv. the number of the account to which money is transferred,

v. the time and date that the data describing the details of the transfer and authorizing the financial institution to carry out the transfer are received by the financial institution, and

vi. the time and date that the confirmation from the financial institution is sent to the licensee.

4. Before any data describing the details of the transfer or authorizing the financial institution to carry out the transfer is entered into the electronic trust transfer system, an electronic trust transfer requisition must be signed by,

i. a licensee, or

ii. in exceptional circumstances, a person who is not a licensee if the person has signing authority on the trust account from which the money will be drawn and is bonded in an amount at least equal to the maximum balance on deposit during the immediately preceding fiscal year of the licensee in all trust accounts on which signing authority has been delegated to the person.

5. The data entered into the electronic trust transfer system describing the details of the transfer and authorizing the financial institution to carry out the transfer must be as specified in the electronic trust transfer requisition.

Application of para. 1 of subs. (2) to sole practitioner

(3) Paragraph 1 of subsection (2) does not apply to a licensee who practises law or provides legal services without another licensee as a partner, if the licensee practises law or provides legal services through a professional corporation, without another licensee practising law or providing legal services through the professional corporation and without another licensee or person as an employee, if the licensee himself or herself enters into the electronic trust transfer system both the data describing the details of the transfer and the data authorizing the financial institution to carry out the transfer.

Same

(4) In exceptional circumstances, the data referred to in subsection (3) may be entered by a person other than the licensee, if the person has signing authority on the trust account from which the money will be drawn and is bonded in an amount at least equal to the maximum balance on deposit during the immediately preceding fiscal year of the licensee in all trust accounts on which signing authority has been delegated to the person.

Additional requirements relating to confirmation

(5) Not later than the close of the banking day immediately after the day on which the confirmation required by paragraph 2 of subsection (2) is sent to a licensee, the licensee shall,

(a) produce a printed copy of the confirmation;

(b) compare the printed copy of the confirmation and the signed electronic trust transfer requisition relating to the transfer to verify whether the money was drawn from the trust account as specified in the signed requisition;

(c) indicate on the printed copy of the confirmation the name of the client, the subject matter of the file and any file number in respect of which money was drawn from the trust account; and

(d) after complying with clauses (a) to (c), sign and date the printed copy of the confirmation.

Same

(6) In exceptional circumstances, the tasks required by subsection (5) may be performed by a person other than the licensee, if the person has signing authority on the trust account from which the money will be drawn and is bonded in an amount at least equal to the maximum balance on deposit during the immediately preceding fiscal year of the licensee in all trust accounts on which signing authority has been delegated to the person.

Electronic trust transfer requisition

(7) The electronic trust transfer requisition required under paragraph 4 of subsection (2) shall be in Form 9A.

Definitions

13. (1) In this section,

"closing funds" means the money necessary to complete or close a transaction in real estate;

"transaction in real estate" means,

(a) a charge on land given for the purpose of securing the payment of a debt or the performance of an obligation, including a charge under the *Land Titles Act* and a mortgage, but excluding a rent charge, or

(b) a conveyance of freehold or leasehold land, including a deed and a transfer under the *Land Titles Act*, but excluding a lease.

Withdrawal by electronic transfer: closing funds

(2) Despite section 12, closing funds may be withdrawn from a trust account by electronic transfer in accordance with this section.

When closing funds may be withdrawn

(3) Closing funds shall not be withdrawn from a trust account by electronic transfer unless the following conditions are met:

1. The electronic transfer system used by the licensee must be one to which access is restricted by the use of at least one password or access code.

2. The electronic transfer system used by the licensee must be one that will produce immediately after the electronic transfer of funds a confirmation of the transfer.

3. The confirmation required by paragraph 2 must contain,

   i. the name of the person or entity in whose name the account from which money is drawn is kept,

   ii. the number of the trust account from which money is drawn,

   iii. the name of the person or entity in whose name the account to which money is transferred is kept,

   iv. the number of the account to which money is transferred, and

   v. the date the transfer is carried out.

4. Before the electronic transfer system used by the licensee is accessed to carry out an electronic transfer of funds, an electronic trust transfer requisition must be signed by,

   i. the licensee, or

   ii. in exceptional circumstances, a person who is not the licensee if the person has signing authority on the trust account from which the money will be drawn and is bonded in an amount at least equal to the maximum balance

on deposit during the immediately preceding fiscal year of the licensee in all trust accounts on which signing authority has been delegated to the person.

5. The data entered into the electronic transfer system describing the details of the electronic transfer of funds must be as specified in the electronic trust transfer requisition.

Additional requirements relating to confirmation

(4) Not later than 5 p.m. on the day immediately after the day on which the electronic transfer of funds is carried out, the licensee shall,

(a) produce a printed copy of the confirmation required by paragraph 2 of subsection (3);

(b) compare the printed copy of the confirmation and the signed electronic trust transfer requisition relating to the transfer to verify whether the money was drawn from the trust account as specified in the signed requisition;

(c) indicate on the printed copy of the confirmation the name of the client, the subject matter of the file and any file number in respect of which money was drawn from the trust account; and

(d) after complying with clauses (a) to (c), sign and date the printed copy of the confirmation.

Same

(5) In exceptional circumstances, the tasks required by subsection (4) may be performed by a person other than the licensee, if the person has signing authority on the trust account from which the money will be drawn and is bonded in an amount at least equal to the maximum balance on deposit during the immediately preceding fiscal year of the licensee in all trust accounts on which signing authority has been delegated to the person.

Electronic trust transfer requisition: closing funds

(6) The electronic trust transfer requisition required under paragraph 4 of subsection (3) shall be in Form 9C.

Requirement to maintain sufficient balance in trust account

14. Despite any other provision in this Part, a licensee shall at all times maintain sufficient balances on deposit in his or her trust accounts to meet all his or her obligations with respect to money held in trust for clients.

AUTOMATIC WITHDRAWALS FROM TRUST ACCOUNTS

Authorizing Teranet to withdraw money from trust account

15. (1) Subject to subsection (2), a licensee may authorize Teranet to withdraw from a trust account described in subsection 16 (1) money required to pay the document registration fees and the land transfer tax, if any, related to a client=s real estate transaction.

Conditions

(2) A licensee shall not authorize Teranet to withdraw from a trust account described in subsection 16 (1) money required to pay the document registration fees and the land transfer tax, if any, related to a client=s real estate transaction unless Teranet agrees to provide to the licensee in accordance with subsection (3) a confirmation of the withdrawal that contains the information mentioned in subsection (4).

Time of receipt of confirmation

(3) The confirmation required under subsection (2) must be received by the licensee not later than 5 p.m. on the day immediately after the day on which the withdrawal is authorized by the licensee.

Contents of confirmation

(4) The confirmation required under subsection (2) must contain,

(a) the amount of money withdrawn from the trust account;

(b) the time and date that the authorization to withdraw money is received by Teranet; and

(c) the time and date that the confirmation from Teranet is sent to the licensee.

Written record of authorization

(5) A licensee who authorizes Teranet to withdraw from a trust account described in subsection 16 (1) money required to pay the document registration fees and the land transfer tax, if any, related to a client=s real estate transaction shall record the authorization in writing.

Same

(6) The written record of the authorization required under subsection (5) shall be in Form 9B and shall be completed by the licensee before he or she authorizes Teranet to withdraw from a trust account described in subsection 16 (1) money required to pay the document registration fees and the land transfer tax, if any, related to a client=s real estate transaction.

Additional requirements relating to confirmation

(7) Not later than 5 p.m. on the day immediately after the day on which the confirmation required under subsection (2) is sent to a licensee, the licensee shall,

(a) produce a paper copy of the confirmation, if the confirmation is sent to the licensee by electronic means;

(b) compare the paper copy of the confirmation and the written record of the authorization relating to the withdrawal to verify whether money was withdrawn from the trust account by Teranet as authorized by the licensee;

(c) indicate on the paper copy of the confirmation the name of the client and any file number in respect of which money was withdrawn from the trust account, if the confirmation does not already contain such information; and

(d) after complying with clauses (a) to (c), sign and date the paper copy of the confirmation.

Special trust account

16 (1) The trust account from which Teranet may be authorized by a licensee to withdraw money shall be,

(a) an account at a chartered bank, provincial savings office, credit union or league to which the *Credit Unions and Caisses Populaires Act, 1994* applies or a registered trust corporation kept in the name of the licensee or in the name of the firm of licensees of which the licensee is a partner, through which the licensee practises law or by which the licensee is employed, and designated as a trust account; and

(b) an account into which a licensee shall pay only,

(i) money received in trust for a client for the purposes of paying the document registration fees and the land transfer tax, if any, related to the client=s real estate transaction; and

(ii) money properly withdrawn from another trust account for the purposes of paying the document registration fees and the land transfer tax, if any, related to the client=s real estate transaction.

One or more special trust accounts

(2) A licensee may keep one or more trust accounts of the kind described in subsection (1).

Payment of money into special trust account

(3) A licensee shall not pay into a trust account described in subsection (1) more money than is required to pay the document registration fees and the land transfer tax, if any, related to a client=s real estate transaction, and if more money is, through inadvertence, paid into the trust account, the licensee shall transfer from the trust account described in subsection (1) into another trust account that is not a trust account described in subsection (1) the excess money.

Time limit on holding money in special trust account

(4) A licensee who pays money into a trust account described in subsection (1) shall not keep the money in that account for more than five days, and if the money is not properly withdrawn from that account by Teranet within five days after the day on which it is paid into that account, the licensee shall transfer the money from that account into another trust account that is not a trust account described in subsection (1).

Interpretation: counting days

(5) In subsection 16 (4), holidays shall not be counted in determining if money has been kept in a trust account described in subsection 16 (1) for more than five days.

Application of ss. 9, 11, 12 and 14

17. Sections 9, 11, 12 and 14 apply, with necessary modifications, to a trust account described in subsection 16 (1).

PART V

RECORD KEEPING REQUIREMENTS

REQUIREMENTS

Requirement to maintain financial records

18. Every licensee shall maintain financial records to record all money and other property received and disbursed in connection with the licensee's professional business, and, as a minimum requirement, every licensee shall maintain, in accordance with sections 21, 22 and 23, the following records:

1. A book of original entry identifying each date on which money is received in trust for a client, the method by which money is received, the person from whom money is received, the amount of money received, the purpose for which money is received and the client for whom money is received in trust.

2. A book of original entry showing all disbursements out of money held in trust for a client and identifying each date on which money is disbursed, the method by which money is disbursed, including the number or a similar identifier of any document used to disburse money, the person to whom money is disbursed, the amount of money which is disbursed, the purpose for which money is disbursed and the client on whose behalf money is disbursed.

3. A clients' trust ledger showing separately for each client for whom money is received in trust all money received and disbursed and any unexpended balance.

4. A record showing all transfers of money between clients' trust ledger accounts and explaining the purpose for which each transfer is made.

5. A book of original entry showing all money received, other than money received in trust for a client, and identifying each date on which money is received, the method by which money is received, the amount of money which is received and the person from whom money is received.

6. A book of original entry showing all disbursements of money, other than money held in trust for a client, and identifying each date on which money is disbursed, the method by which money is disbursed, including the number or a similar identifier of any document used to disburse money, the amount of money which is disbursed and the person to whom money is disbursed.

7. A fees book or a chronological file of copies of billings, showing all fees charged and other billings made to clients and the dates on which fees are charged and other billings are made to clients and identifying the clients charged and billed.

8. A record showing a comparison made monthly of the total of balances held in the trust account or accounts and the total of all unexpended balances of funds held in trust for clients as they appear from the financial records together with the reasons for any differences between the totals, and the following records to support the monthly comparisons:

   i. A detailed listing made monthly showing the amount of money held in trust for each client and identifying each client for whom money is held in trust.

   ii. A detailed reconciliation made monthly of each trust bank account.

9. A record showing all property, other than money, held in trust for clients, and describing each property and identifying the date on which the licensee took possession of each property, the person who had possession of each property immediately before the licensee took possession of the property, the value of each property, the client for whom each property is held in trust, the date on which possession of each property is given away and the person to whom possession of each property is given.

10. Bank statements or pass books, cashed cheques and detailed duplicate deposit slips for all trust and general accounts.

11. Signed electronic trust transfer requisitions and signed printed confirmations of electronic transfers of trust funds.

12. Signed authorizations of withdrawals by Teranet and signed paper copies of confirmations of withdrawals by Teranet.

Record keeping requirements if cash received

19 (1) Every licensee who receives cash shall maintain financial records in addition to those required under section 18 and, as a minimum additional requirement, shall maintain, in accordance with sections 21, 22 and 23, a book of duplicate receipts, with each receipt identifying the date on which cash is received, the person from whom cash is received, the amount of cash received, the client for whom cash is received and any file number in respect of which cash is received and containing the signature of the licensee or the person authorized by the licensee to receive cash and of the person from whom cash is received.

No breach

(2) A licensee does not breach subsection (1) if a receipt does not contain the signature of the person from whom cash is received provided that the licensee has made reasonable efforts to obtain the signature of the person from whom cash is received.

Record keeping requirements if mortgages and other charges held in trust for clients

20. Every licensee who holds in trust mortgages or other charges on real property, either directly or indirectly through a related person or corporation, shall maintain financial records in addition to those required under section 18 and, as a minimum additional requirement, shall maintain, in accordance with sections 21, 22 and 23, the following records:

1. A mortgage asset ledger showing separately for each mortgage or charge,

   i. all funds received and disbursed on account of the mortgage or charge,

   ii. the balance of the principal amount outstanding for each mortgage or charge,

   iii. an abbreviated legal description or the municipal address of the real property, and

   iv. the particulars of registration of the mortgage or charge.

2. A mortgage liability ledger showing separately for each person on whose behalf a mortgage or charge is held in trust,

   i. all funds received and disbursed on account of each mortgage or charge held in trust for the person,

   ii. the balance of the principal amount invested in each mortgage or charge,

   iii. an abbreviated legal description or the municipal address for each mortgaged or charged real property, and

   iv. the particulars of registration of each mortgage or charge.

3. A record showing a comparison made monthly of the total of the principal balances outstanding on the mortgages or charges held in trust and the total of all principal balances held on behalf of the investors as they appear from the financial records together with the reasons for any differences between the totals, and the following records to support the monthly comparison:

i. A detailed listing made monthly identifying each mortgage or charge and showing for each the balance of the principal amount outstanding.

ii. A detailed listing made monthly identifying each investor and showing the balance of the principal invested in each mortgage or charge.

Financial records to be permanent

21. (1) The financial records required to be maintained under sections 18, 19 and 20 may be entered and posted by hand or by mechanical or electronic means, but if the records are entered and posted by hand, they shall be entered and posted in ink.

Paper copies of financial records

(2) If a financial record is entered and posted by mechanical or electronic means, a licensee shall ensure that a paper copy of the record may be produced promptly on the Society's request.

Financial records to be current

22. (1) Subject to subsection (2), the financial records required to be maintained under sections 18, 19 and 20 shall be entered and posted so as to be current at all times.

Exceptions

(2) The record required under paragraph 8 of section 18 and the record required under paragraph 3 of section 20 shall be created within twenty-five days after the last day of the month in respect of which the record is being created.

Preservation of financial records required under ss. 18 and 19

23. (1) Subject to subsection (2), a licensee shall keep the financial records required to be maintained under sections 18 and 19 for at least the six year period immediately preceding the licensee's most recent fiscal year end.

Same

(2) A licensee shall keep the financial records required to be maintained under paragraphs 1, 2, 3, 8, 9, 10 and 11 of section 18 for at least the ten year period immediately preceding the licensee's most recent fiscal year end.

Preservation of financial records required under s. 20

(3) A licensee shall keep the financial records required to be maintained under section 20 for at least the ten year period immediately preceding the licensee's most recent fiscal year end.

Record keeping requirements when acting for lender

24. (1) Every licensee who acts for or receives money from a lender shall, in addition to maintaining the financial records required under sections 18 and 20, maintain a file for each charge, containing,

(a) a completed investment authority, signed by each lender before the first advance of money to or on behalf of the borrower;

(b) a copy of a completed report on the investment;

(c) if the charge is not held in the name of all the lenders, an original declaration of trust;

(d) a copy of the registered charge; and

(e) any supporting documents supplied by the lender.

Exceptions

(2) Clauses (1) (a) and (b) do not apply with respect to a lender if,

(a) the lender,

(i) is a bank listed in Schedule I or II to the *Bank Act* (Canada), a licensed insurer, a registered loan or trust corporation, a subsidiary of any of them, a pension fund, or any other entity that lends money in the ordinary course of its business,

(ii) has entered a loan agreement with the borrower and has signed a written commitment setting out the terms of the prospective charge, and

(iii) has given the licensee a copy of the written commitment before the advance of money to or on behalf of the borrower;

(b) the lender and borrower are not at arm's length;

(c) the borrower is an employee of the lender or of a corporate entity related to the lender;

(d) the lender has executed the Investor/Lender Disclosure Statement for Brokered Transactions, approved by the Superintendent under subsection 54 (1) of the *Mortgage Brokerages, Lenders and Administrators Act, 2006*, and has given the licensee written instructions, relating to the particular transaction, to accept the executed disclosure statement as proof of the loan agreement;

(e) the total amount advanced by the lender does not exceed $6,000; or

(f) the lender is selling real property to the borrower and the charge represents part of the purchase price.

Requirement to provide documents to lender

(3) Forthwith after the first advance of money to or on behalf of the borrower, the licensee shall deliver to each lender,

(a) if clause (1) (b) applies, an original of the report referred to therein; and

(b) if clause (1) (c) applies, a copy of the declaration of trust.

Requirement to add to file maintained under subs. (1)

(4) Each time the licensee or any licensee of the same firm of licensees does an act described in subsection (5), the licensee shall add to the file maintained for the charge the investment authority referred to in clause (1) (a), completed anew and signed by each lender before the act is done, and a copy of the report on the investment referred to in clause (1) (b), also completed anew.

Application of subs. (4)

(5) Subsection (4) applies in respect of the following acts:

1. Making a change in the priority of the charge that results in a reduction of the amount of security available to it.

2. Making a change to another charge of higher priority that results in a reduction of the amount of security available to the lender's charge.

3. Releasing collateral or other security held for the loan.

4. Releasing a person who is liable under a covenant with respect to an obligation in connection with the loan.

New requirement to provide documents to lender

(6) Forthwith after completing anew the report on the investment under subsection (4), the licensee shall deliver an original of it to each lender.

Requirement to add to file maintained under subs. (1): substitution

(7) Each time the licensee or any other licensee of the same firm of licensees substitutes for the charge another security or a financial instrument that is an acknowledgment of indebtedness, the licensee shall add to the file maintained for the charge the lender's written consent to the substitution, obtained before the substitution is made.

Exceptions

(8) The licensee need not comply with subsection (4) or (7) with respect to a lender if clause (2) (a), (b), (c), (e) or (f) applied to the lender in the original loan transaction.

Investment authority: Form 9D

(9) The investment authority required under clause (1) (a) shall be in Form 9D.

Report on investment: Form 9E

(10) Subject to subsection (11), the report on the investment required under clause (1) (b) shall be in Form 9E.

Report on investment: alternative to Form 9E

(11) The report on the investment required under clause (1) (b) may be contained in a reporting letter addressed to the lender or lenders which answers every question on Form 9E.

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