Date of Release: January 31, 1995 **No. A883676**

Vancouver Registry

IN THE SUPREME COURT OF BRITISH COLUMBIA

BETWEEN:)

)

BANK OF MONTREAL) **REASONS FOR JUDGMENT**

)

PLAINTIFF)

) **OF THE HONOURABLE**

AND:)

)

ON-STREAM NATURAL GAS LIMITED) **MADAM JUSTICE HUDDART**

PARTNERSHIP and ON-STREAM)

NATURAL GAS MANAGEMENT INC.)

) **(IN CHAMBERS)**

DEFENDANTS)

R.A. Millar Counsel for the Bank of Montreal

L.C. Donaldson Counsel for B.D.O. Dunwoody Ward Mallette Ltd.

W.A. Ferguson Counsel for Accrued Holdings

& J. Levine Limited Partnership

F.G. Potts Counsel for 71 Limited Partners of

On-Stream Natural Gas

Limited Partnership

Heard at Vancouver: January 19 & 20, 1995

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1 This application for an order approving the sale of promissory notes payable by investors in a limited partnership to the partnership arises in unusual circumstances. This is not a debenture holder's action and the notes are not the subject-matter of this action. The parties agree, however, that this court has the authority to make the orders requested by the Receiver-Manager, under one or more of the supervisory power given this court by sections 66(1)(f) and 77(2)(d) of the Personal Property Security Act, sections 34 and 63 of the Law and Equity Act, and its inherent jurisdiction, depending on the view one takes of the facts.

Background Facts

2 Dunwoody Limited was appointed Receiver-Manager of the On-Stream Natural Gas Limited Partnership in a debenture holders action on February 11, 1988 (Vancouver Registry No. C880049). The Court of Queen's Bench of Alberta recognized that appointment on June 7, 1988. Under it Dunwoody obtained the power to sell the assets of the Limited Partnership. As a result of the sale of assets in Alberta the debenture of the Bank of Montreal was satisfied in full.

3 Meanwhile on May 31, 1988 the Bank had demanded payment of the debt secured by a debenture in favour of Argus Resources Ltd which had been assigned to the Bank as part of tripartite arrangements whereby the Limited Partnership acquired certain gas properties from Argus. The Limited Partnership failed to make the payment and the Bank obtained default judgment in Alberta on October 25, 1988. This proceeding was commenced to register that judgment in this court on December 20, 1988. The balance outstanding on that judgment now totals about $900,000.00.

4 On August 22, 1989, the Bank appointed Dunwoody Limited as receiver-manager of the assets of the Limited Partnership and as its agent to realize on the security of the promissory notes. Three days later it approved an agreement by Dunwoody to sell the promissory notes to Accrued Holdings Limited Partnership for $155,000.00. By that date Richard Demers, the account manager responsible for the loan at the Bank, had become aware of the formation of a steering committee of the limited partners of On-Stream arising from investors' concerns about the conduct of its promoter and general partner, Patrick Cornish. Mr. Demers was not aware of any concern that the Bank was being implicated in the wrong-doing of Mr. Cornish. He was a resident of Calgary and had no idea as to the credit worthiness of the makers of the notes, most of whom were residents of Vancouver. The notes were not due until December 31, 1994, and did not carry interest. He believed that a better price could not be obtained.

5 As required by the Agreement, Accrued paid $25,000.00 to its solicitors to be held in trust pending the approval by this court of the sale. The balance of $130,000.00 was to be paid on closing. The closing was to take place "on the tenth day following expiry of the appeal period from the date of approval of the transactions contemplated hereby by the B.C. Court ... ". There was no provision of a closing date if Accrued waived court approval.

6 Then Dunwoody filed an application for court approval of the sale to be heard on September 15, 1989. The application did not proceed on that date. Dunwoody had agreed to serve the limited partners with notice of that hearing. Lawson, Lundell had written to Dunwoody's Alberta solicitors on August 1, 1989, to put them on notice of the limited partners' concerns that the General Partner did not have the authority to pledge the promissory notes to the Bank and that the notes had not been reduced proportionately with the bank loan.

7 It is conceded that the court would not have approved the transaction on September 15 had the application proceeded because, on September 14, 1989, the limited partners commenced an action against Patrick Cornish, the General Partner, and the Bank of Montreal (***King*** v. ***On-Stream Natural Gas*** (June l0, l993), Vancouver No. C8947ll (B.C.S.C.)). Dunwoody, with the Bank's approval agreed in writing to extend the date for court approval to December 31, 1989. On January 11, 1990, the parties agreed to extend the date to May 31, 1990. On May 30, 1990, the Bank filed an application for the approval of the transaction returnable on June 14, 1990. On May 31, 1990, the Bank and Accrued agreed to extend the date for court approval to June 14, 1990 or to such other date as the application might be adjourned by the court.

8 When the application came before Mr. Justice Low, he granted an adjournment "until after the resolution of the issues between the Bank of Montreal and the Plaintiffs in action number C894711, Vancouver Registry, is determined." In that action the limited partners were seeking rescission and

claiming that the Bank participated in the General Partner's breach of trust. The adjournment was sought by Accrued, supported by the limited partners who had been served with the notice of motion. At the time, the Bank and the limited partners anticipated that the issues between them would be resolved on one of their Rule 18A applications set to be heard on September 5, 1990.

9 Unfortunately, the issues were resolved only after a lengthy trial three years later. On June 10, 1993, Shaw J. dismissed the claim against the Bank, declared the Bank to be the holder of the notes "in due course limited to the extent of the Limited Partnership's indebtedness to the Bank", and granted judgment for $175,000 and interest against the General Partner, Mr. Cornish, and the Cornish companies. He found that Mr. Cornish had misappropriated funds of the Limited Partnership. The Bank was awarded its costs against the limited partners. The limited partners were awarded their costs under a Bullock order against Mr. Cornish and his companies. It is common ground that Mr. Cornish and his companies are judgment-proof.

10 On December 1, 1993, Accrued wrote to Dunwoody's solicitors advising that it was ready to close the transaction.

11 Meanwhile, counsel who had been acting for the Bank and for the Receiver-Manager had formed the view that Dunwoody's agreement with Accrued had been frustrated by the unanticipated intervention of the limited partners' challenge to the Bank's title to the notes, the time and expense required of the Bank to defend that title, and the limitation on the Bank's interest in the promissory notes. He advised Dunwoody that it would have to obtain independent counsel. New counsel for Dunwoody formed the same view. So, the Receiver-Manager set down a motion for directions under Rule 43(5) to be heard May 26, 1994, as to whether the Agreement had been frustrated, and if not, whether the court would approve the sale under its terms.

12 The notes became due and payable on December 31, 1994. About 10% of the original notes were purchased by their makers in 1989. This application is about the rest of them. The group of limited partners represented on this application by Mr. Potts have offered $460,000.00 for the notes. Michael R. Murgatroyd has offered $250,000.00. The Bank is of the opinion that the notes are worth close to their face value. Their face value exceeds the balance outstanding on the Bank's loan.

13 The application came on for hearing before Clancy J. on October 27, 1994. He accorded standing to both Mr. Cornish and the limited partners because their potential liability would decrease with the level of recovery on the promissory notes. He dismissed the application of Accrued that the Bank and Dunwoody continue to be represented by the same counsel, as they had been when the original application for approval was made. He saw the duty of the Receiver-Manager as being to put forward the interests of all parties who might be affected by any order made while the Bank owed no duty to the debtor.

14 Then, Accrued raised three preliminary objections to the nature of the application. Essentially, it wanted the issue as to whether the contract had been frustrated determined. If the contract was not frustrated it wanted the sale approved under the terms of the agreement. Article 4.01 of the Agreement requires the order of approval to include a provision that Accrued will be a holder in due course of the notes upon their endorsement by the Bank in favour of Accrued "as that term is defined in the Bills of Exchange Act (Canada)" and that "the Limited Partnership ... have no further interest whatsoever in the Notes."

15 The Receiver-Manager was unwilling to bring an application to approve the sale because it no longer considered the sale to be in the best interests of the Limited Partnership and was unwilling to recommend its completion.

16 Accrued asked Mr. Justice Clancy to find that Dunwoody had entered into the agreement as agent of the Bank and not in its capacity as Receiver-Manager appointed by the court. He refused to consider that question because it involved the issue of Dunwoody's capacity to sell the notes given the finding of Mr. Justice Shaw that the Bank of Montreal was holder in due course of the notes, limited to the remaining debt of the Limited Partnership to the Bank. He considered that issue required full argument.

17 Mr. Justice Clancy did, however, decide that the directions sought could not be given under Rule 43(5) because they were not for the purpose of effecting a sale, and that he should not consider the question of frustration of the contract as a separate issue. He allowed the amendment of the notice of motion to include an application for the approval of the sale. He suggested the issues that might be considered on such a motion and concluded that there was no reason why Dunwoody could not recommend against completion of the sale.

18 After a pre-hearing conference before Mr. Justice Paris, counsel agreed that the application would proceed as one for the approval of the sale of the promissory notes, and that the court would be asked to consider whether the contract had been frustrated in the context of the hearing of that motion. They agreed that the court was unlikely to approve a contract without legal force.

The Arguments

19 The Receiver-Manager considers that it has an obligation to take account of the interests of all parties, including the debtor and the note holders, as well as the Bank and Accrued. It no longer recommends the sale. Firstly, it considers that the contract has been frustrated. Secondly, it considers that the Agreement is now imprudent although it was appropriate in the circumstances that existed on August 25, 1989. Finally, it says that it agreed to sell the whole of the Limited Partnership's interest in the notes, not only that of the Bank. The Bank agrees, and says that it was willing to approve the sale up to September, 1990. It changed its mind after the failure to have the issues in the investors' action resolved by summary trial.

20 The limited partners say that the Agreement was imprudent when it was made and remains so, if it still has any effect. Since they learned of it they have opposed the Agreement as not taking their interest into account.

21 Accrued says that the Agreement is valid and subsisting and should be approved. However, it says that it bought only the interest of the Bank. It accepts that it is unlikely the court would make an order declaring that Accrued would be a holder in due course as that term is defined in the Bills of Exchange Act in the face of the order of Shaw J. It does not suggest that the order of Shaw J. detracts from the interest of the Limited Partnership in whatever "equity" may remain in the notes after the Bank debt is retired.

22 I am unclear as to why Accrued wants the Agreement to be approved when Accrued does not seek the ancillary orders for which it bargained. From the first minutes of the hearing it has seemed to me that Accrued simply wants the court to order the Bank to endorse and deliver the notes. It has seemed willing to waive performance of all other covenants, including court approval. Accrued has been free to seek specific performance of the agreement since its making. By seeking an adjournment of the application for approval in June 1990, it chose, quite reasonably, to forego that remedy until the state of the Bank's title had been decided. There is no explanation for its decision not to sue for performance after June 10, 1993.

23 I can understand that the Receiver-Manager, whether looking to the authority conferred on it by the court's appointment in 1988 or by the Bank's appointment in 1989, would want this court to exercise its supervisory

power to ensure that Dunwoody is not in breach of its obligations under section 68(2) of the Personal Property Security Act. The limited partners who make up the Limited Partnership object to the Agreement Dunwoody entered and the Limited Partnership has an interest in any sale of the promissory notes.

24 Mr. Ferguson was ambivalent in his response to my query whether Accrued wanted to reserve its right to seek specific performance of the contract. Such an action would be the most appropriate forum for a determination of the issue of frustration. However, in response to my offer to adjourn this proceeding to permit such an action, he was clear that Accrued wants the question of frustration determined on this application and this court to approve the sale "under the Agreement". All counsel agreed that this court has jurisdiction to make that determination despite the concerns expressed by Clancy J. in his reasons of November 21.

25 Mindful of the costs all parties have incurred in this unfortunate situation to date, I have decided that I will not question their conclusion as to my jurisdiction. I will give my opinion as to whether the contract is "incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract." (***Davis Contractors Ltd.*** v. ***Fareham Urban District Council***, [1955] 1 Q.B. 302 (C.A.)).

Discussion

26 The three-fold test for determining whether performance in the present circumstances would render the contract radically different from that which was agreed in the circumstances of August 25, is well-settled:

1. What was the foundation of the contract?

2. Was the performance of the contract prevented?

3. Was the event which prevented the performance of the contract of such a character that it cannot reasonably be said to have been in the contemplation of the parties as at the date of the contract? (***Krell*** v. ***Henry***, [1903] 2 K.B. 740)

27 The promissory notes in issue had an aggregate face value of $1.19 million in August 1989. The sale price of $155,000. reflected a discount of 86%. The Bank and Dunwoody considered this discount reasonable given the collectibility risks and the time delay until the notes came due. Accrued was assuming those risks. Dunwoody, and therefore the Bank, were taking none. The Bank would receive the proceeds very quickly. The Agreement contemplated the approval of the court before September 15, 1989. Closing was to occur 10 days after the expiry of the appeal period from the order approving the sale. Time was to be of the essence. That was the foundation of the contract.

28 The unanticipated litigation is said to be the intervening event that prevented the timely closing that was fundamental to the Agreement.

29 It can be said fairly that the Receiver would not have sold the notes at that discount if it had known that the proceeds of sale would not be received until the collectibility risks had substantially reduced and the notes were due. It can also be said fairly that it is unlikely that either the Bank or Dunwoody would have agreed to such a discount if they had been aware of the worth of the makers of the notes. The reduced collectibility risk is to some extent simply greater knowledge of the limited partners.

30 However, both the Bank and Dunwoody must be taken to have known the risks they were facing, including the potential delay, when they agreed to extend the closing date on May 31, 1990 until such date as the court might determine. There is no question that the delay resulting from the combination of the Agreement and Mr. Justice Low's order caused Dunwoody to lose most of

the advantage it might have gained from the Agreement, but a common object must be frustrated, not merely the individual advantage of one party. Accrued stood only to gain from the delay to which Dunwoody agreed.

31 The steady increase in the value of the notes was entirely foreseeable from the moment that the parties knew the limited partners were challenging the validity of the notes. Either the notes were worth nothing, or they would increase in value with the passage of time until the due date. A bank, a professional receiver, and an investor in discounted debt, would all have understood when they negotiated to extend the deadline for seeking court approval of the sale and thus the closing date of the agreement, that litigation over the issues of breach of trust and participation in that breach of trust could take several years to resolve. They had the opportunity to vary their agreement to take account of the two possible outcomes. They chose to amend only the closing date in such a way as to let the closing date of the Agreement be determined by the exigencies of difficult litigation.

32 This is not a frustrated contract. It is simply an imprudent one. And that leads me to my conclusion that the court should not approve it. Counsel concede that no court could have approved the Agreement in September 1989, or in June 1990, because of the unresolved challenge to the title of the Bank to the notes. I do not think any court would have approved the Agreement if there had been no such challenge and I should not approve it today. As the limited partners told me and would have told the court whenever its approval was sought, the sale price did not take sufficient account of the ability of the makers of the promissory notes to pay. The Bank had made no enquiries about the value of the signatures. The discount was and is too deep.

33 Dunwoody entered this agreement "in its capacity as receiver-manager of the assets, property and undertaking" of the Limited Partnership. Those words cannot be treated as superfluous in the way Accrued would have me read them, such that Dunwoody Limited was acting simply as the agent for the Bank of Montreal, without any obligation to have regard to the interests of the debtor.

34 At the root of Accrued's primary argument is the view that the court should be very cautious before deciding that a receiver's conduct is improvident based on information which came to light after the receiver made its decision. I share that view expressed by Mr. Justice Galligan in ***Royal Bank*** v. ***Soundair Corp***. (l99l), 7 C.B.R. (3d) 1 at 7. The court must have regard to the information the receiver had when it agreed to accept an offer. This preserves the integrity of the process and takes proper account of the interest of the purchaser who negotiates in good faith. But there will be circumstances where other factors override that consideration.

35 This Agreement was made on August 25, 1989, and, as Mr. Ferguson argued on the issue of frustration, was varied for the last time on May 31, 1990. The circumstances existing on May 31, 1990, included full knowledge of the claims being made by the limited partners. The imprudence of the Receiver in accepting too large a discount in August 1989, was compounded by its failure to seek a variation in the price to reflect the increasing value of the notes with the passage of time. Because the May 31, 1990, variation effectively gave control over the date of closing to the court, such a clause was absolutely vital to the prudence of the Agreement. Even if $155,000 were a fair price on August 25, 1989, it would not have been fair in June or September 1990. Time alone would have increased the value of the notes.

36 Finally, the circumstances of this case are so unique that I have no concern that the court's failure to approve the Agreement will make a farce and a mockery of the process or contribute to concern about commercial chaos or even to concern in the marketplace. Rare will be the case where the creditor must bear the cost of defending the title of the thing being sold and thus the cost of the delay in closing the sale while the thing increases in value simply by the passage of time to the very great potential benefit of the

purchaser without additional cost to it. Even rarer will be such a case where the debtor has an interest in the proceeds of the sale. To approve this Agreement would be to say that the court will always approve an agreement reached between a receiver-manager and a purchaser if the process is fair. That is not the law.

Summary

37 The Agreement made between Dunwoody Limited and Accrued Holdings Limited Partnership on August 25, 1989, as amended from time to time, is not frustrated. However, this court does not approve the sale by the Receiver-Manager of the promissory notes under it. Counsel did not address the issue of costs in their submissions. They may arrange a time for doing so through Trial Division.

Vancouver, B.C.

January 31, 1995 "C.M. Huddart, J."