Cassels

BC Court Orders Disclaimer of Presale Agreements in Real Estate Receivership

April 5, 2018

On April 4, 2018, the Supreme Court of British Columbia issued a decision (*Forjay Management Ltd. v. 0981478 B.C. Ltd.*[1]) directing a receiver to disclaim presale agreements in the context of a real estate receivership. The decision clarifies the analytical framework to be applied when considering whether to disclaim contracts in a receivership and offers an example of circumstances in which a court will not defer to a receiver's recommendation.

Background

In October 2017, Madam Justice Fitzpatrick of the Supreme Court of British Columbia (the Court) granted a receivership order in respect of a 92-unit strata condominium development known as "Murrayville House," located in Langley, British Columbia. The development was owned by a single-purpose development company (the Debtor) with no other significant assets.

The receivership order was granted on the application of one of the mortgagees with the support of the other mortgagees. The receivership was precipitated by ballooning debt caused by cost overruns, lengthy delays, the filing of various legal claims and certificates of pending litigation, and allegations of financial misconduct on the part of the Debtor. At or around the time of the receivership order, the creditors faced a shortfall of more than $30 million.

The development was substantially complete at the time of the receivership order, subject only to certain exterior work, common area deficiency work and in suite deficiency work. In addition, all of the units in the development had been made the subject of presale agreements with individual purchasers years prior to the receivership. At the outset of the receivership, it was anticipated that the receiver's task would essentially be to complete the construction, file a new disclosure statement, obtain new home warranty coverage and then monetize the development.

The receiver's task was complicated by changes in the real estate market in British Columbia. Subsequent to the execution of the presale agreements, the value of the units increased by 46%, based on an appraisal obtained by the receiver. That translated into a total increase in value of nearly $5.5 million. In light of this value lift, the receiver was faced with the decision of whether to complete the presale agreements and permit the purchasers to benefit from the lift, or, alternatively, remarket the units at current market prices in order to maximize the realization for the benefit of the creditors.

The receiver decided that it should complete the presale agreements and brought an application seeking directions from the Court confirming that decision. The application, which was heard over five days in March 2018, was supported by the purchasers as well as the B.C. Superintendent of Real Estate. It was opposed by the mortgagees and the Debtor.

The application involved two central issues. The first issue was whether the presale agreements had terminated prior to the receivership as a result of the effluxion of time (by way of the passing of an outside date), in which case the agreements were not binding and the receiver's decision to resurrect them was an improvident one. The second issue was whether, if the agreements were enforceable, they should be disclaimed in favour of remarketing the units and maximizing the realization.

Decision

The Court directed the receiver to disclaim the agreements and remarket the units. In addition, the Court directed that the receiver grant the purchasers a right of first refusal in respect of their units. The purchasers who did not wish to exercise their right of first refusal were entitled to the return of their deposit monies with interest.

The Court was satisfied that the application could be resolved by consideration of the disclaimer issue alone, premised on the assumption that the contracts remained valid and enforceable. As a result of its conclusion that the contracts should be disclaimed, the Court did not need to consider the first issue.

The Court began by recognizing the well-settled principle that a receiver has discretion to disclaim contracts entered into prior to the commencement of a receivership in order to maximize the recovery of the assets under its charge. However, the Court also recognized that a receiver must assess all equitable considerations or "equities" in the course of considering whether to disclaim a contract.

The Court went on to review prior disclaimer decisions in British Columbia and Ontario and ultimately adopted the following analytical framework which was substantially advanced by one of the mortgagees (represented by Matthew Nied of Cassels Brock):

1. First, what are the respective legal priority positions as between the competing interests?

2. Second, would a disclaimer enhance the value of the assets? If so, would a failure to disclaim the contract amount to a preference in favour of one party?; and

3. Third, if a preference would arise, has the party seeking to avoid a disclaimer and complete the contract established that the equities support that result rather than a disclaimer?

Applying the first stage of the analysis, the Court determined that the mortgagees had legal priority over the

purchasers whose agreements expressly provided that they created “contractual rights only and not any interest in land” and that the purchasers would only acquire an interest in land “upon completion of the purchase and sale.” In addition, the Court determined that the purchasers could not have an equitable interest in the units because the remedy of specific performance was not available to them in the circumstances.

Having concluded that the purchasers’ contractual rights did not have legal priority over those held by the mortgagees, the Court proceed to the second stage of the analysis. The Court concluded that there was no doubt that remarketing the units would enhance the value of the assets to be distributed to the stakeholders, and that, on this basis, disclaimer was appropriate. The Court also noted that permitting the presale contacts to complete would require the Court to discharge the mortgages in circumstances where the mortgagees would not receive payment of the amounts they bargained to accept in exchange for discharge, which would be an “exceptional result.”

Having made that determination, the Court proceeded to the third stage of the analysis, which was to consider whether the purchasers had established that the equities supported overriding the mortgagees’ legal priority in their favour, as opposed to allowing a disclaimer.

The Court considered various equitable considerations advanced by the purchasers, including that the contracts did not complete due to the Debtor’s actions; that many of the purchasers would be priced out of the real estate market if they could not complete their contracts; and that the public policy objectives of consumer protection justified completing the contracts. The Court addressed each of those arguments in detail and noted its sympathy for the position of the purchasers, but ultimately concluded that the purchasers had not demonstrated that the equities justified overriding the mortgagees’ legal priority “and giving the purchasers a preference that they would not otherwise enjoy.”

The Court determined that the receiver had not applied the correct analysis to the question of disclaimer and that the receiver’s recommendations should not be accorded any deference. In particular, the Court held that the issues before the Court did not involve a consideration of business choices made by a receiver, which is where deference to the knowledge and experience of a receiver would ordinarily be accorded. The Court also noted that, given the significant dispute between the parties, it “would have been best for the Receiver to have provided facts as known to it and thought to be relevant to a determination, but otherwise to have remained neutral as to the result.”

Implications

This decision illustrates that disclaimer remains a useful tool for maximizing realizations in insolvencies for the benefit of all stakeholders. The decision also confirms that disclaimer will generally be appropriate where continuing a contract would create a preference unless there are compelling equitable considerations which favour creating that preference.

In cases such as these, the purchasers' only recourse will generally be to bring a damages claim against the debtor. While such an option may be fruitful in rare cases, in most insolvencies a damages claim, even if successful, will likely not be recoverable against an insolvent debtor. In addition, in some cases (such as this case) presale agreements may contain exclusion clauses preventing purchasers from bringing claims against the developer beyond seeking return of their deposit monies.

Significantly, the decision in this case was largely driven by the conclusion that the mortgagees had legal priority because the presale agreements expressly provided that they created "contractual rights only and not any interest in land." In the absence of such language, purchasers may have a basis to claim that they have a proprietary or *in rem* interest that takes priority over the interests of secured creditors.

In addition, there was no evidence of any agreement on the part of the mortgagees to partially discharge their security against the development in order to permit the presale agreements to complete. To the contrary, the mortgage terms did not require the mortgagees to discharge their security unless they were repaid in full. This may be distinguishable from cases in which mortgagees agree to partially discharge their security in order to permit presale contracts to complete or have conducted themselves in a manner suggestive of that.

Matthew Nied of Cassels acted for one of the mortgagees in this matter.

Read the full decision here.

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[1] *Forjay Management Ltd. v. 0981478 B.C. Ltd.*, 2018 BCSC 527
