

# Recent Developments in the Law of Set-off

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## I. INTRODUCTION

The law of set-off has a long history. Borrowed from the civil law doctrine of compensation,<sup>1</sup> the English Chancery Courts adopted the equitable doctrine of set-off, which was then known as stoppage. The common law courts in England adopted the defence of set-off in 1729 by way of statute.<sup>2</sup> The two areas of law merged and the modern defence of set-off took shape. As stated by Lord Denning in *Federal Commerce & Navigation Co. v. Molena Alpha Inc.*:

[The] streams of common law and equity have flown together and combined so as to be indistinguishable the one from the other. We have no longer to ask ourselves: what would the courts of common law or courts of equity have done before the Judicature Act? We have to ask ourselves: what should we do now so as to ensure fair dealing between the parties. [. . .] This question must be asked in each case as it arises for decision: and then, from case to case, we shall build up a series of precedents to guide those who come after us.<sup>3</sup>

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1 *Freeman v. Lomas* (1851), 9 Hare. 109, 68 E.R. 435 (cited to Hare.); *Duncan v. Lyon* (1818), 3 John. Ch. 359.

2 Kelly R. Palmer, *The Law of Set-Off in Canada* (Aurora: Canada Law Book Inc., 1993) at 5-9 [Palmer].

3 *Federal Commerce & Navigation Co. v. Molena Alpha Inc.* [1978] Q.B. 927 (Eng. Q.B.), at 974, reversed (1978), [1979] A.C. 757 (U.K. H.L.) [*Federal Commerce*].

This paper aims to provide an overview of recent developments in the law of set-off in Canada and to identify and discuss gaps and unresolved challenges in its application.

### A. Set-off in the CCAA Context

Likely the most significant application of set-off is in the insolvency context.<sup>4</sup> Many of the key developments in the law of set-off in Canada in 2008 and 2009 arose in the context of the *Companies' Creditors Arrangement Act*<sup>5</sup> (CCAA); likely a reflection of recent economic turbulence and debtors' increasing reliance on the CCAA to remedy insolvency. Accordingly, this paper discusses in some detail developments in the law of set-off in the CCAA context, an area of law that is relatively less developed in comparison with set-off in the context of the *Bankruptcy and Insolvency Act*<sup>6</sup> (BIA) and the *Winding-up and Restructuring Act* (WURA).<sup>7</sup>

On September 30, 1997, Parliament enacted Bill C-5,<sup>8</sup> which amended the CCAA to allow for the law of set-off to apply, using language similar to that in the BIA and somewhat similar to that in the WURA. The set-off provision in the CCAA was subsequently amended by Bill C-55,<sup>9</sup> portions of which came into force on September 18, 2009. According to Industry Canada, the amendment was a technical one intended to re-order provisions in the CCAA and correct for legal terms.<sup>10</sup> Section 21 of the CCAA now reads as follows:

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4 Philip R. Wood, *Set-off and Netting, Derivatives, Clearing Systems*, 2nd ed. (London: Sweet & Maxwell, 2007) at 5 [Wood]; Palmer, *supra*, note 2 at 157.

5 R.S.C. 1985, c. C-36.

6 R.S.C. 1985, c. B-3.

7 R.S.C. 1985, c. W-11. Set-off in the bankruptcy context is different from that under the CCAA for various reasons. For treatment of set-off under the BIA and/or the WURA, please see: Palmer, *supra*, note 2 and A. Robert Anderson, Phillip J. LaFlair & Valerie Jepson, "Set-off in Insolvency" (Paper presented at the Lorman Education Services 2002 Seminar).

8 *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act and the Income Tax Act*, 2nd Sess., 35th Parl., 1996-97, cl. 125 (assented to 25 April 1997), S.C. 1997, c.12, s.125, Proclaimed in force 30 September 1997, S.I./97-114, C. Gaz. 1997.II. vol. 131. no. 20.

9 *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*, 1st Sess., 38th Parl., 2004-2005, cl. 131 (assented to 25 November 2005), S.C. 2005, c. 47, s. 131, Proclaimed in force 18 September 2009, S.I./2009-68, C. Gaz. 2009.II. vol. 143. no. 17.1711.

10 "Clause by Clause Bricking Book: An Act to establish the Wage Earner Protection Act, to amend the *Bankruptcy and Insolvency Act* and the *Companies' Creditors*

The law of set-off or compensation applies to all claims made against a debtor company and to all actions instituted by it for the recovery of debts due to the company in the same manner and to the same extent as if the company were plaintiff or defendant, as the case may be.<sup>11</sup>

While the wording of the provision suggests that the law of set-off applies in the CCAA context as it would in ordinary litigation, the reality is that unique facts tend to arise in the CCAA context that might not in ordinary litigation. This modern invitation to apply the ancient doctrine of set-off in the CCAA context has provided the courts with some interesting and unexpected challenges over the past decade.<sup>12</sup>

## II. DEFINITION OF SET-OFF

Set-off is both a practical tool and an equitable remedy; it is founded on principles of natural equity and is used as a form of payment<sup>13</sup> and a means of avoiding circuity of action.<sup>14</sup> According to Palmer it is difficult to define set-off in a simple manner because of the wide-range of set-off.<sup>15</sup> However, in its broadest sense, set-off:

[. . .] arises if A has a claim against B, and B has a claim against A. In this case, an evaluation of the elements of the cross-claims between A and B may be taken to determine the extent, if any, of the ultimate sum payable between A and B. This broad definition, however, covers many different legal issues.<sup>16</sup>

Black's Law Dictionary defines set-off as follows:

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*Arrangement Act* and to make consequential amendments to other Act," online: <http://www.lc.gc.ca/>.

11 CCAA, *supra*, note 5, s. 21. Prior to September 18, 2009, section 21 was known as section 18.1 and read as follows: *The law of set-off applies to all claims made against a debtor company and to all actions instituted by it for the recovery of debts due to the company in the same manner and to the same extent as if the company were plaintiff or defendant, as the case may be.*

12 Approximately 13 decisions have substantively considered section 21 of the CCAA (and its predecessor, section 18.1). Significant cases that consider set-off in the CCAA context prior to the enactment of section 18.1 include: *Quintette Coal Ltd. v. Nippon Steel Corp.* (1990), 51 B.C.L.R. (2d) 105 (B.C. C.A.) [*Quintette Coal*] and *Cam-Net Communications v. Vancouver Telephone Co.* (1999), 71 B.C.L.R. (3d) 226 (B.C. C.A.) [*Cam-Net Communications*].

13 *Re McMurtry & Co.*, [1924] 1 D.L.R. 737 (Ont. S.C.) [*Re McMurtry*].

14 *Jeffs v. Wood*, [1723] 2 Eq. Ca. Ab. 10 at 669 [*Jeffs*].

15 Palmer, *supra*, note 2 at 1.

16 *Ibid.*

1. A defendant's counterdemand against the plaintiff, arising out of a transaction independent of the plaintiff's claim [ . . . ];
2. A debtor's right to reduce the amount of a debt by any sum the creditor owes the debtor; the counterbalancing sum owed by the creditor [ . . . ];
3. The balancing of mutual liabilities with respect to a pledge relationship [ . . . ].<sup>17</sup>

Wood defines set-off as follows:

Set-off is the discharge of reciprocal obligations to the extent of the smaller obligation. It is a form of payment. A debtor sets off the cross-claim owed to him against the main claim which he pays to his creditor. Instead of paying money, he uses the claim owed to him to pay the claim he owes. A bank sets off a cross-claim for a loan owed to it by a depositor against the depositor's primary claim for a deposit owed by the bank. A defendant sets off, against the claimant-creditor, a cross-claim owed by the claimant to the defendant.<sup>18</sup>

Palmer notes the distinctions between two commonly referred to definitions of set-off noted above: set-off as an accounting and set-off as a defence.<sup>19</sup> The former focuses on the practical effect of set-off which results in a discharge of reciprocal obligations. The latter focuses on the notion that set-off is pleaded as a defence to a claim, or as a counter-claim, and cannot be used "as a sword". There is no definitive legal conclusion on the question, but Palmer ably sums up the implications of each characterisation as follows:

Whether a definition for set-off includes accounting or defence aspects may have relevance outside of the availability of the remedy. An accounting approach would focus on the decreased amount that the defendant would be required to pay in satisfaction of the plaintiff's claim, perhaps to the point of saying that the plaintiff's claim had been "satisfied", "released" or "no longer owing". Such a result may have implications in commercial transactions where it is important to determine whether an obligation between parties is still outstanding. An accounting approach may, in some circumstances, affect this obligation. A defence definition would note that a successful use of set-off as a defence could avoid summary judgment and may have implications in determining costs.<sup>20</sup>

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17 *Black's Law Dictionary*, 9th ed., s.v. "setoff".

18 Wood, *supra*, note 4 at 4.

19 Palmer, *supra*, note 2 at 2.

20 Palmer, *supra*, note 2 at 3-4.

### **III. TYPES OF SET-OFF**

Canadian law recognizes three types of set-off: contractual, legal or statutory, and equitable.<sup>21</sup>

#### **A. Contractual Set-off**

Contractual set-off operates primarily on principles of contract. As Palmer states:

Contractual set-off is, not surprisingly, more a matter of contract law than a separate application of set-off. Consequently, the normal rules of set-off regarding mutuality, liquid debts and connected debts do not apply: within the bounds of legality and public policy, parties are free to contract whatever result they wish. Accordingly, agreements to set-off which would, aside from the agreement, not be granted relief due to the absence of the requirements of set-off, will be upheld. [ . . . ]

The converse is that the normal requirements of contract law must be present: offer, acceptance, consideration, intention to create legal relations and capacity must all be satisfied in order for a valid contractual set-off to be made out.<sup>22</sup>

In the 1924 decision *Re McMurtry*, the Ontario Supreme Court in Bankruptcy considered whether an agreement to set off could survive bankruptcy. In that case, the debtor company obtained the services of a printer/publisher (the “Printers”). The debtor company and the Printers agreed that the debtor company would pay for services provided by the Printers by furnishing goods to the individual owners (the “Owners”) of the Printers. On assignment into bankruptcy, the debtor company and the Owners owed similar amounts for the respective printing services and goods furnished. The trustee refused to accept the agreement to set-off because of the bankruptcy, claiming that no set-off should be permitted. The Court found that an agreement did in fact exist among the parties and that there was no reason to conclude that it was not binding in bankruptcy. Significantly, the Court concluded that this dispute should not be decided using principles of set-off but rather principles of contract, as follows:

I do not propose to base my judgment on, as to whether or not there were mutual dealings, and if there were not mutual dealings no right of set-off under the statute, but upon the agreement entered into between the parties. There is no

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21 The *Code Civile du Québec* deals with set-off in ss. 1671-1682. The application of the set-off provisions of the *Code Civile* in the context of the CCAA is beyond the scope of this paper.

22 Palmer, *supra*, note 2 at 263.

suggestion the appellants had notice of any available act of bankruptcy when goods were supplied and credits given. The set-off agreed to under the agreement was equivalent to and must be held as a payment and if at any time the agreement came to an end only the balance of the account and no more could be claimed or paid on either side.

The doctrine of mutual dealings and right of set-off does not apply here, as there was a *bona fide* agreement between the parties as to how they should deal and the debtor estate is bound by its terms.<sup>23</sup>

Similarly, as stated by the Supreme Court of Canada with respect to “contractual compensation”, the civil law equivalent of contractual set-off:

Contractual compensation achieves a similar goal to legal compensation or legal or equitable set-off, the discharge of mutual debts. However, contractual compensation achieves this goal through mutual consent. It provides the contracting parties with a self-help remedy that avoids the technical requirements of legal compensation or legal or equitable set-off: see J.-L. Baudouin and P.-G. Jobin, *Les obligations* (5th ed. 1998), at para. 981, and K. R. Palmer, *The Law of Set-Off in Canada* (1993), at pp. 263-64. Both a contract providing for a right of compensation in Québec and a contract providing for a right of set-off in the common law provinces are to be interpreted by a court in a manner that gives effect to the intentions of the parties as reflected in the words of the contract.<sup>24</sup>

Accordingly, the requirements of mutuality under legal set-off and a “close connection” required under equitable set-off have, rightly, not been elements of analysis in the relatively few contractual set-off cases in Canada. This has been confirmed with respect to the *BIA*<sup>25</sup> and the *WURA*,<sup>26</sup> but not the *CCAA*.

This issue was also considered recently by the Ontario Superior Court of Justice in *Canada (Attorney General) v. Reliance Insurance Co.* in the *WURA* context.<sup>27</sup> In that case, the court was asked to consider the terms of the set-off provisions in four contracts. It was determined that the contracts provided for set-off. The court then discussed whether the *WURA* affected contractual set-off rights. One of the respondents argued that section 73 of the *WURA* should be read to exclude contractual set-off. The Court rejected this argument, noting that:

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<sup>23</sup> *Re McMurtry*, *supra*, note 13 at 738-739.

<sup>24</sup> *Ministre du Revenu national c. Caisse Populaire du bon Conseil*, 2009 SCC 29 (S.C.C.) at para. 22.

<sup>25</sup> *Re Brunswick Chrysler Plymouth Ltd.*, 2005 NBQB 83 (N.B. Q.B.) [*Plymouth*].

<sup>26</sup> *Canada (Attorney General) v. Reliance Insurance Co.* (2008), 40 C.B.R. (5th) 292 (Ont. S.C.J. [Commercial List]) [*Reliance Insurance*].

<sup>27</sup> *Ibid.*

[c]ontracts are not terminated by the mere fact of liquidation and the corporate state and powers of a company in liquidation continue.<sup>28</sup>

The Court concluded that despite the absence of the words “contractual set-off” in the *WURA*, the statutory language “the law of set-off” includes contractual set-off.<sup>29</sup>

Ascertaining whether a party to a contract is entitled to exercise a right of set-off requires a determination of, first, whether an agreement to set off exists; and second, an assessment of the relevant contract or contracts to understand the set-off rights conferred by the agreement. As discussed below, the bulk of Canadian jurisprudence deals with whether there is evidence of an agreement to set off as between the parties, and not what rights arise once a valid agreement is found to exist.<sup>30</sup>

In the context of contractual set-off, while a well drafted set-off provision will provide parties to a contract with a clear understanding of their rights, problems can arise that may require the vigilance of the courts in instances where the set-off provision is unclear or ambiguous, or where one party argues the existence of an oral or implied agreement to set off. While the former was recently considered by the Alberta Court of Queen’s Bench in *Re SemCanada Crude Co.*,<sup>31</sup> the latter is still unresolved. Each will be addressed in turn.

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28 *Ibid.* at para. 23.

29 *Ibid.* at para. 26.

30 This is in contrast with the U.S. bankruptcy jurisprudence which appears to require “mutual debts” even where parties have expressly agreed to a set-off provision. This is in part a consequence of the wording of section 553 of the U.S. Bankruptcy Code, which reads: “(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that [ . . . ]” *Bankruptcy*, 11 U.S.C. § 553 (2007). For a treatment of agreements to set-off in the U.S. Bankruptcy context, please see: *Re Semcrude, L.P., et al.* Case No. 08-11525 (BLS) (Bankr. D. Del. Jan. 9, 2009) but also see: *Re Garden Ridge Corporation, et al.*, 338 B.R. 627; 2006 Bankr, LEXIS 373), aff’d by *Ferguson v. Garden Ridge Corp.* 2008 U.S. Dist. LEXIS 105205 (D. Del. Dec. 29, 2008). There has been considerable commentary and criticism of the SemCrude decision in the United States: please see: Martin J. Bienenstock *et al.*, “Are Triangular Setoff Agreements Enforceable in Bankruptcy?” (2009) 83 Am. Bankr. L.J. 325.

31 *Re SemCanada Crude Co.*, 2009 ABQB 715 [*Husky*]

## i. Drafting

It is common practice in commodities and derivatives trading agreements to include set-off rights in the event one of the parties becomes insolvent. This right is a particularly fair and practical remedy in situations where a party to such a contract could be a net payor in one month and a net payee in another.<sup>32</sup>

In *Husky*, the Alberta Court of Queen's Bench was asked to consider a set-off provision contained in standard form terms and conditions (the "HEMI Terms") incorporated into crude oil purchase and sale agreements between Husky Energy Marketing Inc. ("Husky") and SemCanada Crude Company ("SemCanada Crude"), which read as follows:

*In the event that Buyer shall fail to make timely payment of monies due and owing to Seller hereunder or in the event that Seller shall fail to make timely delivery of any Crude Oil to Buyer hereunder, (the party so failing to perform or pay is referred to herein as the "Defaulting Party") the party not receiving timely delivery or payment (the "Non-Defaulting Party") may, at its option, set-off any or all of the amounts or deliveries which the Defaulting Party owes to it at the time of such set-off (whether under this Agreement or under any other Crude Oil Contract) against any other deliveries or payments which it owes to the Defaulting Party at the time of such set-off (whether under this Agreement or under any other Crude Oil Contract).*

"Party" for the purpose of this Section [. . .] shall include the affiliates of each party (including, but not limited to, parent and subsidiary companies), it being the intent of the parties to this Agreement to treat each party hereto and its respective affiliates as a single legal entity for the purpose of set-off pursuant to this Section [. . .]. [Emphasis Added].<sup>33</sup>

In addition, section 18 of the HEMI Terms contained remedies for events of default or non-performance by the parties. In an event of default, which included one of the parties becoming insolvent, the performing party became entitled to any or all of a suite of remedies against the non-performing party, which included the following:

(a) withhold or suspend shipments under any or all Crude Oil Contracts (as Crude Oil Contracts are defined in Section 13 herein) between the parties without prior notice, (provided that, as soon as possible after having withheld or suspended shipments, the Performing Party shall give notice of such withholding or suspension); and/or

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<sup>32</sup> Examples of this includes the GasEDI 2005 Base Contract for Sale and Purchase of Natural Gas (<http://www.gasedi.ca>), which has a detailed set-off provision, and the 1992 International Swap Dealers Association, Inc. ("ISDA®") Master Agreements.

<sup>33</sup> *Husky*, *supra*, note 31 at para. 5.



(b) request any or additional Security as provided for in Section 17 herein; and/or

(c) set-off amounts and/or deliveries as provided for in Section 14 herein; and/or

(d) establish an Early Termination Date (as defined below) upon which Early Termination Date this Agreement or all Crude Oil Contracts (at the Performing Party's sole option) (as Crude Oil Contracts are defined in Section 13 herein) shall terminate and the Performing Party shall immediately liquidate any or all Transactions (as defined below) then outstanding at such Early Termination Date by following the liquidation steps as outlined in sub-Sections (e) through (g) below. [. . .] [Emphasis added.]<sup>34</sup>

Only Husky and SemCanada Crude were parties to the contract. In this case, Husky purported to set off the indebtedness it owed to SemCanada Crude against a debt owed by one of SemCanada Crude's U.S. affiliates, SemCrude L.P., to one of Husky's U.S. affiliates. In support of its position, Husky relied, in part, on the broad language forming part of the cross-affiliate set-off provision and argued that it evidenced the parties' intention that cross-affiliate set-off would apply generally between the two corporate families. Husky contended that, in the circumstances, mutuality was not an issue because Husky was merely exercising a right under their mutual agreement to set off aggregate obligations between two corporate families. Moreover, Husky argued that the effect of SemCanada Crude's interpretation in the circumstances was to limit the application of section 18, thereby making it commercially unreasonable. SemCanada Crude argued that set-off should not be allowed by virtue of the wording of the italicized proviso, which expressly states that the set-off can only be triggered by a failure to perform under that agreement, and SemCanada Crude had not failed to perform.

The validity of Husky's purported set-off rights turned primarily on an interpretation of the specific contractual provisions cited above, which were drafted by Husky. As stated by Romaine J.:

The core issue is whether the right to set-off that is triggered by section 18 is to be interpreted through a literal interpretation of section 14 or by substituting the concepts of "Performing" and "Non-Performing Party" as set out in section 18 for the concepts of "Defaulting" and "Non-Defaulting Party" as used in section 14; in other words, by interpreting section 18 as providing additional circumstances in which set-off may be allowed.<sup>35</sup>

Employing a plain reading of the HEMI Terms, and applying basic principles of contractual interpretation, the Court accepted SemCanada Crude's interpre-

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<sup>34</sup> *Husky, supra*, note 31 at para. 4.

<sup>35</sup> *Husky, supra*, note 31 at para. 3.

tation of the HEMI Terms, concluding that while set-off was a possible remedy triggered by an event set out in section 18, there was no valid right of set-off in the circumstances.<sup>36</sup> The two types of set-off provided for under the HEMI Terms were (a) direct set-off between Husky and SemCanada Crude alone; or (b) triangular set-off (discussed in more detail below), where Husky could set-off amounts (if any) it or its affiliates owed to SemCanada Crude had SemCanada Crude been indebted to Husky.<sup>37</sup> Since the facts did not give rise to these circumstances, Husky could not rely on any set-off rights under the contract.

Moreover, the Court concluded that the interpretation proposed by Husky offended the trite legal principle that a corporation cannot bind a corporate affiliate with the consent of the affiliate.<sup>38</sup> The Court noted that had it been the intention of the parties to provide for cross-affiliate set-off in the manner suggested by Husky, they would have done so in clear contractual language and obtained the consent of their affiliates.<sup>39</sup> Further, section 18 was rendered neither meaningless nor commercially unreasonable just because set-off was unavailable in the circumstances; set-off was clearly available as a remedy in a range of other circumstances. Indeed, the Court concluded that it was Husky's interpretation that was commercially unreasonable. Significantly, the Court noted that, as Husky's U.S. affiliate was in the process of securing a partial payment from SemCrude L.P., the interpretation proposed by Husky resulted in a potential double recovery to the Husky group of companies, which was a commercially unreasonable result, despite a *post-facto* offer by Husky to reimburse SemCanada Crude for any double recovery.<sup>40</sup> A key message to those drafting agreements is to ensure that the language of a set-off provision clearly articulates and gives effect to the intentions of the parties.

One of the issues raised by the set-off provision cited in *Husky* is this: is it possible for two parties to bind their affiliates, and what would be required to give effect to a cross-affiliate set-off provision, be it "triangular" or "square"? The answer to this question had not previously been considered in the Canadian jurisprudence, and it was not thoroughly canvassed in *Husky*. The answers most likely relate to the basics of contract law, and in particular, privity of contract. Four possible scenarios are discussed below.

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36 *Ibid.* at para. 11.

37 *Ibid.* at para. 17.

38 *Ibid.* at para. 17.

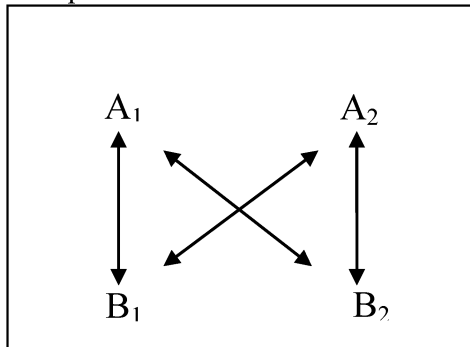
39 *Ibid.* at paras. 13 and 17.

40 *Ibid.* at para. 22.

**a. Square Set-off**

Square set-off is depicted in diagram A below, which illustrates parties  $A_1$  and  $B_1$  and their respective affiliates. A square set-off would allow  $A_1$  to set off amounts it owes to either  $B_1$  or  $B_2$  against amounts owed by  $B_1$  or  $B_2$  to  $A_1$  or  $A_2$ . In essence, each corporate family may be treated as a single entity for the purposes of set-off. However, since courts in Canada have expressly rejected the “single economic unit” doctrine,<sup>41</sup> and have respected the separate legal personality of a corporation, subject to narrow exceptions,<sup>42</sup> in order for this arrangement to be enforceable against all concerned, each party must be a party to the contract. This may also be effected by means of a master netting agreement. In some circumstances, an affiliate may be entitled to take the benefit of a cross-affiliate set-off provision contained in an agreement between two other parties without being a party to that agreement; however, that agreement cannot prevent the affiliate from enforcing payment of a debt owed to it.

A. Square Set-off



**b. Triangular Set-off**

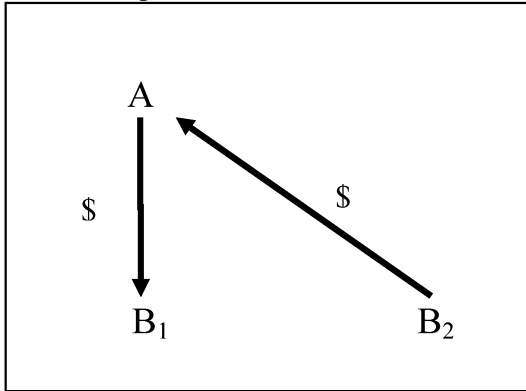
Triangular set-off is depicted in Diagram B, which illustrates party A and party  $B_1$  and its affiliate  $B_2$ . In triangular set-off, A and  $B_1$  can agree between them that any debt owed by A to  $B_1$  can be set off against debt owed by  $B_2$  to A. A party that owns the debt may deal with it as that party pleases and can agree to such a set-off. For the reasons discussed above, this arrangement is binding on A and  $B_1$  only.  $B_1$  and  $B_2$  should have some arrangement between

41 *Acton Petroleum Sales Ltd. v. British Columbia (Minister of Transportation & Highways)* (1998), 1998 CarswellBC 1162, 161 D.L.R. (4th) 481 (B.C. C.A.).

42 *Cunningham v. Hamilton* (1995), 29 Alta. L.R. (3d) 380 (Alta. C.A.), at paras. 4-5; *Re SemCanada Crude Co.*, 2009 ABQB 252 (Alta. Q.B.), at para. 13, leave to appeal to the C.A. refused 2009 ABCA 237 (Alta. C.A.), at paras. 17-18 [*Nexen*].

them to make an intercompany adjustment or transfer to account for the set-off. Triangular set-off is one possible means by which parties can mitigate some of the risk between their corporate families without binding their affiliates. This arrangement is not unlike that considered in *Re McMurry* discussed earlier (with A as the debtor company, B<sub>1</sub> as the Printers and B<sub>2</sub> as the Owners).

### B. Triangular Set-off



### c. Assignment and Guarantee

It may be possible to effect the arrangements discussed above through guarantee, assignment or a combination of both.<sup>43</sup> A guarantee would serve, in essence, to create triangular set-off. Looking back to Diagram B, B<sub>1</sub> has effectively guaranteed the obligations of B<sub>2</sub> to the extent of A's debt to B<sub>1</sub>; if B<sub>2</sub> does not pay, B<sub>1</sub> has agreed that A need not pay its debt to B<sub>1</sub> to the extent of B<sub>2</sub>'s debt to A.

An agreement between two corporate parents that contains a combination of guarantees and assignment provisions would allow for a full cross-affiliate set-off without requiring the corporate affiliates of each parent entering into that agreement. In Diagram A, each of A<sub>1</sub> and B<sub>1</sub> can guarantee the respective obligations of their affiliates A<sub>2</sub> and B<sub>2</sub>, and can allow for the assignment of any debts owed by the affiliates of the other party. To effect the cross-affiliate set-off, A<sub>2</sub> would assign to A<sub>1</sub> any debts owed by B<sub>1</sub> or B<sub>2</sub>. The parent A<sub>1</sub> then owns the aggregate debt owed by each affiliate in the other corporate family (B), and B<sub>1</sub> guarantees the debts of B<sub>2</sub>. This creates a mutual debt between A<sub>1</sub> and B<sub>1</sub>, which can then be set-off. This is another means of aggregating the amounts owed by each member of the corporate family to facilitate a set-off, specifically to avoid having the affiliates enter into an agreement.

<sup>43</sup> ISDA®, User's Guide to the 1992 ISDA Master Agreements.

#### **d. Third Party Beneficiary**

Finally, turning this question on its head, query whether a stranger to a contract could seek to benefit from the contract provision discussed in the *Husky* decision. For example, it is arguable that an affiliate could seek to enforce the *Husky* provision cited above relying on the principles enunciated by the Supreme Court of Canada in *Fraser River Pile & Dredge Ltd. v. Can-Dive Services Ltd.*<sup>44</sup> In *Fraser River*, it was held that a stranger to a contract may take the benefit of a contract if (a) the contracting parties intended to extend the benefit in question to the third party who seeks to rely on the provision, and (b) the activities performed by that third party are the activities contemplated as coming within the scope of the contract or provision, as determined by reference to the intentions of the parties.<sup>45</sup> Arguably, the wording of the provision itself would prevent such an application to succeed, as it does not overcome the italicised proviso in the *Husky* terms and conditions. However, this may not be an obstacle in other set-off provisions; ultimately it depends upon the language of the provision. However, such an approach would be significantly less reliable to attempt to give effect to cross-affiliate set-off rights. Clear contractual drafting and ensuring privity of contract are more reliable methods.

#### **ii. Agreements to Set Off**

Contractual set-off may be found whether the agreement is express or implied.<sup>46</sup> Some early English and Canadian Chancery Court jurisprudence suggests that the courts may rely on the equitable foundations of set-off to relax the evidentiary burden required to prove an agreement to set-off.<sup>47</sup> It has been suggested that “the court accepts slighter evidence” of an agreement to set off “than is usually required in order to establish disputed facts.”<sup>48</sup> In these cases, the courts were not asked to interpret written agreements, but rather to examine the circumstances to ascertain whether an agreement to set-off existed. There have been no recent developments in this area of law of set-off, but it is worth scrutinizing this principle lest it be relied upon in practice.

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44 *Fraser River Pile & Dredge Ltd. v. Can-Dive Services Ltd.*, [1999] 3 S.C.R. 108 (S.C.C.) [*Fraser River*].

45 *Ibid.* at para. 31.

46 *Freeman v. Lomas*, *supra*, note 1 at 114.

47 *Jeffs*, *supra*, note 14.

48 *Canadian Encyclopedic Digest*, Release 3, “Personal Property” by Gloria Mintah, § 187, CD-ROM (Thomson Reuters Canada Limited, August 2009); See also Palmer, *supra*, note 2 at 264.

In the 1865 decision in *Lundy v. McCulla*,<sup>49</sup> the Court of Chancery of Upper Canada relaxed the rules of evidence in order to find an agreement to set off where, it appears, legal or equitable set-off would not have been permitted. In that case, Mowat, V.C. stated:

The evidence which the plaintiff offers of the alleged agreement consists of admissions and conversations of the defendant: and in considering them, it is proper to bear in mind that what the plaintiff seeks is, in effect, to set off against the amount of the due-bill, what is coming to him on the partnership account. In the view of equity, the set-offing of one demand against another between the same parties, is extremely just; though there are sometimes considerations which forbid this being done. If more than this sum is coming from the defendant to the plaintiff on account of the partnership transactions, it is certainly not reasonable that, pending the taking of the partnership accounts, the defendant should seek to compel the plaintiff to pay this sum. It is from a strong sense of the want of equity there is in such a course, that, where there is a technical difficulty in the way of setting off one demand against another in the absence of an agreement for setting it off, this court accepts slighter evidence of such an agreement than is usually required in order to establish disputed facts.<sup>50</sup> [Emphasis Added.]

The Court concluded, based on oral evidence, including that of third parties, that a contract to set off existed between the parties. Similarly, in *Jefferies*, an estate case, the court stated:

However, it seems that the least evidence of an agreement for a stoppage will do [ . . . ]; and in these cases equity will take hold of a very slight thing to do both parties right. And it is still more reasonable, that where the matter of the mutual demand is concerning the same thing, there the Court should interpose, and make the balance only payable.<sup>51</sup>

Both cases appear to suggest that equity should guide the inquiry into the evidence as to whether a contract exists. While both reasons for decision suggest that the tests for legal and equitable set-off could not be met, the facts in that regard are not clear.

*Lundy* has been cited in more modern Canadian jurisprudence, but has not been considered in the CCAA context.<sup>52</sup> Moreover, despite being cited in

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49 *Lundy v. McCulla* (1865), 1865 CarswellOnt 55, 11 Gr. 368 (U.C. Ch.) [*Lundy*].

50 *Ibid.* at para. 2.

51 *Jefferies*, *supra*, note 14 at 130.

52 *Jefferies* has been cited in Canadian jurisprudence, but mostly for the principle set out in *Cherry v. Boulton* (1839), 4 My. & Cr. 442, 48 E.R. 651, 9 L.J. Ch. 118 (Eng. Ch. Div.), which states that a person who is entitled to a share in a specific fund but who is also under a liability to contribute to that fund, cannot recover its share from the fund until the liability to contribute has been determined and accounted for. This

several cases in Canada,<sup>53</sup> it does not appear that Canadian courts have in fact lowered the evidentiary burden required to find an agreement or implied term to set off. The jurisprudence that cites *Lundy* can be divided into two general categories: first, there is one 1911 decision where the principle in *Lundy* is cited, but the court relies on significantly more than just “slighter evidence”; and, second, tax cases where the Court, *post facto*, is asked to determine whether a set-off was intended and had in fact occurred as it relates to a taxpayer’s liability. Each will be discussed in turn.

The Manitoba Trial Court decision in *Bank of Montreal v. Tudhope*<sup>54</sup> cited both *Lundy* and *Jefferis* as authority for a relaxed evidentiary burden to prove an agreement to set off. The defendants agreed to sell buggies and ploughs to the Sylvester Manufacturing Company Limited (“Sylvester”) and Sylvester agreed to purchase drills from the defendants on a continuous basis through the season. Any amounts owing between the parties would be set off at the end of the season. Sylvester subsequently assigned its debt and assets to the plaintiff, and when the plaintiff sought the end-of-season set-off, the defendants refused. It appears that the defendants argued that there was no contract between the parties because there was a dispute as to the price of the drills. On a review of the evidence, the Court found that the parties had expressly agreed to set off any amounts owing at the end of the season, whatever the value of the drills turned out to be.<sup>55</sup> The subsequent assignment did not affect the agreement to set off, or the right of the plaintiff to set off.<sup>56</sup> It does not appear that the evidentiary standard required to find a contract was lowered at all, and, indeed, this looks more like the kind of fact scenario that would today be dealt with in equitable set-off, whether or not an agreement existed.

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right has been said to be “a right analogous to set-off”: Rory Derham, *The Law of Set-off*, 3rd ed. (Oxford University Press, 2003) at 7.

53 *Chamberlain v. Chamberlain* (1886), [1886] O.J. No. 352, 11 P.R. 501 (Ont. C.A.), at para. 8; *Bank of Montreal v. Tudhope* (1911), 1911 CarswellMan 40, 17 W.L.R. 83 (Man. K.B.), affirmed (1911), 1911 CarswellMan 127, 19 W.L.R. 141 (Man. C.A.) [*Tudhope* cited to CarswellMan]; *Docherty v. Minister of National Revenue*, 1991 CarswellNat 431, [1991] 1 C.T.C. 2409 (T.C.C.), at para. 20 [*Docherty* cited to CarswellNat]; *Caraberis v. R.* 1998 CarswellNat 1173, [1998] 4 C.T.C. 2173 (T.C.C.), at para. 18 [*Caraberis* cited to CarswellNat]; see also: *Plymouth*, *supra*, note 25 at para. 44.

54 *Tudhope* (Man. Trial), *supra*, note 53 at paras. 24-25.

55 There is no lowering of the evidentiary burden here either as there is no need to agree on a price in order to find the existence of a contract: S.M. Waddams, *The Law of Contracts*, 5th ed. (Toronto: Canada Law Book Inc., 2005) at ¶ 42.

56 It is noteworthy that the two Canadian cases that consider and rely on *Tudhope* do so for reasons unrelated to the principles set out in *Lundy*: *Henfrey v. G.H. Singh & Sons Trucking Ltd.* (1981), 1981 CarswellBC 361, 33 B.C.L.R. 129 (B.C. S.C.) and *Royal Bank v. Lions Gate Fisheries Ltd.* (1991), 1991 CarswellBC 4, 76 D.L.R. (4th) 289 (B.C. C.A.).

In *Caraberis v. R.*,<sup>57</sup> the Tax Court had regard for a great deal of financial and oral evidence, which together “clearly” supported the existence of an agreement between the parties to set off.<sup>58</sup> In that case, the taxpayers were shareholders in two corporations, which had made loans to the taxpayers. The Minister sought to include the shareholder loans as income in the taxpayers’ income tax returns. The taxpayers claimed that amounts owed by the taxpayers to the corporations under the loan were set off against amounts owed by the corporations to the shareholders. The Court concluded on the evidence that while there was no express agreement to set off, the oral evidence and financial records supported the existence of an agreement between the taxpayers and the corporations to set off and that the set-off actually occurred. Accordingly, the loans were not considered to be income.

In *Docherty v. Minister of National Revenue*,<sup>59</sup> the sole shareholder of a corporation sought to set off loans made to and from the corporation and the shareholder. In its assessment, the Minister denied the set-off and attributed the corporate loan to the taxpayer as a benefit in the taxpayer’s income. The Tax Court was asked to consider the taxpayer’s appeal of the Minister’s assessment. The Minister took the position that there was no right to set off the loans because the financial statements did not reveal such a right. The Court did not consider the validity of the set-off. Rather, the Court held that all documentary evidence, including working papers and accounting books, not simply the financial statements, must be considered in determining whether there is a right to set off.<sup>60</sup> In that case, instead of relying on “slighter evidence” the Tax Court referred the matter back to the Minister to reconsider and reassess the matter in light of *additional* evidence.

Interestingly, *Docherty* cites a 1990 unreported decision of *Murdoch Whitcomb v. Minister of National Revenue*, in which the Tax Court held that evidence of an agreement to set off could be gleaned from prior years’ practices of the parties.<sup>61</sup> This decision also cited *Lundy*, but more importantly, it suggests that past practice between parties might serve as evidence of an agreement to set off. This does not appear to be a lower standard of evidence, however.

*Caraberis* and *Docherty* are both tax cases with similar facts, in which the court was asked to determine whether an agreement to set off existed. In making that determination in each case, the court endorsed the idea that all evidence of such an agreement should be considered. It is not necessary that the agreement be express or that it be documented in the financial statements. In these cases, it is not suggested that the standards of evidentiary proof are lower when determining whether an agreement to set off exists. It is merely

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<sup>57</sup> *Caraberis*, *supra*, note 53.

<sup>58</sup> *Ibid.* at para. 25.

<sup>59</sup> *Docherty*, *supra*, note 53 at paras. 26-27.

<sup>60</sup> *Ibid.* at para. 27.

<sup>61</sup> *Ibid.* at para. 25.



suggested that all evidence must be considered. Indeed, the court had both oral evidence and considerable financial documentation to determine whether, first, the set off was intended, and second, whether it in fact occurred. In these cases, the court had the benefit of hindsight in determining whether there was evidence of an agreement to set off, including the past conduct of the parties.

In contrast, in the insolvency context, typically a party purports to set off, claiming that such a right exists. In such cases, the court will be asked to determine whether there is an agreement to set off. If the agreement is not express, then contract law dictates that an agreement to set off may in certain circumstances be established by oral evidence. However, the approach suggested in *Lundy* is problematic in the insolvency context for several reasons. First, such an approach would result in creditors inviting the court to accept “slighter evidence” of collateral agreements to set off. Given the amount of the court’s time insolvencies already demand, such a “welcome mat” appears counterintuitive. Second, the suggestion that it is equitable and just to relax the evidentiary burden for finding an agreement to set off conflicts with the principle set out in *Cam-Net Communications v. Vancouver Telephone Co.*,<sup>62</sup> which states that the legislative intent animating the *CCAA* requires that the courts remain vigilant to claims of set-off in the reorganization context. This is no different in the context of the *BIA* or *WURA*. In balancing these principles, it must be remembered that permitting set-off results in a preference to that creditor, and in other creditors being deprived of a potential recovery. Third, importing equitable principles into the contractual analysis blurs the lines between contractual and equitable set-off, creating a hybrid category of set-off. This result would be improper, as contractual interpretation and analysis is geared to ascertaining the intent of the parties, in this case, in how to manage risk. Equity is geared to “doing right” between the parties; while equity plays a role in contract, it should not be used to lower the standards when considering parties’ intent, in particular sophisticated commercial parties that have relied on legal advice in drafting a contract.

## ***B. Legal Set-off***

### **i. Same Party in the Same Right**

Legal set-off requires that the obligations between the parties be liquidated debts and that the debts be mutual cross-obligations.<sup>63</sup> A useful interpre-

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<sup>62</sup> *Cam-Net Communications*, *supra*, note 12.

<sup>63</sup> *Canadian Imperial Bank of Commerce v. Tucker Industries Inc.* (1983), 149 D.L.R. (3d) 172 (B.C. C.A.) at para. 6, cited with approval in *Telford v. Holt*, [1987] 2 S.C.R. 193 (S.C.C.) [*Telford*] at para. 25.

tation of the law of legal set-off is found in *Citibank Canada v. Confederation Life Insurance Co.*:

For set-off at law to occur, the following circumstances must arise:

1. The obligations existing between the two parties must be debts, and they must be debts which are for liquidated sums or money demands which can be ascertained with certainty; and
2. Both debts must be mutual cross-obligations, i.e. cross-claims between the same parties and in the same right.<sup>64</sup>

The law requires an analysis of the obligations between the parties, the nature of the obligations themselves and mutuality as between the parties. As stated by Palmer:

[T]he link which binds claims together in legal set-off is not the debt itself, but the ownership of that debt.<sup>65</sup>

Palmer explains mutuality in the context of legal set-off as follows:

Mutuality in legal set-off has three main components: first, that the debts be between the same parties; second, that the debts be in the same right; and third, that an assignment of the debt will destroy mutuality unless the rights to setoff have accrued between the original creditor (the assignor) and debtor prior to receipt by the debtor of the notice of assignment.<sup>66</sup>

There is a wealth of U.S. jurisprudence on mutuality because of the language used in the U.S. Bankruptcy Code, which requires mutual debts to exist to permit any kind of set-off.<sup>67</sup> In Canada, on the other hand, there has been a relative paucity of case law dealing with the meaning of “same parties in the same right.”

This very question was, in part, a subject of inquiry in *Re SemCanada Crude Co. [Trilogy]*,<sup>68</sup> which involved somewhat unique facts in the CCAA

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64 *Citibank Canada v. Confederation Life Insurance Co.* (1996), 1996 CarswellOnt 3219, 42 C.B.R. (3d) 288 (Ont. Gen. Div.), affirmed (1998), 37 O.R. (3d) 226 (Ont. C.A.), at para. 37 [*Citibank Canada*].

65 Palmer, *supra*, note 2 at 45 (endorsed in *Reliance Insurance, supra*, note 26 at para. 23).

66 Palmer, *ibid.* at 46.

67 *ReCrude, L.P., et. al.* Case No. 08-11 525, *supra*, note 30.

68 *Re SemCanada Crude Co.*, 2009 ABQB 397 (Alta. Q.B.), leave to appeal refused 2009 ABCA 275 [*Trilogy*].

context.<sup>69</sup> In *Trilogy*, the Alberta Court of Queen’s Bench was asked to consider, among other things, the impact on mutuality of “operatorship” in the oil and gas context. In particular, one of the key issues was whether mutuality existed as between: (a) a debt owed by Trilogy Energy LP (“Trilogy”) to SemCAMS ULC (“SemCAMS”) in its capacity as operator of certain natural gas processing facilities (the “Operator”) expressly “for and on behalf of” the joint owners of such facilities; and (b) a debt owed by SemCAMS in its personal capacity (i.e. not in its capacity as Operator) to Trilogy for the purchase of raw natural gas.

Trilogy and SemCAMS had a complex relationship, governed by a multitude of contracts. As a natural gas producer, Trilogy entered into several contracts with the Operator for natural gas processing and transportation at various natural gas processing and transport facilities in Alberta. These agreements were entered into between Trilogy and the Operator, expressly “for and on behalf of Joint Owners” of each facility. Trilogy was also a joint owner of three facilities operated by the Operator, and had entered into construction, ownership and operation agreements (“CO&O Agreements”) with the Operator. Under the CO&O Agreements, the Operator was charged with operating the facilities for and on behalf of the joint owners of those facilities. Under each of these agreements, Trilogy was a monthly net payor to the Operator. In addition, Trilogy sold natural gas to SemCAMS under a separate gas purchase agreement (“Inlet Purchase Agreement”), which was entered into by Trilogy and SemCAMS in its personal capacity, not as the Operator of any of the facilities. Under the Inlet Purchase Agreement, SemCAMS was a monthly net payor to Trilogy.

SemCAMS was granted court protection from its creditors pursuant to the CCAA. It owed approximately \$5 million to Trilogy, while Trilogy owed a smaller amount to the Operator. Trilogy purported to set off these debts and, further, to retire the remainder of the debt owed by SemCAMS to Trilogy by withholding payment for services provided by the Operator to Trilogy in the months that followed the granting of the Initial Order. Based on a review of the relevant contracts, and by applying the principles set out in *Bank of Nova Scotia v. Société Générale*,<sup>70</sup> Romaine J. held that the Operator’s relationship with the joint owners of the facilities was either a) a trust relationship or b) one in which the funds collected by the Operator are collected for on behalf of and for the benefit of the joint owners of the facilities.<sup>71</sup> In light of this, Romaine J. proceeded to consider whether mutuality of debt could exist between: (a) a debt owed to a company, in its capacity as trustee or on special account; and (b) a personal debt owed by the same company in its personal capacity.

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<sup>69</sup> The strict application of legal set-off means that mutuality is severed upon an assignment into bankruptcy. In the CCAA context, as will be discussed below, the case law suggests that the CCAA does not sever mutuality.

<sup>70</sup> *Bank of Nova Scotia v. Société Générale (Canada)* (1988), 87 A.R. 133 (Alta. C.A.).

<sup>71</sup> *Trilogy*, *supra*, note 68 at paras. 18-21.

The Canadian jurisprudence has held that mutuality is severed so as to preclude set-off in the following circumstances:

- (a) a debt owed in an individual capacity cannot be set-off against one owed to the individual acting as trustee;<sup>72</sup>
- (b) a debt owed in respect of an account that exists for a special purpose cannot be set-off against another account that exists for a different or no special purpose;<sup>73</sup> and
- (c) a debt owed jointly to joint creditors cannot be set off against a debt owed by one of those creditors to the initial debtor.<sup>74</sup>

In light of these principles, Romaine J. concluded that:

Even if SemCAMS contracting as Operator was not acting as a trustee for the Joint Owners under the CO&O Agreements and the Gas Processing Agreements, it was at a minimum acting as administrator of an account set up for a special purpose. The Joint Owners would surely consider it a misappropriation if money designated for such account was used for the unauthorized purpose of setting-off SemCAMS' debt in its individual capacity.

Thus, whether or not SemCAMS when contracting as Operator was acting as a trustee or on behalf of a "special purpose" Joint Account, the debt owed by SemCAMS in its individual capacity under the Inlet Purchase Agreement cannot be set-off against the debt owed by Trilogy to SemCAMS as Operator under the Gas Processing Agreements or as Operator and Joint Owner under the Trilogy CO&O Agreements.<sup>75</sup>

Significantly, the Court also distinguished the decision in *Royal Trust v. Holden*,<sup>76</sup> which held that a set-off may arise where a beneficiary of a trust owes a debt personally to a third party that owes a debt to the trust. *Trilogy* serves to further restrict its applicability, at least in the commercial insolvency context. Romaine J. stated as follows:

Trilogy relies on the case of *Royal Trust v. Holden* (1915), 8 W.W.R. 500 (B.C.C.A.). This was a matrimonial matter where a divorced husband attempted

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72 *McMahon v. Canada Permanent Trust Co.* (1979), 32 C.B.R. (N.S.) 258 (B.C. C.A.) at para. 9 [*McMahon*]; *Garnett v. McKewan* (1872), L.R. 8 Ex. 10 (Eng. Exch.).

73 *McMahon*, *ibid.*; *National Westminster Bank Ltd. v. Halesowen Presswork & Assemblies Ltd.*, [1972] A.C. 785, 2 W.L.R. 455, 1 All E.R. 641 (U.K. H.L.), at 466 [W.L.R.].

74 *McDougall v. Cameron* (1892), 21 S.C.R. 379 (S.C.C.) at para. 4; *Martin v. McColl*, [1957] O.W.N. 472 (Ont. C.A.), at 288.

75 *Trilogy*, *supra*, note 68 at paras. 31-32.

76 *Royal Trust v. Holden* (1915), 22 D.L.R. 660 (B.C. C.A.); *Palmer*, *supra*, note 2 at 232.

to set-off amounts owed to him by his ex-wife for amounts he was to pay to her under an agreement whereby he paid monthly maintenance payments for her benefit through a trustee. Two members of the British Columbia Appeal Court found for the husband, one on equitable grounds and the other on the basis that the question of a separate state did not really arise at all on the facts. Two other justices dissented, commenting that the maintenance payments were to be paid for a specific purpose and that mutual debts could not arise. As the Court was equally divided, the appeal by the ex-wife was dismissed. The case has been criticized as “not the strongest of decisions” (*The Law of Set-Off in Canada*, Aurora, Canada Law Book, 1993 at 232), and it is noteworthy that it involved a very simple trust with a single beneficiary. Other authority suggests that if a beneficiary’s interest in a trust is not readily ascertainable, a set-off will not be allowed: *Middleton v. Pollock* (1875), L.R. 20 Eq. 29 at p. 34.<sup>77</sup>

Accordingly, an individual in its capacity as trustee of a complex trust is not “the same party in the same right” as that individual acting in its personal capacity. Similarly, an individual in its capacity as administrator of a special purpose account is not “the same party in the same right” as that individual acting in its personal capacity.

While the facts in *Trilogy* are uncommon and unlikely to arise frequently, there are four key lessons for the oil and gas industry, where parties often deal with operators, either as third parties, or in an owner-operator relationship. First, operators of facilities acting for and on behalf of other parties in a trust relationship should be clear with counterparties about the capacity in which they are operating. Counterparties must be made aware of the trust relationship that binds the operator. Second, as a third party, when entering into a commercial relationship with an operator, it would be prudent to have an understanding of the capacity in which that entity is acting, and to factor that in to any agreement with that party. From a credit risk management perspective, it is particularly important to understand the capacity in which a counterparty is acting. Third, joint owners can take some measure of comfort in knowing that they will not be liable for the actions of the operator where it is acting in its personal capacity. Similarly, as beneficiaries of such a trust relationship, if a joint owner of a facility owes a debt to a third party, the law will prohibit that third party from setting off a debt it owes to the operator of that facility. This is reassuring for the operator as well in that it will not be forced to act as a clearinghouse for debt owed by its joint owners to third parties. Fourth, in the insolvency context, joint owners will not risk being held liable for the personal debts of an operator. Joint owners may nevertheless wish to seek assurances from operators that they will not be held so liable.

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<sup>77</sup> *Trilogy*, *supra*, note 68 at para. 34.

The Court of Appeal denied Trilogy leave to appeal the Court of Queen's Bench decision, affirming the legal set-off analysis applied by Romaine J.<sup>78</sup>

## ii. Legal Set-off of Pre-filing against Post-filing Obligations

In *Trilogy*, the court was asked to consider, as an alternative argument, whether set-off is available in the CCAA context as between pre-filing debts and post-filing debts. As Romaine J. concluded that since Trilogy was not entitled to set off, there was no need to consider this issue.<sup>79</sup> As noted above, Trilogy had purported to set off pre-filing amounts owed by SemCAMS to Trilogy against Trilogy's debt to the Operator. The latter arose post-filing as a result of the continuing commercial transactions between the parties.

A similar issue was considered in the 2003 decision *Re Air Canada*.<sup>80</sup> In that case, Farley J. heard an application by certain creditors of Air Canada to vary the initial order under the CCAA, which contained a blanket prohibition on setting off a pre-filing debt owed by the debtor to the creditor against a debt that arose post-filing and owed by that creditor to the debtor.<sup>81</sup> In *Air Canada*, Farley J. concluded that mutuality was not severed on the granting of an initial order so as to preclude legal set off. While Farley J. considered this broad proposition, he did not consider the following typical scenario:

- A and B are in a trading relationship, and each month either party could be a net payor;

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78 Paperny J.A.'s summary of the threshold issue for a leave application in the CCAA context is noteworthy for its succinctness and correctness: "The threshold issue to be determined on an application for leave to appeal under the CCAA is whether the proposed appeal is *prima facie* meritorious: *Resurgence* #1 at para. 35. Trilogy proposes grounds which raise questions of law and questions of mixed fact and law. They boil down to whether each of the respective tests for contractual, legal and equitable set-off were properly applied by the chambers judge. To be reviewable by this Court, Trilogy must point to an error on a question of law, a palpable and overriding error in the findings of fact, or an error in the supervising chambers judge's exercise of discretion. See *Resurgence* #2 at para. 42; *Resurgence* #1 at paras. 28-29. Questions of pure law are reviewable on a standard of correctness, while issues of mixed fact and law, including a judge's interpretation of the evidence as a whole, and whether or not the facts satisfy a legal test, are reviewable on a standard of palpable and overriding error: *Housen v. Nikolaisen*, 2002 SCC 33, [2002] 7 W.W.R. 1 at paras. 36-37 ("Housen")." *Trilogy Energy LP v. SemCAMS ULC (C.A.)*, *supra*, note 68 at para. 13.

79 *Trilogy*, *supra*, note 68 at para. 68.

80 *Re Air Canada* (2003), 2003 CarswellOnt 4016, 45 C.B.R. (4th) 13 (Ont. S.C.J. [Commercial List]) [*Air Canada* cited to CarswellOnt].

81 *Ibid.* at para. 2.

- A becomes insolvent and seeks court protection pursuant to the CCAA;
- As of the filing date, A owes B a pre-filing debt;
- A and B continue commercial relations in the ordinary course post-filing; and
- Post-filing, B becomes a net payor and purports to set off the amount it owes to A against the pre-filing amounts owed by A to B, potentially until the entire pre-filing debt is extinguished.

If *Air Canada* stands, it would appear that a set-off would be allowed in this scenario. However, the mischief created by such a set-off is clear; it creates an incentive for a creditor with a pre-filing claim to procure goods or services from the debtor company in the post-filing period and withhold payment for such goods or services to retire the pre-filing debt. At the same time, it creates a disincentive for the debtor company to continue to do business with its suppliers or customers to avoid having to “work off” the pre-filing debt, an action which, depending on the amounts involved, could dissipate significant assets and jeopardize a successful restructuring.

Faced with such a scenario, restructuring debtors are wise to enter into a “no set-off” agreement, whereby the creditor agrees that it will not in future set-off post-filing obligations it incurs against pre-filing debt owed to it, and the parties acknowledge one another’s right to dispute any existing set-off claims at a later date.<sup>82</sup> While this is a practical solution to a business problem, it does not address the incentives created by the approach taken in *Air Canada*, which, it is respectfully submitted, may in some circumstances run counter to the legislative intent of the CCAA.

The question is whether a CCAA filing should break mutuality and thus preclude legal set-off. A significant difference between an assignment in bankruptcy and an initial order pursuant to the CCAA is that the former results in all property of the debtor devolving upon (i.e. being assigned to) the trustee, while the latter results in the appointment by the court of a monitor to oversee the continued operation of the debtor company. Under the CCAA there is no transfer of the debtor company’s property; the debtor continues to own and operate its assets.

There is no mutuality between a debt owed by a company to a creditor prior to an assignment in bankruptcy, and a debt generated and owed by that creditor to the trustee in bankruptcy after the bankruptcy.<sup>83</sup> Houlden, Morawetz and Sarra explain why set-off is not allowed for post-proposal claims as against pre-proposal claims in a BIA proposal situation, as follows:

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82 This appears to be what happened between the parties in *Air Canada*, where the application dealt only with the set-off pre-filing debts against post-filing debts up to a certain date.

83 *BIA*, *supra*, note 6, s. 71; see *Air Canada*, *supra*, note 80 at paras. 14-15.

It is customary in a proposal to provide that creditors dealing with the debtor after the filing of a notice of intention or a proposal shall have no right of set-off. This is done to prevent creditors from purchasing goods from the debtor and claiming a right of set-off against the amount owing to them by the debtor. Even if such a term is not contained in a proposal, it would appear that there is no right of set-off, since if such were allowed it would be a fraud on the bankruptcy law. [. . .]

If set-off were allowed, it would make it difficult, if not impossible, for a trading company to make a successful proposal.<sup>84</sup>

Similar reasoning has been applied when a company liquidates pursuant to the *WURA*,<sup>85</sup> which permits set-off in a manner similar to section 21 of the *CCAA*, as follows:

The law of set-off, as administered by the courts, whether of law or equity, applies to all claims on the estate of a company, and to all proceedings for the recovery of debts due or accruing due to a company at the commencement of the winding-up of the company, in the same manner and to the same extent as if the business of the company was not being wound up under this Act.<sup>86</sup>

Despite the ostensibly permissive language of the *WURA*, the result of a winding-up order is that mutuality is severed such that legal set-off is unavailable between post-filing and pre-filing claims. This severing of mutuality is so despite the fact that the business and assets of the debtor are not assigned and do not vest in another entity upon a winding-up order, and notwithstanding the fact that the *WURA* provides for set-off “in the same manner and to the same extent” as if the company was not being wound up.<sup>87</sup> The reason that mutuality is severed on the granting of a winding-up order is the change effected on the character and obligations of the debtor.<sup>88</sup> Palmer notes that this result may be counterintuitive. He sets out in some detail three possible rationales for such legal treatment under the *WURA*: the creation of different interests on filing under the *WURA*, the creation of a quasi-trust and the mere assumption that a change has occurred.<sup>89</sup>

In contrast, the decision in *Air Canada* held that the same is not true in the *CCAA* context. This reasoning results in an inconsistency within the Canadian insolvency regime. However, similar arguments can be made in the *CCAA*

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84 L.W. Houlden, G.B. Morawetz & J.P. Sarra, *Bankruptcy and Insolvency Law of Canada*, 3rd ed. Rev., vol. 3, looseleaf (Toronto: Carswell, 2009) at E§64.

85 *WURA*, *supra*, note 7, s. 73; *Air Canada*, *supra*, note 80 at paras. 16-22.

86 *WURA*, *ibid.*

87 *Citibank Canada* (Ont. C.A.), *supra*, note 64 at para. 15; *P. Lyall & Sons Construction Co. v. Baker*, [1933] O.R. 286 (Ont. C.A.), at paras. 16-17 [*P. Lyall & Sons*].

88 *P. Lyall & Sons*, *ibid.*

89 Palmer, *supra*, note 2 at 209-210.



context: the granting of an initial order under the CCAA results in several key changes to the status, function and obligations of the debtor company that would serve to sever mutuality. First, the stay of proceedings preserves the *status quo* among creditors as of the date of filing and restricts the rights of parties to exercise rights or remedies as against the debtor company.<sup>90</sup> Second, the debtor company ceases to act solely in its own corporate interests, and begins to operate under mandatory monitor scrutiny and court direction, with careful attention being paid to the preservation of assets and enterprise value. Under monitor and court scrutiny, the entire mandate of the debtor company changes and its ability to act is strictly curtailed. The debtor may continue its operations during the CCAA proceedings; however, it does so on different terms and with different objectives than in the pre-filing period.<sup>91</sup> Third, the debtor company ceases to serve the interests of its shareholders with the objectives of maximizing profit. Instead, under court guidance, it begins to serve the interests of all stakeholders in a manner consistent with the objectives of preserving the assets of the company and maximizing enterprise value.

This issue is specific to legal set-off, as contractual and equitable set-off do not become unavailable just because there is a break in mutuality. With respect to equitable set-off, while it is arguable that the timing when each of the cross-claims arise could be a factor in determining whether those cross-claims are closely connected,<sup>92</sup> the decision in *Blue Range Resource Corp.* would suggest that when cross-claims arise from the same contract, the distinction between pre and post filing debts will not be a significant factor.<sup>93</sup>

In light of the rationale to explain the loss of mutuality in the WURA context, should the same be true in the CCAA context? At this time, *Air Canada* stands for the proposition that an initial order pursuant to the CCAA does not sever mutuality. While a comprehensive critique of the decision in *Air Canada* is beyond the scope of this paper, it appears counter-intuitive that an exception should be made for CCAA, particularly in light of the similar language used in the statutes and the results such an exception can create.

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90 CCAA, *supra*, note 5 at s. 11; Janis Sarra, *Rescue! The Companies' Creditors Arrangement Act*, (Toronto: Carswell, 2007) [Sarrra] at 34.

91 CCAA, *supra*, note 5 at s. 11.7.

92 *Re Canadian Airlines* (2001), [2001] A.J. No. 226, 2001 CarswellAlta 240 (Alta. Q.B.) at para. 69 [*Re Canadian*].

93 *Re Blue Range Resource Corp.*, 2000 CarswellAlta 731, 261 A.R. 162 (Alta. C.A.) at para. 19 [*Blue Range* cited to CarswellAlta]: the Court held as follows: “[. . .] the fact that the damages owed to [the creditors] arise after the stay order is not relevant when the obligations arise out of the same contracts.”

**a. Set-off May Promote Mischief**

The key policy reason for why a CCAA filing should sever mutuality is the mischief it serves to promote. This mischief was described above in general terms, but the very issue was considered by the British Columbia Court of Appeal in the pre-section 21 decision in *Quintette Coal*.<sup>94</sup> In *Quintette Coal*, the debtor company, Quintette Coal Ltd. (“Quintette”), owed certain creditors a large sum of money as a result of overpayments made by the creditors prior to Quintette’s CCAA filing. Quintette continued to sell coal to the creditors following the CCAA filing; however, the creditors purported to set off the pre-filing amounts against the amounts owing for coal delivered in the post-filing period. Quintette was faced with the prospect of working off its pre-filing debt over time. The issue in that case was whether the stay provision under section 11 of the CCAA could serve as a bar to set-off.<sup>95</sup>

After considering the fundamental purpose of the CCAA and balancing the equities among the stakeholders, the Court concluded that it was not in the best interests of the stakeholders to allow set-off as between pre-filing and post-filing debt. A critical factor in the decision was that allowing the set-off would have granted certain creditors a disproportionate recovery as compared to other creditors:

Quintette as debtor is proposing a compromise or arrangement with its creditors, including the Japanese companies. The Court may sanction and make binding on all creditors, including the Japanese companies, a compromise or arrangement agreed upon by a “majority in number representing three-fourths in value of the creditors, or class of creditors, as the case may be” (s. 6). With respect to value, the \$36 million June 13, 1990 debt owed to the Japanese companies represents approximately 4-1/2 per cent of the total of secured and unsecured debt. It would be anomalous indeed if, by denying or restricting cash flow, a 4-1/2 per cent creditor could frustrate the compromise or arrangement because s. 11 did not apply, whereas if s. 11 did apply so that a stay could be ordered a creditor or creditors of up to 25 per cent could ultimately be forced to defer to the compromise or arrangement agreed upon by the 75 per cent. If the language of s. 11 so confines the Court that that result flows the anomalous consequence must be accepted. On the other hand, if there is a reasonable construction which more nearly reflects the intention of the legislators, and avoids the anomaly, it is to be preferred.<sup>96</sup> [Emphasis added.]

After reviewing the case law, the Court concluded that section 11 of the CCAA provides a discretionary power that could be used to bar such an “anomaly”:

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94 The decision was also preceded the enactment of section 18.1 of the CCAA in 1997.

95 *Quintette Coal*, *supra*, note 12 at para. 12.

96 *Ibid.*

It would be a reasonable expectation that it would be extremely unlikely that the power would be exercised where the result would be to enforce the continued supply of goods and services to the debtor company without payment for current deliveries, whereas it would not be unlikely when the result would be to enforce payment for goods thereafter taken from, or services thereafter received from, the debtor company, as is the case here.<sup>97</sup> [Emphasis added.]

Section 21 had not yet been enacted; had it been, the issue before the Court of Appeal would likely have been whether section 21, which permits set-off, should permit set-off in the circumstances. It is submitted that the mischief created by allowing such a set-off would have been a significant impediment to allowing the set-off in that case.

## **b. Interpretation of the CCAA**

A second key policy reason why a CCAA filing should sever mutuality is that it may run counter to the intent of the CCAA. The standard form CCAA initial order closes off most remedies available to a party in the event that a counterparty files for court protection under the CCAA. By enacting section 21 and permitting set-off, Parliament has signalled that it will not impose on creditors the perceived injustice of having to make full payment of a debt to a debtor company, when a debt owed by the debtor company to the creditor may only be paid by cents on the dollar. The trade-off, of course, is that a party who takes the benefit of a set-off realises its claim on a dollar-for-dollar basis, while other creditors have their relative recoveries reduced as a result. For this reason, it has rightly been held by the B.C. Court of Appeal that the legislative intent animating the CCAA requires that the courts remain vigilant to claims of set-off in the reorganization context.<sup>98</sup> This proposition applies equally to contractual set-off as it does to equitable and legal set-off.

On a purposive reading of section 21 of the CCAA, arguably permitting set-off as between post-filing and pre-filing claims undermines the fundamental purpose of the CCAA and the stay order.

Section 12 of the *Interpretation Act* provides:

Every enactment is deemed remedial, and shall be given such fair, large and liberal construction and interpretation as best ensures the attainment of its objects.<sup>99</sup>

In the *Construction of Statutes*, Sullivan and Driedger set out the principles of purposive analysis of legislative texts:

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<sup>97</sup> *Ibid.* at para. 17.

<sup>98</sup> *Cam-Net Communications, supra*, note 12 at para. 22.

<sup>99</sup> *Interpretation Act*, R.S.C. 1985, c. I-21, s. 12.

- (1) All legislation is presumed to have a purpose. It is possible for courts to discover or adequately reconstruct this purpose through interpretation.
- (2) Legislative purpose should be taken into account in every case and at every stage of interpretation, including the determination of a text's meaning.
- (3) In so far as the language of the text permits, interpretations that are consistent with or promote legislative purpose should be adopted, while interpretations that defeat or undermine legislative purpose should be avoided.<sup>100</sup>

The words of a legislative text must be read in their ordinary sense, harmoniously with the scheme and objects of an act and the intention of the legislature. The Court has warned against considering *CCAA* provisions in isolation: a clear and concise statutory interpretation requires that the provisions of a statute be construed with reference to the context of the particular insolvency and other clauses of the *CCAA*.<sup>101</sup> Notwithstanding the unambiguous language of an act, an interpretation that would frustrate or defeat the intent of Parliament should be rejected.<sup>102</sup> The courts have also acknowledged the need to prevent aggressive creditors from gaining a preference over other creditors or impairing the restructuring process,<sup>103</sup> and in particular, misusing the law of set-off.<sup>104</sup> Finally, the *CCAA* is remedial legislation subject to a liberal interpretation.<sup>105</sup>

Section 21 of the *CCAA* should be assessed with these interpretive tools in mind. Although section 21 expressly permits set-off, courts should consider the purpose of the *CCAA* and take into consideration the whole of the *CCAA* in

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100 Ruth Sullivan, *Sullivan and Driedger On the Construction of Statutes*, 4th ed. (Markham: Butterworths Canada Ltd., 2002) at 195 [Sullivan and Driedger].

101 *Quintette Coal*, *supra*, note 12 at paras. 7-11.

102 *Re Rizzo & Rizzo Shoes Ltd.*, [1998] 1 S.C.R. 27 (S.C.C.) at paras. 21 – 23 and 27; *Jodrey Estate v. Nova Scotia (Minister of Finance)*, [1980] 2 S.C.R. 774 (S.C.C.) at para. 92. Sullivan and Driedger explain: “Statutory interpretation is founded on the assumption that legislatures are rational agents. They enact legislation to achieve a particular mix of purposes, and each provision in the Act or regulation contributes to realizing those purposes in a specific way. An interpretation that would tend to frustrate the purpose of the legislation or the realization of the legislative scheme is likely to be labelled absurd.”, Sullivan and Driedger, *supra*, note 100 at 243-244.

103 J. Sarra, *supra*, note 90 at 10-11; *Re Hunters Trailers & Marine Ltd.* (2001), 2001 CarswellAlta 964 (Alta. Q.B.) at para. 10.

104 *Algoma Steel Inc. v. Union Gas Ltd.* (2003), 63 O.R. (3d) 78 (Ont. C.A.) at para. 14; *Cam-Net Communications*, *supra*, note 12 at para. 22.

105 *Re Lehndorff General Partner Ltd.* (1993), 17 C.B.R. (3d) 24 (Ont. Gen. Div. [Commercial List]) at para. 5; *Hurricane Hydrocarbons Ltd. v. Komarnicki* (2007), (sub nom. *Komarnicki v. Hurricane Hydrocarbons Ltd.*) 425 A.R. 182 (Alta. C.A.) at para. 13; Sarra, *supra*, note 90 at 1.

determining whether set-off of pre-filing and post-filing debt should be permitted. Section 21 should not be interpreted to mean that set-off is allowed in any circumstances, or that it applies *notwithstanding* the provisions of the CCAA. Rather, the law of set-off should take into account the facts surrounding the insolvency.

It must be remembered that the Court of Appeal in *Blue Range* held that concerns about the priority of creditors should be irrelevant in the face of section 21.<sup>106</sup> On the other hand, it has also been held that:

Although *Blue Range* suggests that it is inappropriate to consider prejudice to other creditors in prohibiting set-off, the court did not go so far as to say that a court in determining a close connection is prohibited from considering whether the intention of the CCAA will be entirely defeated.<sup>107</sup>

The fundamental purpose of the CCAA is to facilitate compromises and arrangements among an insolvent company and its creditors as an alternative to bankruptcy. A key mechanism in fulfilling the fundamental purpose of the CCAA is the section 11 stay, which is intended to maintain the *status quo* among creditors while the debtor company endeavours to reorganize.<sup>108</sup> This fundamental purpose is destroyed if creditors are allowed to set off pre-filing debt against post-filing debt and in particular if the creditor withholds funds for an extended period, hampering the debtor company from operating during the stay period, hampering a restructuring and ultimately affecting stakeholder value. If a debtor company provides goods or services and receives no payment in return, the restructuring process will be rendered impossible. This result is especially true if multiple creditors are involved. It is difficult to imagine that the legislators of the day intended that result. If set-off in such circumstances could thwart the restructuring process, then the Court should be very sure before it rejects the break in mutuality that is recognised under the two other insolvency regimes and thus permits a set-off that may undermine the purpose of the CCAA.

### ***C. Equitable Set-off***

The test for equitable set-off is well established. As originally distilled by Macfarlane J. in *Coba Industries Ltd. v. Millie's Holdings (Canada) Ltd.*<sup>109</sup>

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<sup>106</sup> *Blue Range*, *supra*, note 93 at para. 13.

<sup>107</sup> *Re Canadian*, *supra*, note 92 at para. 70.

<sup>108</sup> *Re Doman Industries Ltd.* (2003), 14 B.C.L.R. (4th) 153 (B.C. S.C. [In Chambers]) at para. 22. *Re Doman* has an excellent discussion of the purposes of a stay pursuant to section 11 of the CCAA.

<sup>109</sup> *Coba Industries Ltd. v. Millie's Holdings (Canada) Ltd.* (1985), 20 D.L.R. (4th) 689 (B.C. C.A.) at 9-10.

and affirmed by the Supreme Court of Canada in *Holt v. Telford*:<sup>110</sup>

1. The party relying on a set-off must show some equitable ground for being protected against his adversary's demands: *Rawson v. Samuel* (1841), Cr. & Ph. 161, 41 E.R. 451 (L.C.).
2. The equitable ground must go to the very root of the plaintiff's claim before a set-off will be allowed: [*Br. Anzani (Felixstowe) Ltd. v. Int. Marine Mgmt (U.K.) Ltd.*, [1980] Q.B. 137, [1979] 3 W.L.R. 451, [1979] 2 All E.R. 1063].
3. A cross-claim must be so clearly connected with the demand of the plaintiff that it would be manifestly unjust to allow the plaintiff to enforce payment without taking into consideration the cross claim: [*Fed Commerce & Navigation Ltd. v. Molena Alpha Inc.*, [1978] Q.B. 927, [1978] 3 W.L.R. 309, [1978] 3 All E.R. 1066].
4. The plaintiff's claim and the cross-claim need not arise out of the same contract: *Bankes v. Jarvis*, [1903] 1 K.B. 549 (Div.Ct.); *Br. Anzani*.
5. Unliquidated claims are on the same footing as liquidated claims: [*Nfld. v. Nfld. Ry. Co.* (1888), 13 App.Cas. 199 (P.C.)].

A review of the recent jurisprudence reveals that the elements of the equitable set-off test are generally not at issue, with the exception of the third element. Indeed, very little consideration has been given to the other elements of the test. There are generally two overriding concerns when a party asserts equitable set-off: (a) the close-connection or interconnectedness of the cross claims; and (b) whether it would be manifestly unjust not to allow set-off.<sup>111</sup>

There is little debate with respect to the test itself. However, there has been some dispute about what fact situations may allow for equitable set-off. As noted by Lord Denning in *Federal Commerce* the answer to the question, "what should we do now so as to ensure fair dealing between the parties?" must be asked on a case-by-case basis, and then, "we shall build up a series of precedents to guide those who come after us."

Five recent cases have provided additional guidance in this regard. In four of the cases, the "close-connection test" was not met for various reasons. Curiously mutuality, which is not a requirement for equitable set-off, was absent in all four cases. In the fifth case equitable set-off was allowed.<sup>112</sup> Each will be discussed in turn.

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<sup>110</sup> *Telford*, *supra*, note 63 at para. 35.

<sup>111</sup> *420093 B.C. Ltd. v. Bank of Montreal* (1995), 174 A.R. 214 (Alta. C.A.) at paras. 40-41; *Federal Commerce*, (C.A.) *supra*, note 3; *Blue Range*, *supra*, note 93; *Cam-Net Communications*, *supra*, note 12 at paras. 29-30.

<sup>112</sup> There were other cases that discussed equitable set-off but did not, in our view, provide much insight into equitable set-off. For example, the decision in *Tupper-*

**i. Failure to Make the Connection**

In *Green v. Mirtech International Security Inc.*,<sup>113</sup> the founders of Mirtech International Security Inc. (“Mirtech”) entered into an agreement with one another whereby upon the death of any of the founders, the widow of the deceased founder would be placed on Mirtech’s payroll (the “Compensation Agreement”). Upon the death of Mr. Green, the remaining founders alleged that Mr. Green had misappropriated or converted approximately \$180,000 for his own use and, accordingly, denied Mrs. Green any benefits under the Compensation Agreement. Mrs. Green commenced an action against the founders to enforce the Compensation Agreement. In their Statement of Defence, the defendants claimed that any amount owing to Mrs. Green under the Compensation Agreement should be set off against amounts owing by Mr. Green’s estate for return of the misappropriated funds. The Ontario Superior Court of Justice was asked to make a pre-trial determination as to the availability of set-off in the circumstances.

Legal set-off was not allowed because the defendant’s claim was not a liquidated debt and the cross-obligations were not mutual. In finding that equitable set-off was not allowed, Belobaba J. held that the claims related to two different matters involving two different parties. Moreover, the parties seeking to rely on equitable set-off failed to show that it would be manifestly unjust to allow Mrs. Green to enforce the Compensation Agreement without taking into account the company’s claim against Mr. Green.<sup>114</sup> This was the case, even though there were no assets in Mr. Green’s estate, and therefore it would appear that the defendants had no other recourse.<sup>115</sup> While the Court did not say as much, it would have been manifestly unjust to deny Mrs. Green her compensation pursuant to the Compensation Agreement based on the unproven alleged actions of her deceased husband. Had the defendants proved Mr. Green’s misconduct and that Mrs. Green had benefited from it, then arguably equitable set-off would have been an appropriate defence.

In *Re SemCanada Crude Company [Nexen]*,<sup>116</sup> the validity of a purported cross-affiliate set-off was considered by the Alberta Court of Queen’s

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*ware Canada Inc. v. 1196815 Ontario Ltd.* (2008), 2008 CarswellOnt 778 (Ont. S.C.J.), additional reasons at (2008), 2008 CarswellOnt 2915 (Ont. S.C.J.), additional reasons at (2008), 2008 CarswellOnt 4546 further (Ont. S.C.J.) simply affirmed the prior case law which stated that there was no equitable set-off for unliquidated damages available with respect to a promissory note. The more interesting issue of what impact, if any, the *Arthur Wishart (Franchise Disclosure) Act*, 2000, S.O. 2000, c.3 had on the law of set-off was not decided.

113 *Green v. Mirtech International Security Inc.* (2009), 2009 CarswellOnt 450 (Ont. S.C.J.) [*Green v. Mirtech*].

114 *Ibid.* at para. 19.

115 *Ibid.* at para. 20.

116 *Nexen, supra*, note 42.

Bench in the context of equitable set-off. In that case, Nexen Marketing (“Nexen”) and SemCAMS had entered into two contracts one for the purchase and sale of natural gas and the other for the purchase and sale of condensate. Affiliates of SemCAMS, SemCanada Crude Company (“SemCanada Crude”) and CEG Energy Options Inc. (“CEG”), had over the years, entered into several contracts with Nexen for the purchase and sale of crude oil and natural gas, respectively. When SemCAMS and its affiliates became insolvent,<sup>117</sup> Nexen owed amounts to SemCAMS, while SemCanada Crude and CEG owed amounts to Nexen. Nexen purported to set off these amounts on the basis that SemGroup, L.P., the ultimate corporate parent of the affiliates, had represented the affiliated “Sem” group of companies as a single corporate entity. Based on the single economic unit doctrine, prevalent in the U.S. but rejected in Canada,<sup>118</sup> Nexen asserted that the operation of the affiliates as a single corporate family provided evidence of a connection sufficient to justify equitable set-off.<sup>119</sup>

On examining the evidence, Romaine J. held that the test for equitable set-off had not been met. While it was recognised that mutuality was not strictly required in equitable set-off, membership in a corporate group, in and of itself, was not sufficient to create a “close-connection.” That the affiliates were separate legal entities suggested less of a connection.<sup>120</sup> As stated by Romaine J:

On the relevance of the operation of a corporate group, the Alberta Court of Appeal in *Cunningham v. Hamilton*, (1995), 29 Alta L.R. (3d) 380, at para. 4 made the following comment:

It is true that Broken Hill operates a number of its worldwide companies as an integrated economic unit. But the mere fact it does so does not mean that for legal purposes, separate legal entities will be ignored absent some compelling reason for lifting the corporate veil. As noted in *Adams v. Cape Industries plc*, [1990] Ch. 433 (C.A.), at p. 538, citing Goff L.J. in *Bank of Tokyo Ltd. v. Karoon* (Note) (1876), [1987] A.C. 45:

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117 SemCAMS and SemCanada Crude were each granted an Initial Order pursuant to the CCAA, while CEG filed for bankruptcy protection under the BIA.

118 *Acton Petroleum Sales Ltd. v. British Columbia (Minister of Transportation & Highways)* (1998), 1998 CarswellBC 1162, 161 D.L.R. (4th) 481 (B.C. C.A.).

119 *Nexen*, *supra*, note 42 at para 11.

120 This conclusion affirms the general proposition set out by Palmer that while mutuality is not required by equitable set-off, it is difficult to show a close connection where there was not at least at one point some mutuality between the cross-claims. As stated by Palmer, *supra*, note 2 at page 81: “Mutuality is required, even if in a relaxed fashion. To a large extent, this may be satisfied indirectly by the equitable set-off requirement that the debts must be sufficiently connected. It is difficult to see how such a connection could arise without there being some form of mutuality present, relaxed or otherwise. This requirement of connection should not overshadow the continuing need for some presence of mutuality in equitable set-off.”



[Counsel] suggested . . . that it would be technical for us to distinguish between parent and subsidiary company in this context; economically, he said, they were one. But we are concerned not with economics but with law. The distinction between the two is, in law, fundamental and cannot here be bridged.

The issue of sufficient connection to establish the right of equitable set-off is also an issue in law and equity and not in economics. The fact that the parties to the contracts are separate legal entities implies a lesser degree of connection among the contracts and the transactions. There is nothing in *Telford* that implies that the mere connection of membership in a corporate group is a sufficient connection to establish a right of equitable set-off.<sup>121</sup>

Other aspects of the relevant contracts were considered. It was ultimately concluded that there was no close connection given the timing of the contracts, the transactions they contemplated and the sophistication of the parties. Moreover, Nexen failed to establish that it would be manifestly unjust to allow SemCAMS to enforce its claim against Nexen without taking into account Nexen's claim against SemCAMS' affiliates. On this point, interestingly, Romaine J. took note that, in the insolvency context, it may be inequitable for one member of a corporate family to demand full payment from a party, where others are shielded by virtue of an Initial Order pursuant to the CCAA. However, allowing set-off in the manner purported by Nexen would be contrary to the CCAA. Romaine J. stated:

Nexen submits that it would be unjust in this case if, while two members of the SemGroup seek to shield themselves behind the protection of the CCAA so as to suspend their obligations to pay their debts then due, a third member, SemCAMS, is able to compel full payment. While there may have been some merit in this argument if it were made in conjunction with a necessary finding on the other elements of the test for equitable set-off, it cannot be sufficient to form a basis for equitable set-off if the party seeking set-off has not been able to establish a sufficient connection of the contracts or transactions. Otherwise, any claim of equitable set-off in a CCAA proceeding that involved a corporate group would be sustainable, whether or not clearly connected to the demand at issue. This is clearly not the case: s. 18.1 of the CCAA provides that the law of set-off applies in a CCAA context in the same manner as in other litigation.<sup>122</sup> [Emphasis Added.]

Given the absence of case law relating to cross-affiliate set-off, the *Nexen* decision is important, particularly in the context of the CCAA. This is not to say that affiliate relationships cannot justify set-off; indeed, such a set-off may be allowed in certain circumstances, for example where there is reason to pierce

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121 *Nexen, supra*, note 42 at paras. 12-13.

122 *Ibid.* at para. 19.

the corporate veil or if the affiliate is an agent of the parent.<sup>123</sup> However, care must always be taken in such fact scenarios because the general rule is that cross-affiliate set-off will not be permitted unless expressly agreed by the parties. As stated by Palmer:

It is clear under Canadian law that a company operates as a distinct legal personality from its shareholders, directors, subsidiaries and parent corporations. Despite this basic tenant of common law, there are a surprising number of cases which query whether a company is separate enough from these various other parties to allow, or deny, set-off. The basic rule is that a corporation will be treated as a separate legal entity for purposes of set-off and so will not have mutuality on debts owed by it to third parties with debts owed by third parties to its shareholders, directors or subsidiaries. [. . .]

Individually incorporated subsidiaries exist separately from their parent companies, regardless of the extent of ownership by the parent. A debt owed by a subsidiary to a third party therefore cannot be set-off against amounts owed by the third party to the parent corporation. These basic principles of corporate law, however, have not stopped debtors (and unfortunately, their lawyers) from claiming that set-off should be available in these circumstances.<sup>124</sup>

Similarly, in *Trilogy* (discussed in detail above), in considering equitable set-off Romaine J. concluded that the Operator's claim arising from the multitude of contracts between the Operator and Trilogy, and Trilogy's claim arising from the contract between SemCAMS and Trilogy were not sufficiently connected. Moreover, Trilogy failed to establish that it would be manifestly unjust to enforce the Operator's claim against Trilogy without taking into account Trilogy's claim against SemCAMS.<sup>125</sup> On analysing the contracts, Romaine J. had regard for the timing of the contracts and events, the nature and subject of the transactions and the conduct and relationship among the parties.<sup>126</sup> In examining the equities, consideration was given to the fact that by failing to pay the Operator, it was the Joint Owners that could reasonably be expected to be

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123 *Royal Bank v. Wallace Investment Ltd.* (1961), 1961 CarswellBC 25, 30 D.L.R. (2d) 280 (B.C. Co. Ct.); *Smith, Stone & Knight Ltd. v. Birmingham (City)*, [1939] 4 All E.R. 116 (Eng. K.B.); *Canadian Credit Men's Assn. v. Kruse* (1967), 1967 CarswellMan 5, (sub nom. *Van-Ern Plumbing & Heating Ltd., Re*) 64 D.L.R. (2d) 254 (Man. Q.B.); *New York House Ltd. v. O'Connor-4 Co.* (1998), 1988 CarswellOnt 621, 1 R.P.R. (2d) 295 (Ont. H.C.), affirmed (1991), 1991 CarswellOnt 1730 (Ont. C.A.); *Re Galt-Canadian Woodworking Machinery Ltd.* (1984), 1984 CarswellOnt 198, (sub nom. *Galt-Cdn. Woodworking Machinery Ltd., Re*) 5 D.L.R. (4th) 504 (Ont. S.C.).

124 Palmer, *supra*, note 2 at 244-245.

125 *Trilogy*, *supra*, note 68 at paras. 55-56.

126 *Ibid.* at paras. 41-55.

prejudiced.<sup>127</sup>

In *Re Polywheels Inc.*, the Ontario Superior Court of Justice considered the validity of a set-off between affiliates in the CCAA context.<sup>128</sup> In that unusual case, *Polywheels Manufacturing Ltd.*, (“Polywheels”) leased a manufacturing facility from its affiliate, Cavu Enterprises (“Cavu”). Cavu had obtained financing from Sun Life Assurance Company of Canada (“Sun Life”) and Romspen Investment Corporation (“Romspen”), which was secured by a first mortgage and a second mortgage, respectively. Romspen also obtained a General Security Agreement, an Assignment of Lease and a Guarantee and Postponement of Claim. On securing the financing, Cavu lent a large proportion of the funds to Polywheels. Approximately two years later, Polywheels and Cavu were granted court protection pursuant to the CCAA. Polywheels ceased paying rent to Cavu pursuant to a Court Order, but a Post Filing Rent Charge on a portion of the rent was secured until the expiry of the Stay. Polywheels subsequently disclaimed the lease and eventually vacated the property. Romspen, which had been assigned the lease, brought a motion to enforce Polywheels’ payment of the lease up to the date it vacated the property. In its defence, Polywheels asserted that any rent owing by Polywheels to Romspen should be set off against amounts incurred by Polywheels for post-filing expenses paid to the monitor, which were said to have been incurred by Polywheels on behalf of Cavu and therefore owing by Cavu to Polywheels.

The Court quickly dispensed with the legal set-off argument as there was no mutuality of debt.<sup>129</sup> Equitable set-off was not available either because the claims did not arise out of the same transaction nor were they closely connected.<sup>130</sup> In particular, the Newbould J.’s analysis examined the nature of the debts owing, as follows:

The rental obligation of Polywheels to Cavu arises from the lease of Cavu’s premises made in 1994 and from the continuation of the lease after the July 22, 2008 order. That order did not change the nature of that obligation, although it did allow Polywheels to pay less than what was to be paid under the lease and it secured the balance owing to Cavu by means of the Post-Filing Rent Charge. The cross-claim, being the obligation of Cavu to Polywheels (assuming it exists and ignoring the assignment of it by Polywheels to Romspen) has arisen since July 22, 2008 by expenditures having been made in connection with efforts by Cavu to sell the property. These cross-claims have a temporal similarity although the legal basis for them is quite different. They do not arise out of the same transaction, nor are the transactions closely connected.<sup>131</sup> [Emphasis Added.]

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127 *Ibid.* at para. 58.

128 *Re Polywheels Inc.* (2009), 2009 CarswellOnt 2875, 53 C.B.R. (5th) 109 (Ont. S.C.J. [Commercial List]).

129 *Ibid.* at para. 25.

130 *Ibid.* at paras 29-30.

131 *Ibid.* at para. 30.

Importantly, Newbould J. also concluded that allowing the set-off would be manifestly unjust, and would run counter to the Post Filing Rental Charge, which conferred a benefit on Polywheels and was in part intended to protect Romspen and Sun Life.<sup>132</sup> Thus, in this case, equitable set-off was not permitted because the legal basis for the cross-claims were different, and because the events that followed the CCAA filing would have made it manifestly unjust to allow it. While it was not noted by judge, we would add that there at no time was mutuality as between the cross-claims.

## ii. Facts Gave Rise to a Close Connection

In *Royal Crest Lifecare Group Inc. v. Ontario (Health and Long Term Care)*, the court was asked to consider the availability of equitable set-off between a regulator and a regulated party.<sup>133</sup> In that case, the Ontario Ministry of Health and Long Term Care (the “MOH”) provided a subsidy to Royal Crest Lifecare Group Inc. (“Royal Crest”) pursuant to the *Nursing Homes Act*.<sup>134</sup> The subsidies were provided to Royal Crest for services provided to residents of Royal Crest’s nursing homes for a period from 2000 to 2002 prior to an interim receiver being appointed for Royal Crest in 2002. After the appointment of the receiver, the MOH determined that the MOH had overpaid the subsidy for the years in question by almost \$4 million (the “Overpayment”).

Prior to Royal Crest’s assignment in bankruptcy, the MOH took possession of a nursing home owned and operated by Royal Crest in response to serious compliance issues (the “Control Order”). The statute governing the Control Order provided that the MOH was required to pay Royal Crest reasonable compensation for use of the property for the duration of the MOH’s control of the property, an amount determined to be \$1 million (the “Rent”). The MOH asserted a right to set off the Rent against the Overpayment. Wilton-Siegel J. found that the cross-obligations arose out of the same relationship between the parties. In particular, as stated by the Court:

Under the NHA, the MOH has the responsibility for regulating nursing homes in Ontario, including (1) funding the services provided therein to assist in the delivery of services that meet the statutorily-mandated level of care and (2) monitoring and supervising the care provided by nursing homes to ensure compliance with such standard. These are not unrelated or separable responsibilities. These are directed toward the same objective – ensuring that an adequate standard of care is provided to residents or nursing homes in Ontario. The

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132 *Ibid.* at para 31-32.

133 *Royal Crest Lifecare Group Inc. (Trustee of) v. Ontario (Minister of Health & Long Term Care)* (July 18, 2008), 08-CL-7406 (Ont. Sup. Ct. J.), affirmed 2009 ONCA 397 (Ont. C.A.) [*Royal Crest*].

134 *Ontario Nursing Homes Act*, R.S.O. 1990, c. N.7.

funding is made available by the MOH to the regulated operators of nursing homes by way of a subsidy, provided they comply with the statutory requirements of the NHA. The funding is provided directly by the MOH if a nursing home operator fails to comply with these statutory standards and it becomes necessary for the MOH to assume control of a nursing home.<sup>135</sup>

Accordingly, while the Court had regard for cross-claims, it also examined the relationship between the parties. The Ontario Court of Appeal, in affirming the lower court decision, held that this approach was correct, stating that “the closeness of the cross-obligations can only be assessed in the context of the relationship between the parties.”<sup>136</sup> This also affirmed the conclusions of the Alberta Court of Queen’s Bench in *Re Canadian Airlines Corp.*,<sup>137</sup> which held that refunds owed to a taxpayer could be set off against tax liabilities, even though the tax liabilities arose under two different statutes and were administered by different departments.<sup>138</sup> In this case there was no mutuality as a result of the assignment in bankruptcy. In light of these two decisions, it would appear that a provincial government agency may, on equitable grounds, set off a debt owed to a party against a debt owed by that party to a government department, whether it is the same government department or not. The same likely applies to the federal Crown. This is not to say that equitable set-off will be automatic; an examination of the cross-claims and the manifest injustice will still be required.

The five cases discussed above have assisted in developing the close-connection test and the understanding of the criteria required to meet that test. Where there is no mutuality – at the time of the set-off, or in the history of the relationships between the parties – it will be more difficult to meet the test for equitable set-off, and in particular the close-connection component. This may well be because equitable set-off was an equitable tool created in part to deal with assignment of debts, and not the multiparty fact scenarios recently considered by the courts. It must be noted that this trend runs counter to the widely cited proposition that equitable set-off has no requirement of mutuality.<sup>139</sup> Even where there is a close relationship – be it a corporate family, or one created by marriage – the Court will respect the legal distinctions between separate legal individuals to prevent one party being liable for the actions of another. This latter equitable principle has prevailed. The exception, as set out in the test for equitable set-off, is where the party seeking to rely on the set-off can establish that it would be manifestly unjust not to allow the equitable set-off. In the scenarios reviewed where no mutuality exists, the jurisprudence has provided

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135 *Royal Crest* (Ont. Sup. Ct. J.), *supra*, note 133 at para. 18.

136 *Royal Crest* (C.A.), *ibid.* at para. 6.

137 *Re Canadian*, *supra*, note 92.

138 *Ibid.* at para. 39.

139 *Telford*, *supra*, note 63 at para. 27.

no examples of such manifest injustice. It remains to be seen, for example, under what circumstances a corporation will be held liable for its affiliates debts on the ground of equitable set-off.

In contrast, where only two parties are involved in a potential set-off, it may well be easier to meet the test for equitable set-off. In such cases, the court will examine the relationship between the parties, as well as the connectedness of the transactions.

#### **IV. CONCLUSION**

While the legal principles on which set-off is based are well established, the courts are faced with new challenges in applying these principles to modern day commercial transactions. The recent years have witnessed a substantive enrichment in the law of set-off, in particular in the *CCAA* context. This paper has provided an overview of recent jurisprudence in the law of set-off in Canada, cases which have assisted in building up “a series of precedents to guide those who come after us” in the context of contractual, legal and equitable set-off. In addition, we hope it has anticipated future challenges, and possible frameworks in which they may be resolved.