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• FEDERAL COURT OF APPEAL HOLDS THAT GST/HST DEEMED TRUST HAS PRIORITY OVER SECURED CREDITOR DESPITE BANKRUPTCY OF DEBTOR •

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A recent decision of the Federal Court of Appeal ("FCA"), *Her Majesty the Queen v. Callidus Capital Corporation*, [2017] F.C.J. No. 767, 2017 FCA 162 ("*Callidus*"), serves as a warning to secured creditors asserting self-help remedies in the enforcement of their security that they may be held personally liable for GST/HST amounts that the debtor owes. The FCA held that the Crown has a direct cause of action against secured creditors who enforce their security in the face of GST/HST amounts owing. Such cause of action survives any subsequent bankruptcy of the debtor.

Pursuant to the *Excise Tax Act*, RSC 1985, c E-15 ("ETA"), amounts a tax debtor collects in respect of GST/HST and doesn't remit to the Canada Revenue Agency ("CRA") are subject to a deemed trust in favour of the Crown, which has priority over the interests of secured creditors. However, before the *Callidus* decision it was not clear that, (a) the priority of the deemed trust in favour of the Crown over proceeds of the debtor's assets paid to secured creditors continues to exist notwithstanding the subsequent bankruptcy of the debtor, and (b) the CRA can enforce its rights under the deemed trust by way of a separate cause of action against a secured creditor receiving the funds.

FACTS

The debtor, Cheese Factory Road Holdings Inc. ("Cheese Factory"), was indebted to Callidus Capital Corporation ("Callidus") and Callidus held security from Cheese Factory in respect of such indebtedness. Pursuant to a Forbearance Agreement, dated December 2, 2011, Cheese Factory agreed to market certain of its property for sale and established a blocked account for the benefit of Callidus into which it deposited rental earnings. On or about April 5, 2012, Cheese Factory sold the subject property and shortly thereafter Callidus received the sum of just less than $600,000. On April 2, 2012 (ie. three days earlier), by letter to Callidus, the CRA claimed an amount of $90,844.33 for unpaid GST/HST. Over a year later, on November 7, 2013, at the request of Callidus, Cheese Factory made an assignment into bankruptcy. The CRA subsequently commenced an action against Callidus seeking payment of $177,299.70 plus interest on account of GST/HST that Cheese Factory failed to remit for the period from October 1, 2010, until January 31, 2013.

THE ETA

Subsection 222(1) of the ETA imposes a deemed trust in favour of the Crown for all amounts of collected and unremitted GST/HST, which deemed trust enjoys priority over any secured creditors of the tax debtor. Subsection 222(3) provides that the deemed trust extends to all property of the tax debtor held by the debtor or a secured creditor up to the amount deemed to be held in trust and that the proceeds of such property shall be paid to the Crown in priority to all security interests.

Subsection 222(1.1) provides that Subsection (1) does not apply at or any time after the tax debtor becomes bankrupt. This is consistent with Section 67(2) of the *Bankruptcy and Insolvency Act* (Canada) ("BIA") which provides, with the exception of source deductions, deemed trusts in favour of the Crown do not operate upon bankruptcy, unless they would be considered held in trust in the absence of the applicable statutory provision. Section 86(1) of the BIA further provides that, with limited exceptions for source deductions, pension plan contributions and properly registered security interests, all claims of the Crown rank as unsecured claims upon bankruptcy.

FEDERAL COURT DECISION

The Federal Court held, at first instance, that the deemed trust mechanism under s. 222 of the ETA granted the Crown absolute priority. However, the deemed trust and accompanying priority was extinguished on bankruptcy of the debtor. The Federal

Court further determined that any liability arising under subsection (3) to disgorge proceeds is similarly extinguished upon the debtor's bankruptcy pursuant to subsection (1.1). Accordingly, there was no obligation on Callidus to pay the GST/HST amounts to the CRA. From an insolvency practitioner's perspective, the lower court's decision is the expected result. However, the FCA disagreed and allowed the Crown's appeal.

FCA DECISION

The legal issue before the Court was as follows:'

Does the bankruptcy of a tax debtor and subsection 222(1.1) of the ETA render the deemed trust under section 222 of the ETA ineffective as against a secured creditor who received, prior to the bankruptcy, proceeds from the assets of the tax debtor that were deemed to be held in trust?

Relying on the provisions of subsection 222 of the ETA, the FCA held that the question should be answered in the negative. In this respect, the FCA noted that the issue before it concerned the Crown's recovery mechanisms for dispositions that occurred prior to bankruptcy. The timing of the disposition was viewed as key to the analysis.

The Court noted that subsection 222(3) of the ETA obligates secured creditors to pay proceeds from trust assets to the Crown. Citing a previous decision of the FCA, *Canada (Attorney General) v. National Bank of Canada*, 2004 FCA 92, which considered the deemed trust provisions for source deductions in the *Income Tax Act* (Canada), the Court in *Callidus* held that:

(a) the Crown has absolute priority over proceeds from property subject to the deemed trust;

(b) a secured creditor who does not comply with its obligation to remit deemed trust amounts is personally liable to the Crown; and

(c) the Crown has a separate cause of action against secured creditors who do not comply with their obligations to remit deemed trust amounts.

The Court went on to hold that although subsection 222(1.1) releases the tax debtor's assets from the deemed trust upon bankruptcy, the provision does not extinguish the pre-existing

personal liability of a secured creditor who received proceeds from the deemed trust as that cause of action exists independent from, and irrespective of, any subsequent bankruptcy of the debtor. The evaporation of the trust upon bankruptcy does not, the Court held, work retroactively so at to extinguish liability arising before bankruptcy. Proceeds paid out of priority, in contradiction to the express wording of s. 222(3), creates an obligation on the creditor receiving such proceeds independent of the existence of the deemed trust. To hold otherwise, the FCA noted, would effectively neutralize the deemed trust mechanism with respect to GST/HST amounts.

The FCA also reviewed the garnishment provisions in the ETA noting that such provisions use the same language regarding paramountcy over all statutes except the BIA. Where a requirement to pay ("RTP") is served pre-bankruptcy, the subsequent bankruptcy does not extinguish the liability of a third party who fails to comply with the RTP. The Court held that an inconsistency would arise if the Crown could prevent funds from entering the debtor's estate by way of an RTP, but it could not recover amounts removed from the deemed trust out of priority. With respect, the garnishment provisions of the ETA and the issuance of a RTP is fundamentally different than the deemed trust provisions as the former operates to, in effect, transfer ownership over the amounts otherwise owing to the tax debtor on the garnishee's receipt of the RTP. Although the FCA in *Callidus* does note this difference between the two collection mechanisms it was not viewed as sufficient grounds to distinguish the two.

The balance of the majority decision centered on the FCA's concern that to allow the interpretation Callidus urged, that upon bankruptcy subsection (1.1) operates to extinguish the deemed trust and concurrently the personal liability of a secured creditor who received funds, would allow a secured creditor to manipulate both pre- and post-bankruptcy priority. The secured creditor could trigger, at any time, the bankruptcy of the tax debtor and avoid all consequences of the deemed trust priority. This would, in the Court's view, create a perverse incentive on the part of secured creditors not to abide by the deemed trust.

DISSENT

Pelletier J.A. wrote a dissenting judgment. He found that the trust created by subsection 222(3) of the ETA lapsed upon the bankruptcy of Cheese Factory as a result of subsection 222(1.1). Pelletier J.A. held that the extinction of the deemed trust upon

bankruptcy, by operation of subsection (1.1), puts an end to the deemed trust under subsection (3) and the attendant liability of the secured creditor. He addressed the concern that his reasoning incentivized secured creditors to avoid paying deemed trust amounts in the hope that the deemed trust will later be extinguished by noting that the Crown has other collection tools available to it and in this case CRA appeared to take no steps to enforce its April 2012 demand until November 2013.

DISCUSSION

A. LIABILITY OF SECURED CREDITORS

The *Callidus* decision states that secured creditors who accept proceeds from the realization of the debtor's assets, outside of bankruptcy proceedings, in the face of GST/HST amounts owing to the Crown, will be personally liable for the payment of those amounts, irrespective of whether the debtor is subsequently bankrupt. Upon bankruptcy, the Crown's deemed trust is extinguished. However, pursuant to this decision, it is only extinguished with respect to those assets that are assets of the debtor as of the date of bankruptcy. It continues to exist and attach to all proceeds from sales of the debtor's assets pre-bankruptcy where such proceeds have been distributed.

Any secured creditors seeking to enforce their security interest must be very careful to confirm whether any amounts are owing by the debtor in respect of GST/HST. If the CRA has made demand on the secured creditor for these funds, the secured creditor has an obligation to disgorge any proceeds received from pre-bankruptcy realizations of the debtor's assets up to the amount of the deemed trust. Failure to do so may result in the CRA seeking repayment of those amounts directly from the secured creditor by way of a personal cause of action. It is common practice for secured lenders to reserve for GST/HST and, in light of this decision, it is even more imperative that they do so.

B. INTENTIONAL REVERSAL OF PRIORITIES

From an insolvency practitioner's perspective, initiating bankruptcy proceedings in order to reverse statutory priorities upon bankruptcy, including in respect of the Crown, is a common occurrence that the Courts have acknowledged is legitimate (see *The Bank of Nova Scotia v. Huronia Precision Plastics Inc. and Re Ivaco*, [2006] 83 O.R. (3d) 108 (OCA)). Secured creditors routinely seek to bankrupt debtors if significant amounts of GST/HST are

owed. It is not clear what effect, if any, the comments of the majority of the FCA in *Callidus*, and the concerns raised with respect to the manipulation of pre- and post-bankruptcy priorities, will have on this common practice.

C. FORBEARANCE AGREEMENTS AND OUT-OF-COURT WORKOUTS

Any impact of the *Callidus* decision on the use of forbearance agreements, self-help enforcement remedies and out-of-court workouts is unclear. Lenders regularly employ forbearance agreements to provide debtors with time to pay down their debts and otherwise exit from the lending relationship on mutually agreeable terms. A common condition of a lender's forbearance is a refinancing, equity injection or sale of assets with the proceeds payable to the secured creditor to pay down the total indebtedness.

From a policy perspective, arrangements entered into directly with secured creditors and debtors for the repayment of amounts owing are preferable for all parties as they avoid the time and expense of a court-supervised proceeding. Our legal system strongly encourages parties to negotiate a settlement, if possible. Secured creditors have at their disposal many self-help enforcement mechanisms, including sales and foreclosures pursuant to the *Personal Property Security Act*, RSO 1990, c. P.10 and the appointment of private receivers. If secured creditors face potentially significant liability for unpaid GST/HST amounts, it may be prudent to skip such arrangements altogether and apply to the court for the appointment of a receiver and/or immediate bankruptcy. Often in insolvency situations the debtor's books and records are incomplete and reporting to the secured creditor inaccurate such that amounts owing in respect of GST/HST may be unknown.

In light of the *Callidus* decision, it may be prudent for lenders to avoid the potential risk of being held liable for outstanding GST/HST amounts and, instead of negotiating an out-of-court arrangement for repayment, go straight to court-supervised remedies. This runs counter to the policies of our legal system which emphasize settlement and out-of-court arrangements as preferable to costly formal court proceedings. Whether the *Callidus* decision will deter lenders from employing self-help enforcement remedies and informal workouts is uncertain.

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