Financial Services Flash

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# Pre-Bankruptcy Payment to Secured Creditor Escapes Statutory Deemed Trust

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Secured creditors should take note of *Callidus*,[1] wherein the Federal Court (the "**Court**") held that the bankruptcy of a tax debtor rendered a statutory deemed trust under section 222 of the *Excise Tax Act* (the "**ETA**") ineffective as against a secured creditor who, prior to the bankruptcy, received proceeds from the tax debtor's assets.

## Background

In 2004, Cheese Factory Road Holdings Inc. (the "**Tax Debtor**") obtained a credit facility in the amount of $1,950,000 (the "**Credit Facility**") from Bank of Montreal (the "**Bank**") and granted the Bank certain security in respect thereof (the "**Security**").

By 2011, the Tax Debtor was in default under the Credit Facility. Pursuant to an assignment of debt and security agreement with Callidus Capital Corp. (the "**Secured Creditor**"), the Bank assigned all the Security and the indebtedness owing under the Credit Facility to the Secured Creditor. The Tax Debtor and the Secured Creditor then entered into a forbearance agreement, pursuant to which, amongst other things, the Secured Creditor received funds from the Tax Debtor's sale of, and rents collected from, certain real property.

In April 2012, Canada Revenue Agency ("**CRA**") wrote to the Secured Creditor, claiming amounts collected but unremitted by the Tax Debtor for GST/HST based on the deemed trust mechanism of the ETA (the "**April 2012 Letter**"). The amounts in question went back to as early as 2010. Subsequent to receipt of the April 2012 Letter, the Tax Debtor assigned itself into bankruptcy at the Secured Creditor's request. CRA then commenced an action against the Secured Creditor for the unremitted amounts.

## CRA's Position

CRA contended that it was entitled to a deemed trust over all the Tax Debtor's assets in priority to the Secured Creditor's claims pursuant to subsections 222(1) and 222(3) of the ETA, and that all proceeds received by the Secured Creditor from the Tax Debtor up to the amount secured by the deemed trust ought to be paid to CRA. Moreover, CRA argued that the Secured Creditor became personally and independently liable when it failed to comply with its obligation to remit proceeds received from the sale of assets that were subject to the deemed trust.

CRA submitted that, although subsection 222(1.1) of the ETA released all assets from the deemed trust that were owned by the Tax Debtor at the time of its bankruptcy, this subsection did not alter the personal liability of the Secured Creditor, created by subsection 222(3) of the ETA, who received proceeds pre-bankruptcy from the sale of what were then deemed trust assets. In other words, the Secured Creditor's liability purportedly crystalized before the bankruptcy and had a "*life of its own*"[2] such that the eventual bankruptcy was irrelevant.

## The Secured Creditor's Position

The Secured Creditor argued that the deemed trust ceased to apply once the Tax Debtor became bankrupt, such that CRA's claim ranked as an ordinary unsecured claim behind the Secured Creditor.

[1] *Canada v. Callidus Capital Corp.*, 2015 FC 977, 28 C.B.R. (6th) 209 [*Callidus*].
[2] *Ibid* at para. 16.

The Secured Creditor also put forward a public policy argument, suggesting that if CRA were permitted to recover amounts paid to the Secured Creditor notwithstanding the Tax Debtor's subsequent bankruptcy, creditors would attempt to place debtors into bankruptcy immediately (rather than attempt to enter into forbearance agreements or reach other out-of-court solutions), which would aggravate the social and economic losses of insolvency.

## Outcome

The Court agreed with the Secured Creditor, holding that the ETA became ineffective against the Secured Creditor upon the Tax Debtor's bankruptcy for collected but unremitted GST/HST.

Relying on the seminal case of *Century Services*[3] (which dealt with source deductions and the service of a Requirement to Pay or garnishment), the Court noted that, where Parliament has wanted deemed trusts to remain effective upon insolvency or bankruptcy, it has explicitly done so. The Court was unable to find any such language in section 222 of the ETA or in the *Bankruptcy and Insolvency Act* (the "**BIA**").

Further, the Court noted that subsection 222(1.1) of the ETA provides that any existing deemed trust pursuant to subsection 222(1) is extinguished upon bankruptcy. Read in conjunction with subsections 67(2) and 67(3) of the BIA, Parliament has made it clear that the deemed trust does not exist following bankruptcy unless the amounts deducted are considered source deductions.

Responding to the argument that the Secured Creditor's liability somehow crystalized before the bankruptcy, the Court noted that CRA had not identified any crystalizing moment that immunized the deemed trust from the reversal of priorities upon bankruptcy. The Court noted that, had the Secured Creditor received a Requirement to Pay or a notice of garnishment prior to the bankruptcy, it would have created the obligation for the Secured Creditor to pay the unremitted GST/HST despite the Tax Debtor assigning itself into bankruptcy. However, the April 2012 Letter fell short of this notice threshold.

Ironically, the public policy warning put forward by the Secured Creditor may nonetheless bear fruit: to avoid potential tax liability, a secured creditor that has received payment from a debtor with unremitted GST/HST liabilities should consider having the debtor assigned into bankruptcy before CRA issues a Requirement to Pay or notice of garnishment.

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[3] *Century Services Inc. v. Canada (Attorney General),* 2010 SCC 60, [2010] 3 S.C.R. 379, 326 D.L.R. (4th) 577.