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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"), *Canada 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*, R.S.C. 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

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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 (*i.e.*, 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 section 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 (Minister of National Revenue — M.N.R.) v. National Bank of Canada*, [2004] F.C.J. No. 371, 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 section 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

Justice Pelletier 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). Justice Pelletier 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 *Ivaco Inc. (Re)*, [2006] O.J. No. 4152, 83 O.R. (3d) 108 (C.A.)). 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*, R.S.O. 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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• CLARIFICATION ON PRIORITY DISPUTES IN INSOLVENT CONSTRUCTION LIEN PROJECTS •

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Typically, land for a construction project is held a special purpose entity (a "**ProjectCo**") and beneficially owned by its principals. When multiple projects are on the go with one developer, construction lenders commonly extend credit to one ProjectCo, and, as part of the security package for that loan, take a guarantee from a related ProjectCo ("**GuaranteeCo**") supported by a collateral mortgage against the lands held by such GuaranteeCo.

When it all "hits the fan" for a construction project, the relative priorities of construction lien claimants and mortgagees are addressed under section 78 of the *Construction Lien Act* ("**CLA**").[1] Generally,

- Construction liens have priority over a "building mortgage" and a "subsequent mortgage" for the statutory holdback [s. 78(2)].
- A mortgage registered against the subject land before "the first lien arose" has priority over construction liens to the extent of the lesser of (i) the actual value of the land at the time the first lien arose, and (ii) the total of the advances made prior to the first lien arising [s. 78(3)].

- With respect to a "subsequent mortgage"[2] construction liens have priority over a subsequent mortgage for the statutory holdback.
- Subject to the lien claimant's priority for the holdback, "advances" made "in respect of" a subsequent mortgage have priority over construction liens, so long as the advance was not made (i) "in the face" of a registered construction lien or (ii) after the mortgagee had received a written notice of lien [s. 78(6)].

In *Jade-Kennedy Development Corporation (Re)* ("***Jade Kennedy***")[3], a priority dispute arose between the construction lien claimants and mortgagees on three issues:

(i) Does a construction lender have an obligation to do due diligence prior to making an advance?
(ii) Do amounts owed to a mortgagee for professional fees have priority over construction liens? And,
(iii) Does a collateral mortgage securing a guarantee have priority over the lien claims registered against GuaranteeCo?

FACTS

Jade Kennedy Development Corporation ("**JKDC**") was a single-purpose entity that held title of lands in Markham, ON, for developing a mixed-use condominium project (the "**Project**"). JKDC was one entity within a broader corporate group — known as the Mady Group — that included multiple projects (and ProjectCos) throughout Ontario, including another project in Waterloo, ON known as "144 Park" (the "**144 Park Project**"). Laurentian Bank of Canada (the "**Bank**") was the senior construction lender in both the Project and the 144 Park Project. As security for JKDC's obligations to the Bank, JKDC granted a first mortgage in the principal amount of $45-million in favour of the Bank (the "**Bank Mortgage**").

In addition, JKDC granted to the Bank a collateral mortgage for $3.6 million to secure a guarantee given by JKDC to the Bank for an advance of $3.6 million made by the Bank to the 144 Park ProjectCo (the "**Collateral Mortgage**"). The Bank subsequently assigned the Collateral Mortgage to Marshall Zehr Group Inc ("**MZ**").[4]

On February 11, 2015, Collins Barrow Toronto Limited (the "**Trustee**") was appointed as Trustee pursuant to the CLA (the "**Proceeding**"). Within the Proceeding, the Trustee obtained an order establishing a summary procedure to determine the relative priority of the construction lien claimants and the mortgagees. At the time of the Trustee's appointment, the Bank had been repaid all amounts owing under the Bank Mortgage, except for professional fees incurred during the Proceeding.[5]

The construction lien claimants argued the liens had priority over Bank Mortgage in two ways. First, the liens had priority over the Bank Mortgage because the Bank failed to conduct due diligence when making advances, and, had the Bank done so, it would have determined that trades were not being paid. Second, the liens had priority over the Bank's outstanding professional fees because such fees were not technically "advanced" to JKDC. The lien claimants also argued the liens had priority over the Collateral Mortgage because no advance was made "in respect of" the Collateral Mortgage.

THE DECISION

Due Diligence

The Court held that section 78(6) does not impose an obligation on the mortgagee to conduct due diligence before an advance and there is no basis for implying a further condition in the statute.[6]

Priority of Professional Fees[7]

After reviewing the relevant case law, the Court held that professional fees incurred by the Bank and secured by the Bank Mortgage had priority over the construction liens pursuant to section 78(6) of the CLA. The Court held that an "advance" is not limited to the principal amount advanced under a mortgage; it includes all amounts a mortgagor is contractually obliged to pay in respect of any such principal amount advanced, including enforcement costs.

Collateral Mortgage

The Court held that the construction liens had priority over the Collateral Mortgage. The Court held that, absent special circumstances, " … an advance made under a loan agreement between a lender and a borrower is not "an advance in respect of"[8] a collateral mortgage given to secure the obligations of a guarantor under a guarantee of the borrower's obligation under the loan agreement". First, an advance to a borrower under a mortgage loan supported by a guarantee secured by a collateral charge is not an advance made "in respect of" the guarantee or collateral charge; rather, the advance is made to the borrower, not the guarantor, even if the advance also increases the amount owing under the guarantee. Second, because case law establishes that a collateral mortgage cannot secure (and have priority over lien claims) past advances, it would be impractical and unreasonable to establish a principle that requires advances to be separated based on whether such an advance was made before or after the registration of the collateral mortgage. Third, the Court held that this treatment of advances is inconsistent with the concept of the guarantor's obligations under a guarantee, which typically guarantee the borrower's obligations under a loan, rather than specific advances.

Lastly, the Court did not accept that there were special circumstances in this case that would elevate the priority of the Collateral Mortgage ahead of the construction liens.[9] The Court held that MZ's counsel's submission that the advance to the 144 Park Project would not have been made but for the provision of the guarantee of JKDC secured by the Collateral Mortgage was insufficient to establish "special circumstances" because it remained the case that the advance was made to the 144 Park Project under the loan agreement between those two parties. Additionally, the Court held it was neither possible nor intended to segregate the $3.6 million advance to the ProjectCo for the 144 Park Project from all other advances made to that party. As support, the Court reviewed the terms of the Collateral Mortgage, which provided that it secured JKDC's obligations as guarantor to pay all amounts owing pursuant to its guarantee to a maximum amount of $3.6 million, and did not purport to only secure the particular $3.6 million advance.

ANALYSIS

This case provides needed clarity and certainty on (i) a construction lender's due diligence obligations when making advances to a ProjectCo; and (ii) whether professional fees incurred in the enforcement of a construction lender's mortgage have priority over construction liens. It is clear from this case that a construction lender need only satisfy the requirements of section 78(6) to obtain the priority entitled to mortgagees. Section 76(6) is satisfied provided no construction lien is registered at the time of the advance, and by ensuring no written notice of lien was received prior to making an advance.

More importantly, this case creates uncertainty for construction lenders about the priority (vis-à-vis construction liens) of a guarantee obtained from a GuaranteeCo that is secured by a collateral mortgage as security for advances made to a borrower under a loan. This situation commonly arises when financing development companies with multiple projects on the go.

In *Jade Kennedy*, the Collateral Mortgage was a subsequent mortgage. In the author's view, this uncertainty created from the holding in *Jade Kennedy* is present regardless of whether the collateral mortgage is a "subsequent mortgage" (where priority is governed by section 78(6)) or a "prior mortgage" (where priority is governed by section 78(3)) under the CLA. Section 78(3) caps the priority of a mortgagee to the lesser of the actual value of the premises at the time when the first lien arose, and the total of all amounts that, prior to that time, were "… advanced in the case of a mortgage … ".

With respect to a mortgage securing a guarantee of obligations of one ProjectCo to another ProjectCo, a few questions arise. What are the applicable "premises" when determining the "actual value" of the premises at the time the first lien arose, is it the borrower's land, or the GuaranteeCo's land? What is the total amount " … advanced in the case of a mortgage … " if the advances are made to a borrower under a loan agreement and not to the guarantor? If the collateral mortgage from a GuaranteeCo was the only security obtained from a borrower for a loan, then would the advance to the borrower constitute an "advance in the case of a mortgage"?

Notably, the language in s. 78(3) ("advance in the case of a mortgage") is different than s.78(6) ("advance … in respect of that mortgage"); however, in the author's view, this distinction does not give construction lenders additional comfort that a collateral mortgage from a guarantor that that would be classified as a "prior mortgage" would enjoy greater priority over construction lien claims than a collateral mortgage that is classified as a "subsequent mortgage".

Jade Kennedy has not yet been considered further by the courts. It remains to be seen what will constitute "special circumstances". In the author's interpretation of *Jade Kennedy*, it appears "special circumstances" will depend on the specific facts of the case but will ultimately turn on the specific language of the guarantee and collateral mortgage.

Construction lenders should take note of *Jade Kennedy* when considering with their counsel whether a guarantee from a GuaranteeCo is adequate security for a loan to a development company with multiple projects on the go. Construction lenders should also review their current loans outstanding and consider whether they are adequately secured with respect such loans in which a guarantee from a GuaranteeCo was secured by a collateral charge over development land. Otherwise, lenders may find themselves "holding the bag".

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1 *Construction Lien Act*, R.S.O. 1990, c. C.30.

2 A mortgage registered against the premises after the first lien arose (s. 78(5)).

3 *Jade-Kennedy Development Corp. (Re)*, [2016] O.J. No. 6238, 2016 ONSC 7125. The author acted for Laurentian Bank of Canada in this case.

4 *Ibid* at para. 26.

5 *Ibid* at paras. 4–8.

6 *Ibid* at para. 32–35.

7 *Ibid* at para. 63–66.

8 *Ibid* at para. 61 and 67.

9 *Ibid* at para. 68.