NORTON ROSE FULBRIGHT

Legal update

Common sense prevails: secured creditors not liable under GST/HST deemed trust post-bankruptcy

November 2018
Bankruptcy, financial restructuring and insolvency

On November 8, the Supreme Court of Canada delivered a final ruling on an issue raised by s. 222 of the *Excise Tax Act* (the *ETA*): whether the Crown has a personal right of action under the *ETA's* deemed trust provisions against the secured creditor of a tax debtor who receives payments from that tax debtor prior to a subsequent bankruptcy.

After a protracted dispute in the courts below, and conflicting Federal Court and Federal Court of Appeal rulings on the issue, the Supreme Court decided that no such right of action exists. This issue has potentially wide-ranging implications for secured creditors of tax debtors who are either insolvent, or nearly so.

Relevant statutory provisions

Section 222 of the *ETA* creates a deemed trust for collected but unremitted GST and HST, and provides that such a deemed trust extends to "property held by any secured creditor that, but for a security interest, would be property of" the debtor. However, the *ETA* also expressly provides that this deemed trust does not apply at or after the time a tax debtor becomes bankrupt.

The extinguishment of the *ETA* deemed trust upon bankruptcy is consistent with s. 67(2) of the *Bankruptcy and Insolvency Act*, which provides that with the exception of trusts valid at common law and deemed trusts created under ss. 227(4) or (4.1) of the *Income Tax Act* (relating to source deductions), statutory deemed trusts do not survive bankruptcy.

Canada v Callidus Capital Corporation[1]

Canada v Callidus Capital Corporation involved a forbearance and "soft restructuring" agreement between Callidus Capital Corporation and Cheese Factory Road Holdings Inc. Callidus and Cheese Factory entered into forbearance terms in 2011, which included the granting of additional security and an agreement to deposit certain receipts from operations into a blocked account that was periodically swept by Callidus and applied to Cheese Factory's outstanding debt.

After that, Cheese Factory (at Callidus' request) made a voluntary assignment into bankruptcy.

CRA commenced an action, asserting a personal right of action against Callidus for receipt of funds impressed with a deemed trust. Callidus took the position that Cheese Factory's bankruptcy had extinguished the deemed trust, and with it any personal right of action by the Crown against Cheese Factory's secured creditor. At trial, the Federal Court sided with Callidus.

The majority of the Court of Appeal, in a split decision, sided with the Crown on the basis that an obligation to remit proceeds or property impressed with the deemed trust arose at the time the funds were received, and thus survived the tax debtor's bankruptcy. Pelletier J.A. delivered a strongly worded dissent, in which he held that any liability of a secured creditor for receipt of trust funds depended on the continued existence of the trust, and pointed out that ss. 67(2) and (3) of the *BIA* provide that a deemed trust in respect of unpaid source deductions survives a tax debtor's bankruptcy, and (by implication) a deemed trust for unremitted GST and HST does not.

On November 8th, in reasons delivered orally from the bench, the Supreme Court of Canada unanimously adopted the dissenting reasons of Pelletier J.A., and with that finally determined the issue of whether the Crown's personal right of action against a secured creditor of a tax debtor is extinguished by the tax debtor's subsequent bankruptcy. The Supreme Court expressly did not rule on the scope or enforceability of the s. 222 deemed trust *pre*-bankruptcy.

Implications

The Federal Court of Appeal decision created significant uncertainty and concern for secured lenders who wished to work with distressed debtors outside of bankruptcy through forbearance agreements or similar "soft restructuring" tools. In effect, the Court of Appeal would have required a tax debtor's unpaid GST and HST amounts to be guaranteed by its secured creditors, despite the practical reality that the actual amounts of those arrears can be difficult to determine even by CRA, often requiring an audit.

Moreover, the Court of Appeal's ruling would have created a strong disincentive for a secured creditor to work with a distressed borrower outside of bankruptcy to resolve its balance sheet issues. An asset-based lender or other secured creditor would have been well advised to adopt the practice of petitioning all insolvent debtors into bankruptcy prior to accepting any proceeds from receipts or the sale of assets, absent certainty that nothing is owing to CRA in respect of unremitted GST or HST.

The Supreme Court's ruling will thus come as welcome news to secured lenders in Canada, who may rest assured that (post-bankruptcy at least) they will not be expected to make CRA whole for unremitted GST or HST obligations of borrowers.

The issue of the enforceability of the ETA deemed trust outside of bankruptcy has been left to be decided another day.

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Footnote

1 *Canada v. Callidus Capital Corporation*, 2015 FC 977 (rev'd) 2017 FCA 162, Pelletier J.A. dissenting.

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