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Are Forbearance Agreements on the Endangered Species List: The Effect of Canada v. Callidus Capital on Lenders' Dealings with Insolvent Borrowers

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"And oftentimes excusing of a fault doth make the fault the worse by the excuse…"

- William Shakespeare, The Life and Death of King John

Introduction

The recent Canadian Federal Court of Appeal case of *Her Majesty the Queen v. Callidus Capital* (2017)FCA 162 may signal the end of an important assumption made by many, if not most, Canadian special loans bankers andinsolvency practitioners regarding the treatment of collected but unremitted Harmonized Sales Tax ("HST") in a bankruptcy. This case has serious implications for any lender where there is a risk that the borrower has not collected or remitted HST as required.

Before getting into the facts of the case, some context is required.Specifically, the legislative landscape is complicated and can be difficult to understand. The sheer density and verbosity of the relevant provisions of the *Excise Tax Act* R.S.C. 1986, c. E-15 (the"ETA"), and the awkward interplay of those sections with the federal *Bankruptcy and Insolvency Act* R.S.C. 1985, c. B-3 (the "BIA") may be one of the reasons why lenders have made assumptions that, while logical on their face, are susceptible to subsequent interpretation by the Courts. The *Callidus* case is an example of such a situation.

What is a "Deemed Trust"?

The federal *Excise Tax Act* provides that anyone who collects HST from third parties is deemed to hold those funds in trust for Her Majesty (the "Subsection (1) Trust"), separate and apart from the debtor's other property. The Act goes on to extend this "deemed trust" to all property of the party that collects the tax from customers. In other words, it's not only the money itself collected on account of HST that is held in trust, but at any time that HST has been collected and not remitted, all property of the debtor is subject to a trust (the "Subsection(3) Trust"), to the extent of the unremitted HST, in favour of Her Majesty.

"Deemed Trust" in this context means a trust that arises by operation of law that otherwise would not necessarily meet the test for an express or resulting trust at common law. Typically,deemed trusts are

employed where legislation requires a private actor to collect from third parties taxes that are destined for Her Majesty.Deemed trusts can arise pursuant to federal legislation (HST collected from customers and deductions from employee paycheques for withholding taxes are “deemed” by the law to be held in trust for Her Majesty).

The upshot of the legislative framework is that unremitted HST constitutes a “super priority” obligation, taking priority over virtually all other claims, securedor otherwise, against the property of the debtor. In addition, the Crown can bring legal proceedings against any creditor, including a secured creditor, who receives payments while the HST remains outstanding, to essentially claw back the payments made to that creditor. Clearly, parliament has made it abundantly clear that using monies collected from customers on account of HST to pay one’s own creditors is a serious matter, and the legislative scheme aims at preventing such a result.

Why Does the Law Make an Exception When the Borrower Becomes Bankrupt?

The situation changes if the debtor becomes bankrupt. Thefederal *Excise Tax Act*, (the statute that governs HST in Canada) provides that the deemed trust is not operative in a bankruptcy.This exception in the event of a bankruptcy is consistent witha general principle of Canadian insolvency law, namely, in bankruptcy, the Crown ranks as an unsecured creditor, as reflected in s. 86(1) of the BIA A notable exception to this general rule arises when the Crown is entitled by legislation to a security interest in the assets of the debtor and the Crown has registered that security in the appropriateland or personal property security registry. The Crown’s security interest, like any other security interest, ranks from the date of registration. This system affords predictability and allows lenders to assess their position based on a review of the public record.

How Does this Affect Secured Creditors?

The problem in *Callidus* was this: even if the federal Crown cannot claim a deemed trust interest against the property of the bankrupt debtor itself, can it still advance a claim, notwithstanding the bankruptcy, against creditors of that debtor who received payments from the debtor prior to the date of bankruptcy? It had widely been assumed that once the tax debtor becomes bankrupt, the deemed trust disappears entirely. As result, payments received by a secured creditor can not be the subject of a claim by Canada Revenue Agency (“CRA”).*Callidus* calls this assumption into question. To summarize, the majority of the Federal Court ofAppeal held that, notwithstanding the bankruptcy of the debtor, the Crown still maintains the right to bring an action against secured creditors of the bankrupt who received payments prior to the date of bankruptcy. The Court relied on the fact that the provisions of the ETA that render the deemed trust for HST arrears to be inoperativein a bankruptcy do not specifically also say that the Crown’s cause of action against creditors, secured and otherwise, who receivedpre-bankruptcy payments from the debtor while the HST wasoutstanding, is also inoperative. The majority held that it was open to Parliament to phrase the legislation in such a way that both the deemed trust against the property of the bankrupt *and* the crown’s right of action against third-party creditors of the bankrupt disappeared ina bankruptcy. Parliament chose not to do so and thereby made clear its intention that the cause of action against creditors of thebankrupt would survive bankruptcy, notwithstanding the fact that the deemed trust against the assets of the bankrupt itself is inoperative.

Who should be Concerned by this Case and Why?

This decision may not sit well with lenders. Typically, a lender simply doesn’t know, and has noconvenient way of ascertaining, that the borrower has stopped making HST remittances, or has not remittedthe correct amount. Any lender who receives payments of any sort from a commercial borrower may be at risk. For example, regular deposits made in the ordinary course of business into an overdraft facility operating account that reduce the overall loan balance may subject a lender to exposure to CRA.

For most lenders the immediate effect of this decision may in the way they approach forbearance agreements. The past several years have seen a shift in the approach of Canadian lenders in respectof delinquent borrowers. Where receivership was once seen as the remedy of choice when default occurred, lenders today are more inclined to work with the debtor, in order to obtain more cost-effective and timely results. The relative availability of alternative sourcesof credit means that it is more common today for lenders to require a defaulting borrower to relocate its financing requirements, often under the auspices of a type of agreement referred to as a “forbearance agreement”.

Forbearance agreements, which can be quite detailed, frequently require the debtor to reduce the overall indebtedness below an agreed- upon level or to obtain refinancing of the credit facilities with a new lender by a certain date. Typical forbearance terms include requiring rental income generated by a certain property to be paid to the lender, reducing the balance of the debtor disposing of certain assets, with the proceeds utilized to reduce the overall indebtedness.

Many lenders are, or were, comfortable with the conceptual difficulty associated with receiving payments from a distressed borrower based on the assumption that a subsequent bankruptcy would render the entire deemed trust inoperative. If trouble arose with respect to unremitted HST, the lender could avoid liability by the simple expedient of securing the bankruptcy of the borrower. It did not matter when the bankruptcy occurred, as long as, at some point, the debtor became bankrupt.

As a result of the holding of the majority of the Court in *Callidus*, this may no longer be the case.

The Facts of the Case

Cheese Factory Road Holdings Inc. ("Cheese Factory") is a privately-held Ontario corporation that carried on business as a real estate investment company. Cheese Factory is orwas the registered owner of two properties located in Cambridge, Ontario (the "Properties" or, individually, a "Property").

CRA claimed that between 2010 and 2013, Cheese Factory collected but failed to remit GST and HST to the Receiver General for a total amount of $177,299.70.

Pursuant to an Assignment of Debt and Security agreement dated December 2, 2011, Bank of Montreal assigned to Callidus all of its right, title and interest in and to certain direct and indirect indebtedness and obligations owed to it by Cheese Factory, along with certain security. The total debt assigned to Callidus was approximately $3.5 million.Pursuant to a Forbearance Agreement dated December 2, 2011 (the "Forbearance Agreement"), Callidus agreed to forbear from enforcing the BMO agreements, subject to the terms and conditions of the Forbearance Agreement.Pursuant to the Forbearance Agreement, Callidus also agreed to extend to Cheese Factory (and other debtors) certain demand credit facilities, which amended the credit facilities granted by BMO.

Pursuant to the terms of the Forbearance Agreement, Cheese Factory agreed to market one Property for sale and to deliver the net sales proceeds to Callidus to partially repay the amounts owed to Callidus. In April, 2012, Cheese Factory sold the Property for a purchase price of $790,000 and Callidus received the sum of$590,956.62 from the sale of the Property which was applied to partially reduce the outstanding indebtedness.

In addition, the Forbearance Agreement and a separate Blocked Accounts Agreement required Cheese Factory to open accounts (the "Blocked Accounts") at Royal Bank of Canada ("RBC") and to deposit all funds received from all sources into the Blocked Accounts. Funds deposited into the Blocked Accounts were swept from the account by Callidus and applied against the indebtedness. Allrent proceeds received from the tenant of the unsold Property were deposited into the BlockedAccounts. The sum of $780,387.62 in gross rent was eventually deposited into the Blocked Accounts.

In April , 2012, the Crown, by way of a letter to Callidus, claimed anamount of $90,844.33 on the basis of the deemed trust mechanism of the *Excise Tax Act*, R.S.C. 1985, c. E.15, as amended (the "ETA").

On or about November 7, 2013, at the request of Callidus, Cheese Factory made an assignmentin bankruptcy. The Crown then commenced a legal proceeding against Callidus in which it claimed from Callidus the total amount of$177,299.70 plus interest on the basis of the deemed trust mechanism governed by the ETA on account of GST and HST that Cheese Factory collected but failed to remit.

The Crown contended that, as a result of Cheese Factory's failures to remit GST and HST to the Receiver General, all of Cheese Factory's assets were deemed to be heldin trust in favour of the Plaintiff in priority to the claims of Callidus pursuant to section 222 of the ETA and all proceeds of Cheese Factory's property received by Callidus, up to the amount secured by the deemed trust, should have been paid tothe Receiver General of Canada as a result of the deemed trustmechanism under section 222 of the ETA.

Callidus argued that, as a result of the bankruptcy of Cheese Factory, the deemed trust disappeared, and with it, any liability on the part of Callidus in connection with pre-bankruptcy payments also disappeared.

The issue before the Court was: Does the bankruptcy of a tax debtor render the deemed trust under theETA 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?

The Majority Position

The majority of the Court, consisting of two of the three Judges of the Federal Court of Appeal hearingthe case, held that, while the ETA releases a tax debtor's assets from the deemed trust upon bankruptcy, the Act does not extinguish thepre-existing personal liability of a secured creditor who received proceeds from the deemed trust. The personal liability is fully engaged, the debt is due and

can be pursued by the Crown in a cause of action independentof any subsequent bankruptcy proceedings. The continued existence of the cause of action is not dependent on the debtor's other assets that may or may notremain in trust, as it arises because of the secured creditor's breachof a statutory obligation to remit. In the words of the Court: "To find otherwise would effectively neutralize the deemed trustmechanism with respect to GST/HST amounts."

The Court went on to observe that a subsequent bankruptcy simply operates to release the debtor's assets from the deemed trust: "the argument that the evaporationof the trust on bankruptcy works retroactively, and undoes or unwinds legal obligations that are already engaged, has no support in the text."

The Court went even further in itsjustification for its finding: "A finding that the secured creditor's obligation to pay Crown proceeds fromthe deemed trust disappears on bankruptcy would allow the secured creditor to benefit from the debtor's failure to remit…As happened here, a secured creditor could choose the timing of bankruptcy and liquidate the deemed trust assets so as to satisfy their interests at the expense of the Crown…the secured creditor could, at any time, simply triggerthe bankruptcy of the tax debtor and avoid all consequences of the deemed trust priority."

The Minority Position

Pelletier J.A., the third Judge on the panel hearing the appeal, dissented from the reasons given by the other two Judges. With respect, the dissenting opinion appears more commercially reasonable, more persuasive and more in line with the treatment of deemed trustsin bankruptcy than the majority decision.

Justice Pelletier starts with the proposition that, absent a clear indication of a contrary intention, legislation should be interpreted on the assumption that the Crown only collects amounts which it is owed and not more. In this case, the legislator dealt with this issue by defining the property subject to the deemed trust in such a way that trust property, and therefore the proceeds of trust property, is equal to the amount of the deemed trust.

How this seemingly-simplistic and somewhat circular proposition operates in the context of the facts of this case can be illustrated by anexample devised by the Court:

> Let us assume that a tax debtor has collected and failed to remit$20,000 on account of GST/HST. The tax debtor has real property which is subject to a mortgage. The mortgage lender forces the sale of the property and receives proceeds of $50,000. [the ETA] creates a deemed trust with respect to the $20,000 collected as tax but not remitted to the Receiver General. [The ETA also] creates a trust with respect to the debtor's property but only to the extent of the amounts held in trust…As a result, the mortgage lender, having received proceeds of property equal in value to the amount deemed to be held in a subsection (1) trust, i.e. $20,000, is liable to pay that amount to the Crown.
>
> Would the result be any different if, subsequent to the Crown's demand for payment of $20,000, the tax debtor made a $10,000 payment to the Receiver General on account of GST/HST collected but not remitted? The amount for which the secured creditor was liable would be different but the manner of determining the amount of that liability would be the same. The payment to the Receiver General would reduce the amount of the deemed trust to $10,000 which in turn would reduce the extent to which the debtor's property was subjectto the subsection (3) deemed trust. The secured creditor would be liable to pay the proceedsof the property subject to the subsection (3) trust, i.e. $10,000.Similarly, if the tax debtor were to pay the entire $20,000, the amount of the secured creditor's liability would be reduced to nil.
>
> The significance of the last example is that a demand for payment by the Crown does not "crystallize" the amount of the debtor's or the securedcreditor's liability to the Crown. That liability is determined by the amount deemed to be held in the subsection (1) trust which in turn determines the extent to which property of the debtor is deemed to be held pursuant to the subsection (3) trust.
>
> How is this scheme affected by the bankruptcy of the taxdebtor? After bankruptcy, there is no amount deemed to be held in trust pursuant to the ETA for amounts collected as tax but not remitted, pre-bankruptcy. The subsection (3) trust which aroseprior to bankruptcy no longer has any subject matter because the trust only attaches to propertyof the tax debtor to the extent of the subsection (1) trust which no longer exists. This is true for the tax debtor as well as for the tax debtor's secured creditors.

Pelletier J.A. saw no difference in principle between the reduction of the trust to nil by payment or by operation of law. In either case, the trust, whose operation depends upon the existence of an amount deemed to held in trust pursuant to subsection (1), is at an end. Had Parliament meant to make

thesubsection (3) trust a function of the continued existence of unremitted amounts, it could have said so easilyenough.

In addition, the *Excise Tax Act* provides for enforcement mechanisms, such as the Enhanced Requirement to Pay that allow CRA to put lenders on specific notice that the Crown is claiming a super- priority interest in the property ofthe Debtor, and that further dealings with the debtor are undertakenat the lenders' risk. In the Callidus case, although the Crown put the lender on notice of its claim by way of a letter, it did not take the step of serving an Enhanced Requirement to Pay, which would have had the definitive effect of priming the claim of the secured lender in favour of the Crown.

Analysis

The implication of this case is clear: unless and until *Callidus* is overturned by the Supreme Courtof Canada, lenders accept payments of any sort from their borrowersat their own peril. Any payments in any form received by the lender can be essentially "clawed back" byCRA. Questions such as whether the lender is on notice that the debtor is in arrears of HST remittances,or the debtor has misrepresented or deliberately concealed its true situation from the lender do not appear to be relevant for this particular analysis.

The policy considerations underlying this decision are also easy tosee. In choosing from a menu of options that will undoubtedlyleave some stakeholder aggrieved, the legislators' highest priority is preventing businesses from charging and collecting HST from customersand using those funds to pay down its loan balances.

What the majority fails to address is the question of why CRA did not serve an Enhanced Requirement toPay or avail itself of other collection tools contained in the ETA that would have had the effect of making it clear that the funds collected from customers on account of HST are the property of Her Majesty and can be traced into any party who receives that property. This observation was not lost on Justice Pelletier, who stated:

> I recognize that this results in a situation in which a secured creditor has an incentive toresist payment in the hope that the amount of the subsection(1) deemed trust will be extinguished and may even help that process along by petitioning the tax debtor intobankruptcy. I would only say that in this case, the Crown made a demand for payment in April 2012 but appears to have taken no steps to enforce its demand until November 2013. Nor does the Crown appear to have had recourse to the other collection tools available to in under the Act. I am not persuaded that the view I take of this matter puts the Crown's interests unjustifiably at risk.

The *Callidus* decision also leads to an odd, and potentially absurdresult: if a bankrupt collects and fails to remit HST, and holds those funds in its bank account on the date of bankruptcy, a secured creditor has priority over the Crown to those funds. If the same debtor pays the same funds in the same bank account to the same secured creditor on the day before it becomes bankrupt, the Crown's deemed trust interest is engaged and the Crown has priority over the secured creditor.

Finally, this case may suggest the possibility that taxation andcommercial statues in general have become too complicated, at the expense of comprehensibility. It is interesting to observe that both the majority and the minority Judges used the same logical device to support its position. Specifically, the majority argued that "if the legislator intended for the law tobe 'X', then 'X' would be specifically spelled out in the legislation. Since the legislation doesn't say 'X', then the legislator clearly meant 'y'". The minority argued the opposite: "If the legislator intended for the law to be "y", then "y" would be specifically spelled out in the legislation. Since the legislation doesn't say 'y', then the legislator clearly meant 'X' ".

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