2018 Developments in Canadian Insolvency Case Law: What Lenders Need to Know

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In 2018, several insolvency cases were litigated that will be of interest to commercial lenders in restructuring and insolvency proceedings. This article summarizes the core issues of importance to lenders in each of these cases. Status updates on the cases reported in our 2017 roundup of key developments in Canadian insolvency case law are included at the end of this article.

May 25, 2018

PRIORITY OF HST DEEMED TRUSTS

Canada v. Toronto-Dominion Bank

In this case, the Federal Court (FC) considered liability of secured creditors outside a bankruptcy when payment is received from a debtor with HST/GST liability. The FC found that the *Excise Tax Act (Canada)* (ETA) imposes an obligation on secured creditors to repay money received out of proceeds of sale subject to a deemed trust for unremitted HST/GST (i.e., federal/provincial sales tax).

In reaching its decision, the FC raised the possibility that this obligation may not extend to unsecured creditors, as the wording of the ETA gives the Canada Revenue Agency (CRA) priority over secured interests only, but chose not to decide this issue. The defence of *bona fide* purchaser for value was not available to the secured creditor because the amendments to the ETA requiring HST/GST liabilities to be paid in priority to secured creditors are based on the premise that a secured creditor cannot invoke the *bona fide* purchaser for value defence. If this defence were available, secured creditors would almost always be able to defeat the deemed trust.

The FC based its decision, in part, on the decision of the Federal Court of Appeal in *Canada v. Callidus Capital Corp.*, which the Supreme Court of Canada (SCC) overruled; however, the SCC did not comment on lender liability outside the bankruptcy context.

Status: This decision is being appealed (leave to appeal this decision is not required). No date has been set for the appeal.

Takeaway: For the time being this decision holds that absent a bankruptcy, secured creditors will be forced to return money received that was subject to an HST/GST deemed trust upon demand from the CRA.

March 16, 2018

APPROVAL OF LITIGATION FUNDING AGREEMENTS AND LENDER SPONSORED CCAA PLANS

Arrangement relatif à 9354-9186 Québec inc. (Bluberi Gaming Technologies Inc.) -and- Ernst & Young Inc.

The Québec Superior Court (QSC) considered whether to authorize the filing of a plan of arrangement by a creditor that would provide broad releases in its favour, or grant the debtor's application for litigation funding and a litigation financing charge to file a lawsuit against the same creditor. Pursuant to the terms of the litigation funding agreement (LFA) a third party would fund the debtor's legal fees and disbursements in connection with the proposed litigation, in exchange for a portion of any proceeds derived thereof. The QSC dismissed the motion for authorization to file a plan, finding that although it was possible for a creditor to bring forward a *Companies' Creditors Arrangement Act* (CCAA) plan, in the present case, it constituted an attempt to use the CCAA proceedings for an "improper purpose" and that it would result in a "substantial injustice" to the debtor. Instead, the QSC granted the debtor's motion for approval of the LFA. In doing so, the QSC held that creditor approval was not necessary to bring its lawsuit against the creditor, and established that in general, third-party funding agreements are legal and should be approved subject to certain principles. One of the primary principles to consider is whether the funding is necessary to provide a plaintiff access to justice. In this case, the debtor did not have sufficient funds to advance the claim without third-party funding.

Status: Leave to appeal was granted on April 20, 2018 and the appeal was heard on the merits on December 3, 2018. No decision has been issued.

Takeaway: In appropriate circumstances, insolvent companies, through LFAs, have more options to pursue outstanding claims and increase recovery for creditors.

March 15, 2018

IS A GROSS OVERRIDING ROYALTY AN INTEREST IN LAND?

Third Eye Capital Corporation v. Ressources Dianor Inc./Dianor Resources Inc.

There were two issues before the Court of Appeal for Ontario (ONCA):

1. Whether a gross overriding royalty (GOR) (a royalty interest attached to the lease or licence issued by the Crown and paid out of the revenue from the production of oil and gas) will be considered an interest in land

2. And if so, whether an interest in land can be vested out in an insolvency proceeding so that the purchaser would acquire the land free and clear of the GOR.

The ONCA clarified the test set out in *Bank of Montreal v. Dynex Petroleum Ltd*. A GOR can be an interest in land (i) where the language used in describing the interest is sufficiently precise to show the parties intended the royalty to be a grant of interest in land, and (ii) where the interest out of which the royalty is carved is itself an interest in land. On this basis, the ONCA reversed the decision of the lower court and found that the GOR, in this instance, was an interest in land as the royalty agreement expressly stated that the GOR was an interest in land. The parties registered the GOR on title, and the GOR was carved out of Dianor's working interest in the mining claims subject to the GOR. The common law recognizes mining claims as an interest in land. As such, both parts of the test were satisfied.

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The ONCA invited further submissions regarding whether courts in insolvency proceedings have the power to vest out interests in land. Such submissions have now been made; however, no decision on this second question has been issued.

Status: An extension of time has been granted to file a leave to appeal application of this decision to the SCC, as the parties await the decision of the ONCA on the second aspect of the appeal.

Takeaway: Although, on the facts of the case, the GOR was found to be an interest in land, the second question of the appeal may find that courts in insolvency proceedings have the power to vest out interests in land, such that, in insolvency proceedings, this interest in land may be lost and attach to proceeds of sale only.

February 21, 2018

DISCRETIONARY NATURE OF PRIORITY OF RECEIVER'S CHARGE

Royal Bank of Canada v. Reid-Built Homes Ltd.

The Alberta Court of the Queen's Bench (ABQB) considered whether the priority of the court-appointed receiver's charge securing fees and approved borrowings is discretionary and whether the receiver's charge is subordinate to a municipality's claim for property taxes. The ABQB found that the doctrine of paramountcy did not automatically apply to subordinate the municipality's property tax claims. However, the ABQB has the discretion to grant a super-priority charge to the receiver and to order that its charge ranks ahead of claims of secured creditors and municipalities. The court's discretion must be exercised in the circumstances of the case, having regard to the purposes of the legislation and the particular receivership proceeding. In this case, the ABQB found that the purpose of the receivership was liquidation and that, accordingly, there was no apparent benefit to the municipality arising out of the receivership. The ABQB therefore held that the municipality's claim was not subordinate to the receiver's charge.

Status: This decision is being appealed. The appeal is scheduled to be heard on February 14, 2019.

Takeaway: This decision illustrates the discretionary nature of the priority of court-ordered charges in insolvency proceedings. While the court has the power to subordinate a municipality's property tax claim to the receiver's charge and borrowing charge, this discretion will only be exercised in appropriate cases.

January 30, 2018

NEW B.C. LIMITATIONS ACT AND SECURED INTERESTS

Leatherman v. 0969708 B.C. Ltd.

The British Columbia Court of Appeal (BCCA) interpreted provisions of B.C.'s recently amended *Limitations Act* that create a specific rule for discovery of claims to realize or redeem security. This rule dictates that a claim to realize or redeem security is discovered on the first day that the right to enforce the security arises. The limitation period with respect to demand obligations, however, commences on the first day after a demand for performance is made.

In 2013, the lender granted a mortgage payable on demand, secured by an interest in land. Prescribed terms attached to the mortgage stipulated that if default occurred on the mortgage,

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it was at the lender's discretion to enforce its security. The borrower missed annual interest payments in 2013, 2014, 2015 and 2016. The lender did not take any action until 2016, when it demanded payment. The BCCA found that the limitation period for the right to enforce the security had commenced upon default on the first interest payment in 2013 and, as such, the limitation period had expired by the time enforcement steps took place in 2016. The lender was still permitted to pursue an action to recover the debt, as the obligation to pay was found to be a demand obligation, and the limitation period with respect to the payment obligation had not begun to run until a demand was made. The security, however, became enforceable as soon as a default occurred.

Status: The SCC refused leave to appeal this decision on October 4, 2018. As the SCC declined to hear the appeal, there will be no further appeal of this decision.

Takeaway: In British Columbia, the limitation period for enforcing security under a demand loan may commence upon any default, despite no demand having been made.

2017 CASE UPDATES

EFFECT OF BANKRUPTCY ON HST DEEMED TRUSTS

Canada v. Callidus Capital Corp.

Date of Decision: November 8, 2018

Under the ETA, the CRA enjoys a deemed trust for unremitted HST/GST. In the event of a bankruptcy, the CRA's priority is lost and it becomes an ordinary unsecured creditor of the tax debtor. In this case, a payment was made to the secured creditor by the debtor prior to bankruptcy at a time when HST arrears were outstanding and the obligation to remit was secured by a deemed trust. When the CRA pursued the lender for the amount of the outstanding HST, the debtor was assigned into bankruptcy. The SCC reversed the lower court's decision, adopting the reasons of the dissenting Justice. Accordingly, the SCC found that the priority of the CRA against a secured creditor is lost when the deemed trust is extinguished by bankruptcy, even if a distribution has already occurred. The SCC declined to comment on the liability of secured creditors to disgorge funds paid to it by a tax debtor that is liable for HST/GST outside of the bankruptcy context (the matter that is under consideration in *Canada v. Toronto-Dominion Bank*).

Takeaway: The SCC's decision provides definitive confirmation that the HST/GST deemed trust is not effective against secured creditors post-bankruptcy even if a distribution was received prior to the bankruptcy.

INTEGRITY OF COURT-ORDERED SALE PROCESS

Séquestre de Gestion EGR inc. et Lemieux Nolet inc., syndics de faillite et gestionnaires

Under the *Civil Code of Quebec* (CCQ) a debtor can prevent the exercise of security by paying to the secured creditor the amount owed to it and any costs it had incurred in enforcement. In this case, the Quebec Superior Court of Justice found that the CCQ governs the sale of assets by a receiver in Quebec and allowed a debtor to contest approval of a sale by paying down the debt owed to the secured lender. Click here for a full summary of this decision.

Updated Status: Leave to appeal this decision to the Québec Court of Appeal has been filed. No date has been set for the leave hearing.

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PRIORITY OF ENVIRONMENTAL RECLAMATION OBLIGATIONS

Orphan Well Association v. Grant Thornton Limited (also known as Redwater)

In this important decision, the Alberta Court of Appeal upheld the lower court decision, which held that certain sections of the *Oil and Gas Conservation Act* (Alberta) and *Pipeline Act* (Alberta) were inoperative to the extent that they are used by the regulator to:

- Prevent the abandonment of an insolvent debtor's assets by a court-appointed receiver or trustee, and
- Require the receiver or trustee to satisfy certain environmental claims in priority to the claims of secured creditors.

Click here for a full summary of this decision.

Updated Status: The SCC heard an appeal of this decision on February 15, 2018. No decision has been issued.

PRIORTY OF DIP CHARGES

Canada North Group Inc.

In this decision, the Alberta Court of the Queen's Bench found that the deemed trust securing unremitted source deductions under the *Income Tax Act (Canada)* could be subordinated to court ordered super-priority charges. Click here for a full summary of this decision.

Updated Status: The Alberta Court of Appeal heard an appeal of this decision on October 4, 2018. No decision has been issued.

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