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

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In 2017, a number of insolvency cases were litigated, in various provinces across Canada, which may materially affect the realization and recovery rights of commercial lenders in restructuring and insolvency proceedings. This article summarizes the core issue of importance to lenders in each of these cases and provides an update on their appeal status.

November 2, 2017

INTEGRITY OF COURT-ORDERED SALE PROCESS

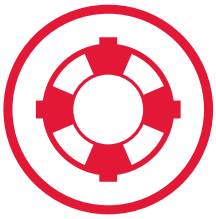
Séquestre de Gestion EGR inc. et Lemieux Nolet inc., syndics de faillite et gestionnaires

In this case, a receiver conducted a sales process in respect of real property. The receiver subsequently sought approval of the sale, which the debtor contested by seeking to enforce its right under the *Civil Code of Quebec* (CCQ) to prevent the exercise of security by paying to the secured creditor the amount owed to it and the costs it had incurred. The receiver argued that if the debtor were successful, the integrity of the sales process would be undermined. The Quebec Superior Court of Justice (QCSC) found that the sale of assets by a receiver in Quebec is governed by the provisions applicable to security realization in the CCQ. Therefore, the debtor was allowed to pay down the debt to the secured lender (including the costs of the sales process) and retain possession of its real property, despite the successful sales process ran by the receiver.

Status: The frustrated successful bidder under the sales process filed a declaration of appeal to the Quebec Court of Appeal (QCCA) on November 10, 2017.

Takeaway: The QCSC's decision could potentially have a chilling effect on sales processes, as bidders may be reluctant to go through the cost and expense of submitting a bid only to have it undermined by the debtor.

September 11, 2017



PRIORITY OF DIP CHARGES

Canada North Group Inc.

The Alberta Court of Queen's Bench (ABQB) considered whether the deemed trust (a form of super priority statutory security interest over the assets of the tax debtor) in favour of Canada Revenue Agency (CRA) for unremitted source deductions (i.e., payroll taxes) could be primed by court-ordered charges such as a charge securing debtor-in-possession (DIP) financing granted in a proceeding under the *Companies' Creditors Arrangement Act* (Canada) (CCAA) (Canada's principal statute for the restructuring of large insolvent debtors).

CRA submitted, among other things, that pursuant to the terms of the *Income Tax Act* (Canada) (ITA), the deemed trust securing unremitted source deductions takes priority over any security, other than certain types of security prescribed under the ITA, and thus could not be primed. The ABQB found that the deemed trust could be subordinated to court-ordered super priority charges and expressly elected not to follow the Nova Scotia Supreme Court's decision in *Re Rosedale Farms*, which came to the opposite conclusion in the context of proposal proceedings under the *Bankruptcy and Insolvency Act* (Canada) (BIA). BIA proposal proceedings are typically used for smaller, less complicated restructurings.

Status: Leave to appeal the decision to the Alberta Court of Appeal (ABCA) was granted on November 1, 2017.

Takeaway: Until the ABCA renders its decision, the ABQB's ruling is encouraging to lenders as it finds that interests arising under fiscal statutes such as the ITA are able to be subordinated by court-ordered super priority charges. There is however, conflicting case law in Canada that may ultimately require the Supreme Court of Canada (SCC) to resolve.

July 27, 2017

EFFECT OF BANKRUPTCY ON HST DEEMED TRUSTS

Canada v. Callidus Capital Corporation

Under the *Excise Tax Act (Canada)* (ETA), the CRA enjoys a deemed trust for unremitted HST/GST (i.e., federal/provincial sales tax). In the event of a bankruptcy, the CRA's priority is lost and it becomes an ordinary unsecured creditor. 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 Federal Court of Appeal reversed the decision of the lower court and found that secured creditors who do not comply with the obligation to pay over to the CRA proceeds derived from assets subject to a deemed trust are liable to the CRA, which has a separate cause of action against them irrespective of the subsequent bankruptcy of the debtor.

Status: Leave to appeal this decision to the SCC was filed on September 27, 2017. Leave has not yet been granted.

Takeaway: Until the SCC renders its decision, the Federal Court of Appeal's decision demonstrates that the HST/GST deemed trust can be effective against secured creditors post-bankruptcy if a distribution was received prior to the bankruptcy.

May 17, 2017

PRIORITY OF ENVIRONMENTAL RECLAMATION OBLIGATIONS

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

In the receivership of a junior oil and gas producer, Redwater Energy Corporation (Redwater), the regulator in Alberta brought an application for a declaration that the receiver should not renounce certain uneconomic wells without using estate funds to abandon and reclaim the wells, effectively asserting a priority over the existing lender who had first-ranking security

over the assets of Redwater. The ABCA upheld the decision of the lower court, 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: (i) prevent the abandonment of an insolvent debtor's assets by a court-appointed receiver or trustee; and (ii) require the receiver or trustee to satisfy certain environmental claims in priority to the claims of secured creditors as this would be outside of the scheme of distribution set out in the federal BIA, which enjoys paramountcy over provincial legislation.

Status: On November 9, 2017, the SCC granted the leave application filed by the regulator. The appeal has been expedited and will be heard by the SCC on February 15, 2018. For more information on this matter, please see our November 2017 *Blakes Bulletin: Supreme Court of Canada Grants Leave to Challenge Unconstitutionality of Alberta's Oil and Gas Regime*.

Takeaway: The SCC's decision to grant the leave application raises questions as to the priority of secured obligations vis-à-vis abandonment and reclamation obligations. There will be some degree of uncertainty until the SCC renders its decision.

February 20, 2017

CAN POST-FILING CLAIMS BE SET OFF AGAINST PRE-FILING CLAIMS?

Arrangement relatif à Métaux Kitco inc.

The QCCA considered whether section 21 of the CCAA allows set-off or compensation (the civil law equivalent of set-off) between pre-filing and post-filing obligations. In this case, the CRA was owed money by the debtor prior to the commencement of the debtor's CCAA proceedings. A tax refund obligation owing to the debtor arose after the proceedings commenced. The QCCA upheld the lower court decision (for different reasons). The QCCA held that the CRA could not set off its obligation to pay the post-filing tax refund to the debtor as against the pre-filing obligation owed to the CRA for taxes by the debtor and that allowing it to do so would, in effect, result in an unjust preference. We note that there is case law in Ontario (*Air Canada (Re)* and *Tucker v. Aero Inventory (UK) Limited*) and British Columbia (*North American Tungsten Corporation v. Global Tungsten and Powders Corp.*), which conflicts with *Kitco*. However, there is supporting case law in Alberta (*FAST Industries Ltd. v. Sparta Engineering Inc.*).

Status: Leave to appeal to the SCC was not sought and time to seek leave to appeal has expired.

Takeaway: It is unclear whether the QCCA decision to prohibit setting off pre-filing obligations against post-filing obligations will be adopted in jurisdictions outside of Quebec and Alberta. One consequence may be additional litigation regarding the characterization of an obligation as pre-filing or post-filing.

We will continue to monitor these cases and provide updates as warranted.

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