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CRA DEEMED TRUST TRUMPS CONTRACTUAL RIGHT TO SET OFF

BY DAVID MANN, DAVID LEGEYT

In the recent decision of *Ministre du Revenue national c. Caisse populaire du bon Counseil*, 2009 SCC 29 ("*Caisse populaire*"), the Supreme Court of Canada (the "SCC") considered whether a lender's contractual rights in respect of its customer's term deposit account may be defeated by a deemed statutory trust in favour of the Crown.

Any property of a taxpayer that is subject to a "security interest" within the meaning of the term in s. 224(1.3) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Suppl.) ("ITA"), is, to the extent of any unremitted source deductions by the taxpayer, deemed to be held in trust for the Crown pursuant to the operation of s. 227(4.1) ITA and s. 86(2.1) of the *Employment Insurance Act*, S.C. 1996, c. 23 ("EIA").

The issue in this case was whether Caisse populaire du bon Counseil (the "Caisse"), by virtue of its contractual arrangements with its customer, Camvrac Enterprises Inc. ("Camvrac"), held a "security interest" over the proceeds of Camvrac's deposit account with the Caisse that would be defeated by the deemed trust in favour of the Crown created by s. 227(4.1) ITA and s. 86(2.1) EIA.

BACKGROUND

In September 2000, Caisse granted Camvrac a $277,000 line of credit. Soon thereafter, the parties entered into a "Term Savings Agreement", whereby Camvrac deposited $200,000 with the Caisse. The Term Savings Agreement placed encumbrances on the deposit such that it could not be negotiated or transferred, not be withdrawn before maturity and could be given in security only in favour of Caisse. A further agreement was entered into (the "Security Given Through Savings Agreement"), which stipulated that "to secure the repayment" of the line of credit, Caisse was entitled to set-off amounts owed to it by Camvrac against the amount of the deposit account, coupled with a right of retention over the deposit account.

Following Camvrac's assignment into bankruptcy in February 2001, the Caisse closed the deposit account and set-off the proceeds against the debt outstanding under the line of credit. In June 2001, the Crown gave the Caisse notice to pay $26,863.53 from the proceeds of the deposit account for unremitted employment insurance premiums and income tax deducted at source by Camvrac – it was the Crown's assertion that such amounts were subject to its deemed trust under s. 227(4.1) ITA and s. 86(2.1) EIA.

DECISION

In a 5-2 decision, the SCC held that the agreements between Caisse and Camvrac respecting the term deposit did indeed constitute a "security interest", and, therefore, as a result of the deemed trust created by s. 227(4.1) ITA and s. 86(2.1) EIA, the Crown was the beneficial owner of Camvrac's term deposit to the extent of the unremitted source deductions.

Parliament has defined "security interest" in s. 224(1.3) ITA to include "any interest in property that secures payment or performance of an obligation". Rothstien J. in writing for the majority made note that Parliament has intentionally chosen an expansive definition of "security interest", and that while Parliament has provided a list of "included" specific examples, these examples do not diminish the broad scope of the words "any interest in

property". It was further held that the creation of a "security interest" does not require any particular form, although the majority went on later in the decision to consider particular words used by the parties in its characterization of the agreements (the majority made note of the use of the word "security" in the title of the "*Security* Given Through Savings Agreement", and that this agreement expressly stipulated that the term deposit was "to *secure* the repayment" of the line of credit).

The Caisse argued that its contractual rights to set-off with Camvrac is not a "security interest", as this contractual right did not confer on it an inertest in Camvrac's property with the intention of securing the line of credit. Rather, the Caisse asserted that the contractual right to set-off simply allowed it to extinguish its own indebtedness to Camvrac.

The majority decision rebutted the argument of the Caisse by emphasizing that while the *mechanism* by which the Caisse would realize on its security was a contractual right to set-off, the deposit itself was encumbered by the conditions agreed to by Camvrac and imposed by the Caisse in order to ensure that the remedy of set-off would be effective; the fact that the Caisse could realize on its security by way of a book entry did not diminish the fact that the *purpose* of the deposit was to secure Camvrac's obligation to Cassie.

The majority holding in *Caisse populaire* makes clear that, in determining if a "security interest" exists as defined in s. 224(1.3) ITA, the court will look to the purpose and effect of the overall contractual relationship between the parties in respect of the property under consideration, as opposed to focussing on the nature of the particular remedy (set-off) purported to be exercised by the creditor.

The dissenting opinion, on the other hand, focused on the remedy of set-off to conclude it is not a "security interest", as creditors who exercise their right to set-off are merely extinguishing mutual obligations, and not enforcing a security by realizing on the debtor's property.

CONCLUSION

The decision in *Caisee populaire* shows that a lenders' contractual right to set-off amounts owed to it by a creditor against the creditor's (encumbered) term deposit account will be defeated by a deemed trust in favour of the Crown over such property. Also, the majority holding in *Caisse populaire* makes clear that, in determining if a "security interest" exists as defined in s. 224(1.3) ITA, the court will look to the overall contractual relationship between the parties in respect of the property under consideration, as opposed to focussing on the nature of the particular remedy (set-off) purported to be exercised by the creditor.

What remains to be seen is whether this decision will be used by analogy in PPSA cases to expand the definition of "security interest", such that lenders' rights under other types of agreements where cash is posted as credit (and the lender enjoys a right to set-off against the debtor) will be considered a "security interest", thus requiring the lender to perfect such rights by registration under the applicable PPSA.

REORGANIZATION PROCEEDINGS CONTINUED NOTWITHSTANDING ALLEGATIONS OF CONFLICT

BY DAVID MANN, DAVID LEGEYT

In a recent decision of the Ontario Superior Court of Justice, Re Smurfit-Stone Container Canada Inc., Justice Pepall examined the conflicting interests that arise where companies within a group of restructuring companies have made intercompany loans to one another, and where the board of directors mirror each other in each subsidiary.

The factual background of the group of companies is required to understand this case. The parent company Smurfit-Stone Container Enterprise Inc. ("Enterprise"), is a US Company, with two wholly owned Canadian subsidiaries: Smurfit-Stone Container Canada ("Smurfit Canada") and Stone Container Finance Company of Canada II ("Finance II"). Smurfit Canada and Finance II have identical boards of directors.

Prior to the companies seeking protection from their creditors, Finance II raised funds in the public debt market by issuing unsecured senior notes in the amount of $200,000,000 to the noteholders, guaranteed by Enterprise. By way of an intercompany loan, Finance II then lent the proceeds of the raised funds to Smurfit Canada. The entire Smurfit-Stone group of companies sought creditor protection under the CCAA and Chapter 11 in the United States. The companies implemented a claims process, wherein Finance II did not make a claim against Smurfit Canada. The noteholders brought an application to lift the stay and have a trustee in bankruptcy appointed. The noteholders alleged that Finance II and Smurfit Canada have inherently conflicting positions in their restructurings and as a result there is a conflict of interest in having overlapping directors and officers, mutual counsel, and the same court monitor.

The Court identified two issues in this case: (1) did a conflict of interest exist that merited relief being granted,

namely the appointment of a trustee in bankruptcy; and (2) is this a case where the stay should be lifted to appoint a trustee in this respect.

It was the position of the noteholders that there was an irreconcilable conflict of interest between Finance II and Smurfit Canada in the CCAA and the Chapter 11 proceedings ongoing that the interest of Finance II and its noteholders was to ensure that Finance II maximized recovery from Smurfit Canada and from Enterprise. Further it was their position that the overlapping directors and officers among Finance II, Smurfit and Enterprise, mutual counsel, and the same monitor, could not properly maintain the conflicting fiduciary duties throughout the restructuring. The noteholders argued that an assignment into bankruptcy and the appointment of a Trustee in Bankruptcy would eliminate the conflict issues.

In examining these issues Justice Pepall noted that CCAA restructurings often involve consolidated plans that address intercompany claims and that in particular section 3(1) of the CCAA contemplates these types of group filings. Justice Pepall continued in stating:

> … conflicts are frequently found in the CCAA proceedings particularly those involving corporate groups. If one were to insist on independent counsel and an independent court officer for every instance of perceived conflict interest, restructuring proceedings of corporate groups would become completely, unwieldy and unproductive.

Importantly, the Court found that it was not yet determined whether the intercompany claim of Finance II was a debt or equity claim, and it was therefore unclear whether Finance II would have a claim entitling it to vote in the plan. The Court found that this issue could be addressed in the plan itself or beforehand by way of a motion. The Court found that there was no evidence that the applicants were not working on a plan in good faith for the benefit of all stakeholders or that the interests of Finance and the noteholders were not being taken equally into account. The Court found that there was no evidence of any breach of any duty by any of the impugned parties: the directors, officers, counsel or court appointed monitor.

Finally, Justice Pepall found that stay of proceedings should not be lifted to allow the assignment into bankruptcy. She found that the Court in exercising the discretion to lift the stay should balance the interests of creditors and debtors and consider the prejudice that may be suffered by each party. Reminding the parties of the underlying purpose of the CCAA, the Court cited the purpose as outlined in *Chef Ready*, that is, to facilitate the making of a compromise or arrangement between an insolvent debtor company and its creditors. Justice Pepall outlined this purpose is to be applied to the whole of the group of companies and stated that:

> [t]he goals of the CCAA apply not only to the individual companies but to interdependent corporate groups operating as a single enterprise, particularly when the treatment of the corporate group as an integrated system will result in greater value.

Lifting this stay against Finance II would cause series prejudice to the applicants in the restructuring and therefore the Court denied the application of the noteholders.

COURT RESTRICTS ACCESS TO DEBTOR'S DATA ROOM

BY DAVID MANN, DAVID LEGEYT

Recently, in *Re AbitibiBowater Inc.*, the Province of Newfoundland sought a court order granting it access to the electronic data room of Abitibi created for the purpose of dissemination of certain non-public financial and operation information to its counsel, certain creditors, and the Monitor. The Court denied the Province's application on the basis that it could not prove itself to be a legitimate stakeholder of Abitibi, and on several policy grounds. However, the Court was clear that there may be cases in the future where, on the basis of the particulars of each case, it would be appropriate for the Court to grant access to data rooms to stakeholders that otherwise have been denied such access by the debtor.

It is not uncommon, in a large corporate reorganization under the *Companies' Creditors Arrangement Act*, for a restructuring company to establish and maintain an electronic data room wherein non-public financial and corporate information is kept and catalogued. Access, as moderated by the debtor, would normally be restricted to the debtor's legal and financial advisors, and perhaps permitted stakeholders, to allow them to access information and better assess the ongoing state of the debtor's business. There is no statutory requirement that a data room be established – these are the voluntary initiative of the debtor, and are created in order to facilitate the restructuring process.

In the restructuring of AbitibiBowater Inc. (and its related entities, collectively "Abitibi"), such a data room was established and, upon execution of confidentiality agreements, certain creditor and stakeholder groups (through their counsel) were granted access. The Province of Newfoundland requested access to the data room and was denied by Abitibi. The Province brought a motion seeking to compel Abitibi to allow it access.

The Court noted the breadth of the information contained in the Monitor's Reports circulated to the general creditor group, although extensive, did not contain the same extent of financial information as contained in the data room. As such, the data room contained certain information that was not being disclosed to the creditors and stakeholders en masse.

The Court found that the Province was neither a creditor nor genuine stakeholder in the restructuring of Abitibi. However, the Province took the position that it required access in order to assess Abitibi's ongoing status and ability to cover the Province's claims against it. The Province alleged employment-related, tax, and environmental claims existed whereby it was either a direct or potential creditor of Abitibi. Abitibi denied the Province's assertions that it had any actual or contingent claims. Abitibi also raised a contingent claim of its own against the Province in excess of $300 million, and alleged that the Province was seeking access to the data room for ulterior purposes, including to better assess its position in respect of this potential litigation.

The Court dismissed the Province's motion stating that its arguments were not persuasive, whereas the concerns of Abitibi were serious and compelling. In its reasons, the Court considered the underlying principles of the CCAA, the status of the Province, and the "stakeholder" argument.

In considering the purpose of the CCAA, the Court stated it is a remedial statute designed to serve a broad constituency of stakeholders in a corporate reorganization. This includes serving the public interest, but is balanced with serving the individual interests of each player in the process. As such, consideration of broader socio-economic factors must be done within the scope of facilitating a successful restructuring to the benefit of the debtor company and its creditors.

Ultimately, the Province failed to demonstrate that it was a creditor of Abitibi, or even a potential stakeholder in the restructuring. Moreover, the Court did not agree that granting the Province's motion would serve the greater interests of the parties or the restructuring. The Court recognized that the data room was implemented to assist and enhance the restructuring process and was not created for the purpose of open access to every creditor or potential creditor.

The Court also noted that fair and equitable treatment under the CCAA does not equate to equal and identical treatment. The Court did not see the Province as being unfairly discriminated against. It noted that the case law does not support the premise that all similarly situated stakeholders must be treated alike, and nor should stakeholders be elevated to the status of creditors in every situation where their rights may be effected.

The Court did not go so far, in this decision, as to suggest that access to data rooms should be restricted in all cases to those whom the debtor considers appropriate to have access. Instead, the Court closed with reference to the oft cited words of Farley J., and stated "justice does not dictate to grant the access sought. Nor does practicality demand that it be done here." This leaves the question open of whether, in future cases, creditors and stakeholders could obtain access to a debtor's non-public and confidential electronic data room, notwithstanding the restructuring debtor's objection.

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