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set-off or security interest? Supreme Court's expansion of enhanced federal deemed trust provisions raises some troubling issues

Caisse Populaire Desjardins de l'Est de Drummond v. Canada, 2009 SCC 29

On June 19, 2009, the Supreme Court of Canada (the "**SCC**") rendered its long awaited decision in *Caisse Populaire Desjardins de l'Est deDrummond v. Canada,* 2009 SCC 29 ("***Caisse Populaire***"). In *Caisse Populaire*, the SCC considered whether a financial institution's right to set-off amounts owed to it by a depositor against the amount of the deposit, coupled with a right of retention over the account, gave rise to a "security interest" that would be defeated by the deemed trust created by s. 227(4.1) of the *Income Tax Act* and section 86(2.1) of the *Employment Insurance Act*. Under those sections income tax and employment insurance premiums required to be deducted by an employer but not yet remitted to the Canada Revenue Agency ("**CRA**") are deemed to be impressed with a trust in favour of the federal Crown at the time the unremitted amounts were deducted at source. The deemed trust trumps the rights of any secured creditor having a "security interest" in the property of the taxpayer regardless of when the security interest arose. In a 5-2 decision the SCC held that the bundle of rights that the financial institution had against the deposit account did indeed constitute a security interest that was defeated by the deemed trust.

In one sense the case is just another skirmish in the long-running war of words between the courts and Parliament over how "super" the "super-priority" of the deemed trust provisions really is.[1] However, its impact may well extend beyond federal tax and employment insurance legislation into the realm of provincial personal property security law. While the majority purports to confine the reasons to the federal legislation, the definition of "security interest" in the ITA closely resembles that used in provincial *Personal Property Security Acts* ("**PPSAs**"),

[1] The present version of the Deemed Trust provision has been subject to expansionary evolution as Parliament has sought to strengthen the mechanism in response to a line of restrictive SCC decisions. See *Dauphin Plains Credit Union Ltd. v. Xyloid Industries Ltd.*, [1980] 1 S.C.R. 1182; *Royal Bank of Canada v. Sparrow Electric Corp.* [1997] 1 S.C.R. 411; and *First Vancouver Finance v. M.N.R.*, [2002] 2 S.C.R. 720.

and the Court's *obiter* forays into provincial PPSA law may (inadvertently) introduce some uncertainty into an area of the law that most secured transaction lawyers have assumed was fairly well settled. If the majority's reasoning is adopted in PPSA cases involving cash collateral and set-off agreements, banks and other deposit-taking institutions may need to take a closer look at these agreements to guard against attack not only by the CRA but by other creditors and trustees in bankruptcy eager to find chinks in the banks' PPSA armour. The case may also have unfortunate implications for how cash is posted as credit support for derivatives transactions.

background

In September 2000, Caisse Populaire Desjardins de Bon Conseil (the "***Caisse***") granted Camvrac Enterprises Inc. ("**Camvrac**") a $277,000 line of credit under a variable credit contract. Soon thereafter Camvrac entered into a term savings agreement with the Caisse, under which it deposited $200,000 into a term savings account with a maturity date of October 2005. The amount deposited under the term savings agreement could not be withdrawn or transferred until maturity, nor could the funds be granted as security to any party other than the Caisse. The Caisse and Camvrac also signed a "Security Given Through Savings" agreement under which the Caisse could use the deposited funds as security for the repayment of any amount owed to the Caisse. Under this agreement, the Caisse had a right to withhold payment of the deposit amount and to "compensation" (the civil law term for set-off), as well as the right to create a hypothec over the deposit.

After Camvrac was assigned into bankruptcy in February 2001, the Caisse closed the term deposit account and set-off the proceeds against the outstanding debt under Camvrac's line of credit. The CRA subsequently issued a notice to the Caisse to pay $26,863.53 in source deductions that Camvrac had failed to remit, relying on the deemed trust, which takes priority over the "security interest" of any "secured creditor". The Caisse appealed the notice to the courts on the basis that it was not asserting a security interest in the deposit but was only exercising a contractual right, but the Federal Court and the Federal Court of Appeal dismissed the appeals, holding that the set-off arrangement satisfied the statutory definition of "security interest". The Caisse appealed to the SCC.

Supreme Court decision

In its 5-2 decision, the SCC dismissed the appeal, finding for the Crown. Writing for the majority, Mr. Justice Rothstein found that the agreements between the Caisse and Camvrac did give rise to a "security interest" (as defined in the ITA) in Camvrac's deposit account, and was therefore defeated by the deemed trust in favour of the Crown.

The majority noted that Parliament has intentionally chosen a very expansive definition of "security interest" for the deemed trust provisions and that substance rather than form determines whether a security interest is involved. According to Mr. Justice Rothstein, where contractual compensation (i.e. contractual set-off) is in issue, the intentions of the contracting parties as reflected in the words of the contract must be given prime consideration in determining whether the arrangement is a security interest: “If the substance of the agreement demonstrates that the parties intended an interest in property to secure an indebtedness, then a security interest exists within the meaning of s. 224(1.3).”

The majority emphasizes that the term “security interest” as used in the federal legislation is independent of the definition under provincial personal property security legislation. However, the federal definition is in fact very similar to that used in provincial *Personal Property Security Acts,* and in an extended *obiter* digression, Mr. Justice Rothstein takes issue with the dissenting minority’s view that set-off combined with a right of retention does not give rise to a security interest under provincial law.

The majority also pointed to language in the agreement between the Caisse and Camvrac that would seem to encourage the security interest characterization. For instance, one agreement is entitled “Security Given Through Savings” and refers to Camvrac’s term deposit as being used to “secure the repayment of the line of credit.” Mr. Justice Rothstein found that the use of the “security” language implied “that the Caisse itself conceived of its agreements with Camvrac as creating ‘security’ for the line of credit.”

What is interesting and somewhat troubling about the majority decision is that it does not fully address the issue that a security interest, whether under federal or provincial law, must first be an “interest in property”. If there is no interest in property there is no security interest regardless of whether the effect of the arrangement is to “secure” an obligation. As the strong and well-reasoned dissenting judgment of Madame Justice Deschamps explains, a right of set-off alone does not create a property interest in the debtor’s assets; it merely allows two offsetting claims to be netted against each other. Mr. Justice Rothstein agreed that a right of set-off by itself is not a security interest, but when combined with a right to withhold payment under the deposit (the right of retention) and prevent the depositor from withdrawing funds, the result is a security interest because the set-off remedy is effective only because of the right of retention. It is not explained why two contractual rights, neither of which creates a property interest alone, become a property interest when combined. In addition, the reference to the language of security in the reasoning is curious, because as both the majority and the dissent argue, it is the functional relationship of the rights to the account that determine whether a security interest exists, not the particular wording used to describe the arrangement.

implications

Financial institutions and other lenders may well wonder what impact this case will have on the legal characterization of such common arrangements as cash collateral agreements that include minimum balance requirements and limited withdrawal rights. If the reasoning in the case is widely followed (and not “distinguished on its particular facts”) it may expose lenders to attack not only from the CRA but from trustees in bankruptcy and secured creditors of their depositors if the "security interest" has not been perfected by registration under the applicable PPSA or published as a movable hypothec without delivery in the province of Québec. Avoiding the use of the term "security" in drafting a cash collateral agreement may be advisable to avoid application of the reasoning in *Caisse Populaire* since the majority seemed to attach considerable weight to the use of such terms in characterizing the agreement.

Cash collateral agreements commonly rely on what has been called a "triple cocktail" of set-off, security interest and "flawed asset". Flawed asset is the term used to describe the lender's suspension of the depositor's right to withdraw the deposit until the loan obligations have been satisfied. In effect, *Caisse Populaire* stands for the proposition that the first and third element of the "triple cocktail" automatically combine to form the second, even though the lender may regard them as conceptually distinct. Generally lenders register the security interest created by cash collateral agreements, but sometimes they do not, and even if they do, they may wish to rely solely on the right of set-off, which in some circumstances may take priority over perfected security interests that would rank ahead of the lender's. *Caisse Populaire* may make it risky not to register a cash collateral agreement and may limit the lender's ability to elect the remedy of set-off without regard to the security interest. Lenders would therefore be well advised to ensure that any agreement that contains both a right of set-off against a deposit and a limitation on the depositor's right to withdraw the deposit has been duly registered as a security interest. Under provincial PPSAs registration would not estop the lender from later taking the position that no security interest was involved since registration does not determine whether the PPSA applies.

The case may also create some uncertainty for counterparties in collateralized derivatives transactions that use cash as credit support. Unlike the U.S., Canadian jurisdictions do not allow security interests in cash on deposit to be perfected by "control", which gives the secured party automatic priority over most other creditors of the depositor (although probably not over statutory deemed trusts such as the one in *Caisse Populaire*). Security interests in cash must instead be perfected by registration, which can expose the counterparty to the risk of subordination to prior registered interests. Instead, counterparties often rely on an Ontario variant of the standard ISDA Credit Support Annex in which "cash" is absolutely transferred to the secured party but gives rise to a debt obligation that may be set-off against the pledgor's termination obligations, with no PPSA registration. Since these agreements commonly contain minimum margin requirements that include cash, they could well be characterized in much the same way as the agreements in *Caisse Populaire*, meaning that a secured party can no longer escape from the disadvantages of a security interest in cash by using set-off. Should secured counterparties now register as a matter of course even if they are relying on the set-off alternative for cash? Should cash no longer be acceptable eligible credit support for derivatives? As with many other questions raised by this case, the answers are far from clear.

conclusion

Although *Caisse Populaire* involved less than $27,000 and statutory provisions designed to protect federal Crown revenues, its implications for insolvency, secured lending and derivatives practice may extend far beyond that limited sphere. Whether lenders and counterparties respond to the case by routinely registering rights of set-off or no longer accepting cash deposits as collateral may depend on how confident they are that lower courts will confine the case to its particular facts. Meanwhile, in one if its relatively rare commercial law decisions, the land's highest court has regrettably made the law less rather than more certain.

By: Rob Scavone and Tobias Whitfield.

For more information, contact any of the lawyers listed below:

Calgary	Michael A. Thackray, QC	403.531.4710	michael.thackray@mcmillan.ca
Toronto	Peter A. Willis	416.865.7210	peter.willis@mcmillan.ca
Montréal	Judie Jokinen	514.987.5026	judie.jokinen@mcmillan.ca

a cautionary note

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