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Deemed Trust for Taxes Trumps Bank's Security Interest

A recent Federal Court decision held that a "deemed trust", which is a mechanism allowing the government to collect taxes from defaulting taxpayers, takes priority over the security interests of third parties.

In *Canada v. Toronto-Dominion Bank*, the Bank was sued by the government for $68,000 that a customer named Weisflock had used to pay off a loan secured by his home mortgage. The funds came from the proceeds of the sale of Weisflock's home.

The claim against the Bank reflected the amount of unpaid GST that Weisflock owed the government, having collected it from customers of his landscaping business. It hinged on a tax-tracing mechanism known as a "deemed trust", found in section 222 of the *Excise Tax Act* (ETA). It allows the government to collect Weisflock's unpaid taxes that were now in the Bank's hands, by declaring that: (1) the Bank holds that same amount in trust for the government; and (2) the trust takes priority over the Bank's secured interest in the money. Here, the government relied on section 222(3) specifically, which extends that trust concept to cover Weisflock's *property*, and operates in priority to any security interest the Bank had in that property *or its proceeds*.

The Bank objected to the claim on several bases, one being that those "proceeds" of Weisflock's mortgage would materialize only if the Bank had to *realize* on its security; in this case, Weisflock had sold his home and repaid the loan voluntarily. The court rejected this argument, noting that "proceeds" – while not defined in the ETA – is usually given a broader meaning, and includes something received upon selling or otherwise disposing of collateral. It is not restricted to forced sales or the realization of security interests.

That meant that the deemed trust mechanism could apply even where a tax debtor like Weisflock voluntarily sold his home. If he chose to use the funds not to service his tax debt but rather to pay off a secured creditor like the Bank, then the mechanism was triggered; the Bank became statutorily obliged to remit the funds on Weisflock's behalf.

The court also rejected the Bank's equity-based defence, finding it could not circumvent the deemed trust by claiming it was a *bona fide* purchaser for value of Weisflock's money. Although the defence is not limited to "sales" transactions only, the Bank had not "purchased" anything here. It received money in voluntary repayment of a loan, and discharged its security in return. The court found that a secured creditor like the Bank could not invoke this defence, although it remained available to unsecured creditors (such as suppliers, landlords or public utilities) who receive payments from a tax debtor.

The court conceded that this distinction "might appear absurd", but pointed out the ETA's deemed trust provision clearly reflected a legislative intent to disregard the proprietary interests of even secured creditors like the Bank, in order to grant the government an absolute priority respecting taxes. The court was not entitled to alter that priority, however harsh the outcome may be on lenders.

The court accordingly ordered the Bank to pay the government $68,000 from the funds it had received from Weisflock. See: *Canada v. Toronto-Dominion Bank*, 2018 FC 538.

Purchase Deposit Forfeited Despite OBCA Protections

On the sale of three adjacent homes with a total price of $7 million, the seller negotiated an agreement of purchase and sale with Benedetto, who planned to incorporate a new company to be named as the buyer. The agreement reflected that Benedetto acted "In Trust For A Company to be Incorporated without any Personal liabilities," mimicking section 21(4) of the Ontario *Business Corporations Act* (OBCA). Under that provision, a person in Benedetto's position is not personally bound by such contracts, and is not exposed to personal liability under them.

Benedetto never took steps to incorporate the company as intended, and later advised the seller that he had decided not to proceed. Relying on the OBCA-based liability exclusion – and despite his own decision to abort the deal – he asked for the return of $100,000 in personal funds that he had paid the seller as a deposit.

The seller refused, and asked the court for summary judgment and a declaration that it could keep the $100,000. It argued simply that, by law, a buyer's failure to close a real estate transaction results in the deposit being forfeited, unless stated otherwise in the agreement.

The court sided with the seller. The agreement's OBCA-based language did protect Benedetto from personal liability under pre-incorporation contracts. However, it protected him only from being *bound* by the contract, and from being personally sued for *damages* if it failed to close. It did not impact a tendered deposit, which protects the seller from risk by guaranteeing the performance of a contract and recompensing the seller for having to take the property off the market. To hold

otherwise would not be commercially reasonable, since it would render the concept of a deposit meaningless.

In light of Benedetto's own failure to close the deal, the deposit on behalf of the yet-to-be-incorporated company was declared forfeited to the seller. See *Benedetto v. 2453912 Ontario Inc.*, 2018 ONSC 4524.

Failure to Provide Valid Mortgage Statement Invalidates Lender's Sales

In a factually-complex case, the Appeal Court confirmed a narrow legal point: A mortgagee's failure to provide an accurate Mortgage Statement triggered the statutory suspension of all mortgage enforcement rights, which had a domino-like effect of invalidating subsequent sales of the property during the suspension period.

The court described a web of transactions that had the parties "locked in a terminal struggle." A man named Van Alphen leased property, through his numbered company ("135"), to operate his business. The landlord had a mortgage with Bayview Financial ("Bayview"), but defaulted on payment in 2008. Bayview issued a Notice of Sale and claimed the full $368,000 owed under its mortgage.

Van Alphen saw this as an opportunity to buy the landlord's property himself, and over the next few years took a series of steps toward that goal. First, he caused 135 to default on its rental obligations to the landlord, which increased the existing financial pressure the landlord faced from Bayview. Then, he used one of his other numbered companies ("117") to buy the Bayview mortgage, register an assignment, and obtain an attornment of the rents. The landlord responded by applying under the *Commercial Tenancies Act* (CTA) to pursue the rent arrears, and to restrain 117 from taking mortgage enforcement steps.

This gave rise to what the court called "a strange twist". Van Alphen stopped paying rent, so the landlord was unable to make its mortgage payments. The landlord eventually obtained a CTA order against Van Alphen for $240,000 in arrears. Van Alphen risked forfeiting his lease, but the landlord risked losing the property to Van Alphen acting under his power of sale as the new mortgagee. As the court summed it up: "The fight was ongoing about the relationship between the rents and the mortgage payments from the beginning until the bitter end at trial and Mr. Van Alphen did not provide ongoing and proper disclosure of what he was doing."

Van Alphen then made three different attempts to purchase the landlord's property at a highly-favourable price. Each bid was later held invalid by a trial judge tasked with resolving the matter.

The first attempt failed because 117 had assigned the mortgage to another financial institution, and had no legal interest in the property that it could sell. The Second Sale, in which 117 conveyed the property to itself under its power of sale, hinged on what the judge ruled was an invalid Notice of Sale from Bayview. The judge also noted that an updated Mortgage Statement, reflecting the state of affairs in the rent/mortgage balance interplay, had never been provided as required by the *Mortgages Act*. The purported Third Sale, which was predicated on the defective Second Sale, was also held invalid. The trial judge also noted Van Alphen's lack of good faith in setting a reasonable price for the property.

Van Alphen appealed those rulings. The Ontario Court of Appeal focused on two aspects: (1) whether Bayview's Notice of Sale was invalid under section 31(1) of the *Mortgages Act*, for failing to reflect the correct mortgage redemption amount; and (2) whether either mortgagee (*i.e.* Bayview or 117 thereafter) had failed to comply with the Mortgage Statement provisions in section 22(2) of the *Act*, because the Statement did not reflect the reduced balance achieved through the attornment of rents. Under the latter provisions such failure, without reasonable excuse, suspends the mortgagee's enforcement rights, including the power of sale, until a correct Mortgage Statement is delivered.

The Appeal Court considered the interplay and intent behind these sections of the Act. The fundamental purpose of an updated Mortgage Statement is to allow the mortgagor to intelligently assess its legal position. Here, and despite two requests, Bayview failed to supply the landlord with a timely and accurate Mortgage Statement within the deadline in section 22(2); 117 also failed to do so when later called upon to do the same. The landlord had made the requests after pointing out that the error in the Notice of Sale. Since section 22(2) was not complied with respecting the updated Mortgage Statements, the trial judge was correct to find that 117's mortgage enforcement rights were statutorily suspended starting before the Second Sale date and ending only at trial, when the outstanding factual issues were resolved and the mortgage accounts were fully reconciled with the rent accounts. This alone invalidated both the Second and Third Sales, since they were purportedly executed at time when 117's rights were suspended and it was wholly precluded from dealing with the property.

Nonetheless, the court examined the validity of Bayview's Notice of Sale under section 31(1) of the Act as well. It held that even with the interrelationship between the rent payments and the mortgage balance, the Notice of Sale had not become so inaccurate with the flow of time that a fresh version was needed. Rather, changes could be addressed through a new Mortgage Statement under section 22 of the Act. The errors in the Notice were known to the landlord, and did not materially impair its ability to redeem or assess its position under the mortgage, on a standard of commercial reasonableness, (The court did add that in some uncommon scenarios, a fresh Notice might be required where the debt changes over time; however this depended on the circumstances, including whether there was a timely, accurate, and complete Mortgage Statement that could correct information in the Notice of Sale).

In the end, and in light of the statutory suspension of 117's mortgage enforcement rights and the timing of the Second and Third Sales, the court confirmed the trial judge's ruling that those transactions were invalid. It dismissed Van Alphen's appeal. See *1173928 Ontario Inc. v. 1463096 Ontario Inc.*, 2018 ONCA 669.