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I. INTRODUCTION

Unlike Australia and the United States, Canada does not have a separate bankruptcy court. The Canadian federal government has the power to establish a bankruptcy court,[1] but it has elected not to do so. Instead, section 183 of the Federal Bankruptcy and Insolvency Act[2] (BIA) confers original, auxiliary, and ancillary jurisdiction in bankruptcy, at law and in equity, on the superior courts in each of the provinces and the Yukon Territory. Section 183 also confers appellate jurisdiction in bankruptcy matters on the regular provincial courts of appeal and on the Supreme Court of Canada.[3] It is common in Canada to speak of the "Bankruptcy Court," but this colloquialism merely means that a particular superior court is exercising its section 183 jurisdiction.[4] Despite the absence of an autonomous bankruptcy court, jurisdictional questions do arise from time to time. For example, a party may

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1. The Parliament of Canada has the power, "from Time to Time [to] provide for the Constitution, Maintenance, and Organization of a General Court of Appeal for *Canada*, and for the Establishment of any additional Courts for the better Administration of the Laws of *Canada*." CAN. CONST. (Constitution Act, 1867) § 101.

2. R.S.C., ch. B-3 (1985), *amended by* STAT. CAN. 1992, ch. 27 (Can.).

3. The BIA sets out substantive rules to be applied by the superior court when it sits in bankruptcy. Where the BIA is silent, the substantive rules to be applied will be the federal and provincial laws that would be applied by the court sitting in its regular capacity. As far procedural rules are concerned, § 4 of the General Rules under the BIA (SOR/92/57590) provides that the practice of the court in civil matters, in cases not provided for by the Act or the Rules, applies to proceedings under the Act or the Rules.

4. Section 185 of the BIA authorizes the chief justices of the provincial superior courts to nominate or assign one or more judges in their courts to exercise the powers and jurisdiction of the superior court under the BIA. However, the exercise of this power neither makes the nominated judge(s) *persona designata* nor does it deprive non-nominated members of the superior court from continuing to exercise their bankruptcy jurisdiction. *See* Dominion Shipbuilding & Repair Co., 3 D.L.R. 274 (Ont. 1926); *Re* Holley, 26 D.L.R. 4th 230 (Ont. Ct. App. 1986).

object that a proceeding has been launched before a superior court in its civil capacity when it should have been addressed to the court in its bankruptcy capacity.[5] Such objections, however, are only procedural in character, have no constitutional dimension, and do not affect the substantive principles of law in issue in the litigation.

This being the case, I may now safely turn to the topic on which I had originally agreed to contribute this short paper. The topic involves a small, but constitutionally and economically important, fragment of the larger interface between federal and provincial powers. The problem for consideration is to what extent the federal government's insolvency powers[6] in Canada can and should be used to alter the order of distribution of a debtor's estate in bankruptcy from the priorities that would be applied under provincial (and, sometimes, federal) law outside the debtor's bankruptcy.

II. THE ROLE OF SECURED CREDIT IN THE MODERN ECONOMY

To enable the reader to appreciate the nature of the problem, I must begin with a sketch of the role of secured credit in modern economies and the evolution of Canada's chattel security law.[7]

Access to large amounts of credit for commercial and consumer purposes, on a short-, medium-, or long-term basis, is the lubricant without which modern economies could not survive. In Canada, the outstanding volume of commercial and consumer credit at any time, not including credit extended to the various levels of government, runs to several hundred billion dollars. The volume of consumer credit alone, not including loans secured by residential mortgages, amounts to over sixty billion dollars.

Although much credit is unsecured, creditors frequently will insist on security to ensure payment of the debt.[8] Whether security is required, and will be given, will depend on a variety of factors: the size and duration of the credit, the bargaining strengths of the parties, the debtor's credit rating, and the cost of the credit. For the typical consumer, however, and for all but the

5. The case law is collected in 2 HOULDEN & MORAWETZ, BANKRUPTCY AND INSOLVENCY LAW OF CANADA §§ 1-7 (3rd ed. 1992); B. Boucher, "La Jurisdiction de la Cour de Faillite: une Perspective Quebecoise," 24 C.B.R.3d 61 (1994) (collecting case law for Quebec).

6. CAN. CONST. (Constitution Act, 1867) § 91(21).

7. In this paper "secured transactions," "security in personal property," and "chattel security" are used interchangeably. Historically, common-law jurisdictions treated security in realty (immoveables) separately from security in personal property (movables). Although the difference has little significance in bankruptcy law, at the suggestion of the organizers of this conference, this paper is confined to the chattel security issues.

8. From an economic perspective, there is no difference between "vendor credit" and "lender credit." In common-law jurisdictions, the two types of credit have long been treated differently for legal purposes. Unless otherwise indicated, the difference will be ignored in this paper.

largest blue-ribbon corporations, the granting of security will be *de rigueur* where substantial amounts of credit are being sought.

A creditor has important reasons for seeking security. The most important reason is to be able to realize the collateral if the debtor fails to pay or becomes insolvent. In a typical insolvency, an unsecured ordinary creditor will recover five cents or less on the dollar. Secured creditors, on the other hand, can expect to recover fifty percent or more of what is owing to them. Another important reason encouraging a creditor to seek security is to obtain leverage over the debtor. An unsecured creditor can only threaten to sue or to deny the debtor further credit. Neither option may make much impact on a recalcitrant debtor or one who is facing pressures from a variety of sources. Debtors cannot afford to be so cavalier in their dealings with a secured creditor since they know the secured creditor can always seize the collateral and bring the business to a halt if the debtors fail to cooperate. A third reason for seeking security is to prevent the debtor from granting security to another creditor, and thus subordinating the first creditor's claim.

III. EVOLUTION OF CANADIAN CHATTEL SECURITY LAW

The early common law was very hostile to non-possessory security interests in personal property (typically a chattel mortgage or bill of sale, as it used to be called). The common law treated them as presumptively or conclusively fraudulent vis-a-vis the debtor's other creditors.[9] As perceived by the courts, the mischief lay in the secured party permitting the debtor to hold himself out as still exercising dominion over his chattels when in truth he had "sold" them on a conditional basis to a creditor.

Although a radical change in attitude occurred in nineteenth-century industrial England, the Canadian reaction was more ambivalent. On the one hand, Canadian courts followed the liberating decisions of the House of Lords in *Holroyd v. Marshall*[10] and *Tailby v. Official Receiver*[11] recognizing respectively the validity in equity of a chattel mortgage on after-acquired property and an assignment of future receivables. Conditional sale agreements, so important for the nascent instalment credit industry, and the fixed and floating charge found an equally hospitable climate in Canada. In tandem with these essentially provincial developments, the federal government also incorporated in the Bank Act[12] the generous warehouse receipt provisions

9. *See* An Act Against Fraudulent Deeds, Alienations, Statute of 13 Eliz., ch. 5 (1570) (Eng.); Twyne's Case, 76 Eng. Rep. 809 (Star Chamber 1601).

10. 10 H.L.C. 191; 138 Rev. Rep. 108 (1862).

11. 13 App. Cas. 523 (1888).

12. STAT. CAN. 1991, c. 46.

which, in their expanded "Section 88" garb[13] were to play such an important role over the next century in encouraging the chartered banks to provide inventory financing facilities to the Canadian timber, agricultural, mining and other resource industries.

These strong pro-secured creditor developments were offset by the introduction of burdensome registration and affidavit requirements for major security devices. In short, the evolving attitudes of the common law and equity courts were considerably more liberal than the suspicious minds of the provincial legislatures.

The same ambivalence, only more so, was found in the United States, whose chattel security law, prior to the adoption of the Uniform Commercial Code ("UCC"), was fearsomely complex.[14] The great achievement of Article 9 of the UCC, easily the most innovative and radical of the nine substantive articles of the Code, was to simplify, rationalize and modernize the American law of secured transactions in personal property. Since the early 1960s, Article 9 has been in force in all of the American states, with the exception of Louisiana, a civil law jurisdiction.[15] Louisiana has since also joined the Article 9 club.

Article 9 has also found a very congenial home in the Canadian common law provinces in the form of the personal property security acts.[16] Ontario was the first province to adopt such an act.[17] Since then all the Western Provinces (British Columbia, Alberta, Saskatchewan and Manitoba), New Brunswick, and the Yukon and Northwest Territories have followed suit. No less striking is the fact that the new Quebec Civil Code, which came into effect on January 1, 1994, has also incorporated many of the features of an Article 9 regime.

The Canadian personal property security acts, although differing greatly in detail and sometimes in substance, all share the following Article 9 characteristics. They substitute the generic concept of a security interest for the multiplicity of security devices known to the common law or existing in equity. Every security interest is now governed by the same rules of creation, attachment, perfection, priorities and enforcement unless functional distinctions justify the adoption of separate rules. In all the provinces a computerized "real time" central registry system has replaced the old manually operated city

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13. *Id.* § 427.

14. The story is beautifully told in 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY ch. 1-8 (1965).

15. Article 9 was revised in 1972 and is currently in the course of a further revision.

16. *See* Jacob S. Ziegel, *The New Provincial Chattel Security Regimes*, 70 CAN. BAR REV. 681 (1991).

17. Personal Property Security Act, S.O., ch. 73 (1967) (Ont.). The Act was only fully proclaimed in 1976 and was completely revised in 1989. *See* S.O., ch. 16, (1989); Ziegel, *supra* note 16, at 686-89.

or county based registries. Affidavits are abolished for all purposes. All that is required to perfect a security interest by registration is the submission of a one-page skeletal document called a "financing statement,"[18] which will remain valid for as long as the secured party wishes it to be[19] unless the registration is previously discharged.

In short, in Canada secured parties have come as close to reaching Nirvana as it is possible to do in an imperfect world.

IV. A HELPING HAND FROM BANKRUPTCY LAW

In the Canadian Constitution, primary responsibility for regulating questions of bankruptcy and insolvency law rests with the federal government pursuant to section 91(21) of the Constitution Act. The first comprehensive Bankruptcy Act was adopted by the Canadian Parliament in 1919. It was modelled on the British Bankruptcy Act of 1914 and followed the same conceptual structure as the British Act.[20] This meant that until the 1992 amendments to the BIA[21] secured creditors continued to, and to a large extent still, enjoy the same deference in bankruptcy as they enjoy outside bankruptcy.[22]

"Secured creditor" is broadly defined in section 2 of the BIA and certainly encompasses all consensual forms of secured credit. Pursuant to section 69.3(2), a secured creditor is not affected by the stay of proceedings which applies to all other proceedings initiated against the bankrupt without the court's consent. Instead, subject to a modest exception,[23] the secured creditor is free to demand release of the collateral and to realize or otherwise deal with it as he would be entitled to outside bankruptcy. It is also

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18. *See e.g.*, Personal Property Security Act, S.O., ch. 16, § 45 (1989) (Ont.); R.R.O. 1990, Reg. 912.

19. Personal Property Security Act, S.O. ch. 16, § 51(1) (1989) (Ont.).

20. The Canadian Act, however, did not adopt the British distinction between personal bankruptcies and the winding up of insolvent companies; both proceedings are basically governed by the same provisions. In Canada banks, trust companies, and other designated corporations affected with a strong public interest can only be wound up under the Winding Up Act, R.S.C., ch. W-11, (1985) (Can.).

21. *See* BIA, ch. 27, 1992 S.C. 559 (Can.).

22. The relevant 1992 amendments are considered hereafter.

23. The trustee can seek a court order postponing the secured creditor's right of repossession for a maximum period of six months. In practice such requests appear to be rarely made and, if the reported cases are a reliable guide, are not often granted. Under the new commercial reorganization provisions adopted in 1992 (BIA Part III, Division 1), the automatic stay triggered on the filing of a proposal, or notice of intention to file a proposal, applies to all creditors, including secured creditors. *See* BIA, ch. 27, §§ 69.1-69.2, 1992 S.C. 616-620 (Can.). However, this change does not appear to affect the relative priorities of consensually secured claims and statutory lien claims in favor of public agencies discussed later in the paper.

abundantly clear, subject to the rules against fraudulent preferences,[24] that a security interest which is valid and enforceable before bankruptcy will be so treated *after* the debtor's bankruptcy.[25] Most important, as will be explained hereafter, the secured creditor's rights will not be subordinated to the claims of the preferred classes of creditors established pursuant to section 136(1) of the Act.

V. THE COUNTER-ATTACK: DEEMED TRUSTS AND SUPERPRIORITY CLAIMS

If the story ended here, this Paper would not be needed, and we could conclude that Canada has indeed become a secured creditor's heaven. The real picture, however, is considerably more complex. For more than twenty-five years, public authorities in Canada have reacted with increasing concern to the monopolization of a debtor's assets by secured creditors and the debtors' consequent inability to meet their liabilities to the Crown and its many agencies. Until the 1992 amendments to the BIA, tax and similar governmental claims enjoyed preferred status under section 136(1) of the Act, but this only meant they ranked ahead of ordinary and deferred creditors. They were still subordinated to secured creditors.

To remedy what was perceived to be a serious inequity, the federal and provincial governments counter-attacked. The counter-attack took the following forms.[26] First, legislation was adopted creating a lien or charge in favor of the Crown against the debtor's assets which purportedly ranked ahead of all other liens and charges. Second, where taxes or other dues had been collected by the debtor on behalf of the taxing or assessing authority, or had been deducted from the salary of an employee, the amounts in question were deemed to be held in trust for the public authority.[27] Third, under section 224(1.2) of the Federal Income Tax Act, Revenue Canada was authorized to require a third party owing money to a delinquent taxpayer to make the payment to the federal government regardless of any prior claims against the same funds.[28]

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24. BIA, R.S.C., § 95 (1985) (Can.). Fraudulent preferences are also regulated under provincial assignments and preferences acts, and these have been held to be *intra vires* the provinces. See Robinson v. Countrywide Factors Ltd., [1978] S.C.R. 753 (1977).

25. BIA, R.S.C., ch. B-3, § 72 (1985) (Can.).

26. *See generally* ANNE E. HARDY, CROWN PRIORITY IN INSOLVENCY (1986); Baird, *Statutory Trusts and Liens -- Priority Over Claims of Secured Creditors*, 25 C.B.R. (N.S.) 261 (1978); W.A. Bogart, *Statutory Claims and Personal Property Security Legislation: A Proposal* 8 CAN. BUS. L.J. 129 (1983-84).

27. *See, e.g.*, Income Tax Act, ch. 63, § 227(4), 1970-1971-1972 S.C. 1311, 1850 (Can.); Canada Pension Plan Act, R.S.C., ch. C-8, § 23(3)-(4) (1985) (Can); Unemployment Insurance Act, R.S.C., ch. U-1, § 57(2)-(3) (1985) (Can.); Employment Standards Act, R.S.O., ch. E-14 (1990), *amended by* ch. 16, S.O. 1991 (Ont.).

28. S.A. Roebuck, *Revenue Canada's New Super Priority for Withholding*, 69 C.B.R. (N.S.)

The legislation under this ever expanding legislative network varied widely, but the following beneficiaries were the most important: (1) federal and provincial taxing authorities in respect of income taxes, provincial sales taxes, federal goods and services tax (GST), and premiums payable under the federal Unemployment Insurance Act and the Canada Pension Plan Act; (2) workers' compensation boards in respect of assessments against employers under provincial workers' compensation legislation; and (3) employees in respect of wages and other benefits owing to them pursuant to employment standards acts. A notable feature about these legislative intrusions is the fact that only rarely were they brought about by changes in the personal property security acts themselves;[29] it seems rather as if consensual and non-consensual security interests were travelling in different orbits.

Nevertheless, consensually secured creditors were not about to throw in the towel, and they quickly took issue with provisions they regarded as deeply inimical to their legitimate interests. They fought their battles in the courts and in the legislative halls. Each of these *fora* must be examined separately.

V. SUPERPRIORITY AND DEEMED TRUST PROVISIONS IN THE COURTS

The outcome of the judicial struggles differed greatly depending on whether the statutory provisions were being challenged outside or inside the debtor's bankruptcy. If the debtor is not bankrupt, no constitutional issue exists because the rules governing competing property claims fall preeminently under the provinces' property and civil rights power under section 92(13) of the Constitution Act. The due process clause in the Canadian Charter of Rights and Freedoms[30] does not protect economic rights.[31]

Secured creditors' lawyers were therefore remitted to interpretational arguments, and for the most part, they met with very sympathetic judicial ears. Thus, a provision conferring priority on a statutory tax lien was deemed to be only prospective in its effect and not to override existing interests,[32] and a deemed trust was recognized only if the debtor had in fact kept the collected

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33 (1988).

29. An exception appears in § 30(7) of the Ontario Personal Property Security Act. This section provides that a security interest in an account or inventory and its proceeds are subordinate to the interest of a person who is the beneficiary of a deemed trust arising under the Ontario Employment Standards Act or the Pension Benefits Act. Comparable provisions are found in several of the other Personal Property Security Acts. All the provincial acts also have a provision, like Ontario's § 4(1)(a), stating that the act does not apply to a lien given by statute or rule of law unless otherwise provided.

30. CAN. CONST. (Constitution Act, 1982) pt. 1 (Canadian Charter of Rights and Freedoms) § 7.

31. PETER W. HOGG, CONSTITUTIONAL LAW OF CANADA Vol. II, at 33-8 (looseleaf) (3d ed. Supp.).

32. Board of Indus. Relations v. Avco Fin. Serv. Realty Ltd., [1979] 2 S.C.R. 699.

taxes in a separate account.[33] Even fancier arguments have been used in restricting the federal government's garnishment powers under the Income Tax Act.[34] These are familiar interpretational problems in many branches of law and basically raise the same question: how far should courts go in interpreting tolerably plain language to avoid what seems to them an offensive result? With some notable exceptions, Canadian judges yielded when government drafters rewrote the legislation to make it clear the tax lien had priority over existing as well as future security interests and that the validity of a deemed trust did not depend on the debtor keeping the money in a separate account or the government being able to trace the collected funds through equitable tracing rules.

Constitutional issues arise where the debtor is in bankruptcy and the BIA provisions come into conflict with provincial legislation creating superpriority liens and establishing deemed trusts in favor of provincial government claims. As previously mentioned, the federal government has the responsibility for bankruptcy and insolvency legislation. However, this fact does not preclude the provinces from adopting overlapping legislation if it can be justified as an exercise of provincial powers in respect of "property and civil rights" under section 92(13) of the constitution. Where such duplicative provisions exist, the paramountcy doctrine established under section 91 of the constitution comes into play. The courts must then decide whether the federal and provincial legislation can coexist or whether the provincial legislation must yield to the supremacy of the federal enactment. When confronted with the issue, the "pronounced" tendency of the Supreme Court of Canada has been to apply the paramountcy doctrine narrowly and leave inefficiencies resulting from duplicative legislation to be resolved by political means.[35] The accepted test of incompatibility is whether the federal and provincial laws contradict each other, so making it impossible for the citizen to comply with both laws at the same time.[36] Unlike the United States courts, Canadian courts have not adopted a preemption test in applying the paramountcy doctrine.

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33. Dauphin Plains Credit Union Ltd. v. Xyloid Indus. Ltd. [1980] 1 S.C.R. 1182.

34. *See e.g.*, *Re* Pembina on the Red Development Corp., 85 D.L.R. 4th 29 (Man. Ct. App. 1991); *Re* Lloyds Bank Can., 60 D.L.R. 4th 272 (Alta. Ct. App. 1989); Canada Trusts Mort. Corp. v. Port O'Call Hotel, Inc., 24 C.B.R. (3d) 257 (Alta. Ct. App. 1994).

35. *See* HOGG, *supra* note 31, at Vol. I, ch. 16.2. A striking example of such accommodation in the bankruptcy area is found in Robinson v. Countrywide Factors, Ltd., [1978] 1 S.C.R. 753 (1977). In *Robinson*, the Supreme Court upheld the constitutionality of the voidable preferences provisions in the Saskatchewan Assignments and Preferences Act even though substantially the same ground is covered in the Federal Bankruptcy Act. *See* BIA, R.S.C., ch. B-3, §§ 91-95 (1985) (Can.).

36. In Smith v. The Queen, [1960] S.C.R. 776, 800, Justice Martland stated the test as being whether "compliance with one law involves breach of the other." *See also* HOGG, *supra* note 31, at ch. 16.4.

The compatibility of the provincial Crown liens and deemed trust provisions with the Federal Bankruptcy Act was decided by the Supreme Court in a series of cases in the 1980s. In *Deputy Minister of Revenue (Quebec) v. Rainville*,[37] the Quebec government claimed to be a secured creditor in the distribution of the bankrupt's assets. Quebec argued that under its legislation its claim for unpaid sales taxes was treated as a secured claim (*privilege*) that satisfied the definition of secured creditor in the Bankruptcy Act. A majority of the Supreme Court denied Quebec's claim on the ground that section 107(1)(j) of the Bankruptcy Act[38] made it clear that a claim for unpaid taxes was to be treated as a preferred claim and not as a secured claim.[39]

In rendering the majority judgment, Justice Pigeon stressed that section 107(1)(j) made it clear the Crown's claim was limited to that of a preferred creditor "notwithstanding any statutory preference to the contrary." This left open the question of whether other provincial Crown claims, governed not by section 107(1)(j) but by section 107(1)(h) and not containing the same exclusionary language,[40] were also restricted to preferred creditor status. The issue came before the Supreme Court in *Deloitte Haskins and Sells Ltd. v. Workers' Compensation Board*.[41] This case involved a claim to superpriority status conferred on the Alberta Workers' Compensation Board under Alberta legislation for unpaid assessments otherwise falling under section 107(1)(h). A majority of the Supreme Court, this time speaking through Justice Wilson,[42] held it made no difference because Parliament intended to restrict all the claims enumerated in section 107(1)(a) - (j) to preferred creditor status. The Supreme Court reaffirmed this interpretation in *Federal Business*

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37. [1980] 1 S.C.R. 35 (1979).

38. Section 107 read in relevant part:

> (1) Subject to the rights of secured creditors, the proceeds realized from the property of a bankrupt shall be applied in priority of payment as follows:
>
> . . . .
>
> (j) claims of the Crown not previously mentioned in this section, in right of Canada or any province, *pari passu* notwithstanding any statutory preference to the contrary.

Bankruptcy Act, R.S.C., ch. B-3, § 107 (1970) (Can.).

39. Justice Estey dissented because he believed § 107(1)(j) was not intended to preclude the provincial Crown from claiming secured creditor status if it met the definition of secured creditor in the Bankruptcy Act. *Rainville*, [1980] 1 S.C.R. at 49-50.

40. Section 107(1)(h) stated that:

> "all indebtedness of the bankrupt under any Workmen's Compensation Act, under any Unemployment Insurance Act, under any provision of the *Income Tax Act* . . . creating an obligation to pay to Her Majesty amounts that have been deducted or withheld, *pari passu*."

41. [1985] 1 S.C.R. 785.

42. Justice Estey again dissented essentially on the same grounds he articulated in *Rainville*.

Development Bank v. Commission de la Sante et de la Securite du Travail,[43] another Quebec appeal, which involved a claim for unpaid sales taxes.

British Columbia v. Henfrey Samson Belair Ltd.[44] was the last of the quartet of Supreme Court decisions to be decided in the 1980s. Its policy implications for the provinces were even more serious than the rule enunciated by the Court in the three earlier decisions. The issue in *Henfrey Samson* was not the constitutionality of a provincial superpriority provision, but the validity of a deemed trust provision involving sales taxes collected by an auto dealer pursuant to British Columbia's Social Services Tax legislation (SSTA)[45] but not remitted by the dealer before it became bankrupt. Section 18(1) of the Act provided that sales taxes collected by a vendor were deemed to be held in trust for the province and were deemed to be held separate from the vendor's assets whether or not they were kept separate by the vendor. Section 18(2) provided that taxes held in trust, or required to be collected and remitted by the vendor, were to form a lien and charge on the vendor's entire assets.[46]

The vendor had failed to segregate the collected taxes. Nevertheless, relying on a line of lower court decisions, the province argued its deemed trust claim was justified under section 47(a) of the old Bankruptcy Act,[47] and that it did not have to invoke the lien provisions in the SSTA. Section 47(a) provided the property of a bankrupt divisible among his creditors did not comprise property held by the bankrupt in trust for any other person.

A divided Supreme Court rejected the Crown's argument and overruled the contrary lower court decisions. Writing for the majority, Justice McLachlin expressed the view that sections 107(1) and section 47(a) of the Bankruptcy Act had to be read harmoniously as part of a coherent scheme of distribution of the bankrupt's assets.[48] Section 47(a) was concerned with the preservation of rights established by general principles of trust law whereas section 107(1)(j) was concerned with statutorily created claims of the federal and provincial governments for unpaid taxes. It was for the federal government, she reasoned, to determine the meaning of concepts and principles appearing in the Bankruptcy Act, and that meaning could not be changed by provincial legislation.[49] There was no doubt in her mind that Section 47(a) was meant to be limited to true trusts and to identifiable assets. Justice Cory, dissenting, favored a more elastic reading of section 47(a). He took a more realistic view of the dilemma facing the Crown if its *in rem* claim was

43. [1988] 1 S.C.R. 1061.

44. [1989] 2 S.C.R. 24.

45. Social Service Tax Act, R.S.B.C., ch. 388 (1979) (B.C.).

46. This provision was clearly addressed to the likelihood of a vendor not having segregated the collected taxes from other monies received by him.

47. *See* BIA, R.S.C., ch. B-3, § 67(a) (1985) (Can.).

48. *See Henfrey Samson*, [1989] 2 S.C.R. at 30-32.

49. *Id.* at 35.

restricted to taxes that could actually be traced at the time of the vendor's bankruptcy.[50]

VI. CRITIQUE OF THE SUPREME COURT JUDGMENTS

Secured creditors had long opposed the Crowns' attempts to trump secured creditors' claims through the adoption of "self-serving" superpriority claims and deemed trust provisions. Thus, they welcomed the Supreme Court decisions as vindicating their position.[51] Whatever one may think about the cases as an exercise in statutory interpretation, there should be no illusions about their policy and practical implications. Four such consequences are of particular importance.

The first consequence is that it leads to forum shopping. Secured creditors will put a debtor into bankruptcy for the sole purpose of avoiding provincial superpriority claims and deemed trust provisions even though the debtor's other creditors will derive no benefit from it. Such bankruptcy proceedings are commonplace in Canada today and, surprising as it may seem, the courts have refused to interfere by denying the bankruptcy petition.[52]

A second consequence is that the constitutional decisions lead to uneven results. These decisions do not impair the federal government's power to adopt superpriority and deemed trust provisions in non-bankruptcy legislation and to make it clear that they shall apply after a bankruptcy as well as before it. Such provisions are becoming increasingly common and the courts are still wrestling with the consequential interpretational issues.[53]

The third objection to the constitutional decisions is that they turn chattel security policy on its head. For the most part, and outside the areas covered by section 427 of the Federal Bank Act, provincial law governs the creation and recognition of chattel security interests, and provincial law also determines

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50. For further discussion of the judgments, see Jacob S. Ziegel, *The Supreme Court of Canada Scuttles the Deemed Trust in Bankruptcy*, 15 CAN. BUS. L. J. 498 (1989).

51. Some lawyers tried to push secured creditors' luck even further by arguing that the quartet of Supreme Court decisions also undermined the validity of the long standing provisions in provincial chattel security Acts invalidating unperfected security interests against trustees in bankruptcy. *See* Andrew J. Roman and M. Jasmine Sweatman, *The Conflict Between Canadian Provincial Personal Property Security Acts and the Federal Bankruptcy Act*, 71 CAN. B. REV. 77 (1992). *But see* Jacob. S. Ziegel, *Personal Property Security and Bankruptcy: There is No War! A Reply to Roman and Sweatman*, 72 CAN. B. REV. 44 (1993).

52. *See, e.g.*, *Re* Harrop of Milton Inc., 92 D.L.R. 3d 535 (Ont. 1979). *Re* Bank of Montreal and Scott Road Enterprises Ltd., 57 D.L.R. 4th 623 (B.C. Ct. App. 1989). Indirectly, the BIA appears to sanction the practice since § 13.4 allows the trustee to act for a secured creditor in enforcing the secured creditor's claim subject to certain safeguards being met.

53. *See e.g.*, *Re* 1653 Investments Ltd., 129 D.L.R. 3d 582 (B.C. 1981); Attorney General of Canada v. Samson Belair Ltd., 17 D.L.R. 4th 544 (B.C. Ct. App. 1985). Some of the decisions may no longer be relevant in light of the recent amendments to the federal provisions.

priorities among competing interests. Canadian bankruptcy law has long recognized this reality.[54] It is anomalous, therefore, that provincial law is precluded from subordinating provincially created consensual security interests to Crown liens in bankruptcy as well as outside it. Although provincial law may be schizophrenic in taking with the right hand what is given with the left, it is for the provinces and not federal law to resolve this conflict.

The last objection is that the invalidation of provincial priority rules in bankruptcy is repugnant to what influential bankruptcy scholars believe is a basic postulate of bankruptcy policy.[55] These scholars believe bankruptcy law's primary function is to prevent piecemeal dismemberment of an insolvent's estate, to provide an orderly and efficient procedure for the gathering in and liquidation of the debtor's assets, and to distribute the net proceeds among the creditors. According to this school of thought, prebankruptcy rights and obligations should be recognized in bankruptcy and only such substantive changes should be permitted as are essential for the realization of bankruptcy's primary goals.

The merits of the above arguments are contestable. In particular, there are bankruptcy theorists and lenders who view the adoption of substantive policies as a legitimate goal for federal bankruptcy law. They may in fact see it as intrinsic to the national character of bankruptcy legislation. However, the theoretical aspects of the invalidation of provincial lien provisions have received scant attention in Canada. The constitutional battles have largely been viewed as proxies for the much broader public choice debate involving the inherent merits of Crown liens and whether they should be given superpriority status at any time, whether in or outside of bankruptcy and whether pursuant to provincial or federal law. It is to this larger canvass that I must now turn.

VII. THE PROS AND CONS OF CROWN PRIORITIES

Since the publication of the Report of the Study Committee on Bankruptcy and Insolvency Legislation in 1970,[56] there has been a vigorous debate in Canada about the priority position of Crown claims.[57] Before describing

54. *See* BIA, R.S.C., ch. B-3, § 72(1) (1985) (Can.) (stating the "Act shall not be deemed to abrogate or supersede the substantive provisions or any other law or statute relating to property and civil rights that are not in conflict with [the BIA].").

55. For example, see Morris G. Shanker, *The Use and Abuse of Federal Bankruptcy Power* 26 CASE W. RES. L. REV. 3 (1975). THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986).

56. *Report of the Study Committee on Bankruptcy and Insolvency Legislation* 112-13, 122-23 (Ottawa 1970).

57. *See id. See also* Law Reform Commission of British Columbia, *Report on the Crown as Creditor: Priorities and Privileges* L.R.C. 57 (1982); Canada, *Proposed Bankruptcy*

the positions taken by the protagonists on either side of the debate, it is important to distinguish between those critics who would deny any priority to Crown claims and those who would retain the Crown's preferred creditor position in what was section 136(1) of the pre-1992 Bankruptcy Act.

One might have expected consensual secured creditors to have acquiesced in the federal and provincial governments and their various agencies retaining their status as preferred creditors, or at least to be neutral with respect to it, since they were not prejudiced by it. As we have seen, the quartet of Supreme Court decisions strongly protected secured creditors from provincial attempts to bypass the rankings established in section 136(1). Nevertheless, in the ongoing debate over the past twenty-five years secured creditors have been firmly opposed to any preferential treatment of Crown claims, whether with respect to ordinary creditors or with respect to secured creditors.

Secured creditors' voices have overshadowed the views of unsecured creditors. Secured creditors presumably calculated that it was better to take a principled position than to concede any merit in the argument favoring preferential treatment of Crown claims. A bystander might also have detected an element of Machiavellianism. In Canada, when a secured creditor holds, or a combination of secured creditors hold, a security interest in all or substantially all of a debtor's assets, on the debtor's bankruptcy there is usually nothing left over to be divided among the bankrupt's unsecured creditors. This being the case, it matters little to the latter group whether the Crown is treated as a preferred creditor or is remitted to the bottom of the ladder with the other unsecured creditors. The pickings for both will be equally slim.

The arguments against giving Crown claims secured status, and *a fortiori* superpriority status, are fairly straightforward. Crown claimants, it is argued, can diversify their risks over large numbers of taxpayers and can contain their losses by better policing of debtors. It is also contended that conferring priority, superpriority, or deemed trust status on Crown claims suffers from all the evils of secret liens and is profoundly unfair to consensual secured creditors in two ways. First, secured creditors have no reliable means of determining the existence of Crown claims at the time they advance the funds. Second, the emergence of superpriority claims after the secured creditor has changed its position totally undermines the value of the secured creditor's security. From the secured creditor's perspective, it does not matter whether the Crown's claim appears in the guise of a deemed trust or whether it is

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Amendments—Report of the Advisory Committee on Bankruptcy and Insolvency 78-79 (1986); HARDY, *supra* note 26, at ch. 6; Susan J. Cantlie, *Preferred Priority in Bankruptcy*, *in* CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW ch. 17 (Jacob S. Ziegel ed., 1994).

described in the legislation as a lien that takes priority over every other claim against the same collateral.

The various government departments and agencies have been just as vigorous in arguing their case.[58] It is pointed out that, unlike consensual creditors, the Crown cannot choose its debtors and that the Crown has a duty to taxpayers to collect what is owing. Canadians should not be asked to assume further burdens in the name of risk diversification. The suggestion that better policing of debtors would reduce the Crown's losses is dismissed as empty rhetoric because of the reduced staffing of government revenue offices in a time of fiscal restraints and the lack of realism in expecting the tax collector constantly to stand guard over taxpayers.

Representatives of Revenue Canada and its provincial counterparts also forcibly argue that deemed trusts, since they involve monies actually received by the debtor, should be treated differently from unpaid taxes. Such funds are essentially in the same position as proceeds from the disposition of collateral under a security agreement, which are protected under all the provincial personal property security acts.[59] It is objected that the Supreme Court's decision in *Henfrey Samson*[60] encourages collusion between the secured creditor and the debtor to ensure that collections made by the debtor on behalf of the Crown go to swell the funds available to satisfy the secured creditor's claim and therefore to reduce the contingent liability of the debtor's senior officers on guarantees given the secured creditor.

VIII. BILL C-22 AMENDMENTS

These arguments and counter-arguments came to a head in Bill C-22 and its important amending provisions to the Bankruptcy Act enacted by the Canadian Parliament in 1992. The federal cabinet found itself in the invidious position of having to mediate between the anti-Crown position generally favored by the bankruptcy branch of the Department of Consumer and Corporate Affairs (the federal department responsible for the administration of bankruptcy legislation) and the pro-Crown position urged by Revenue Canada and its provincial allies.

The federal government struck a compromise between the competing positions in a fairly complex set of provisions whose effect was as follows.[61]

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58. For one recent scholarly exposition, see B.J. Skulski, The Deemed Trust and Enhanced Provisions of the Excise Tax Act and Their Application in Relation to the Bankruptcy and Insolvency Act (1994) (unpublished memorandum, on file with the author). For an earlier and much cited defense of the Crown's position, see Morris G. Shanker, *The Worthier Creditors (And a Cheer for the King)*, 1 CAN. BUS. L. J. 340 (1975-76).

59. *See, e.g.*, Personal Property Security Act, S.O., ch. 16, § 25 (1989) (Ontario). See the broad definition of "proceeds" in § 1(1) of the Act.

60. [1989] 2 S.C.R. 24.

61. The summary that follows is not meant to be an exhaustive treatment. The summary

First, section 136(1) was revised to eliminate preferred creditor status for federal and provincial claims for unpaid taxes and for all other Crown claims treated as preferred under the pre-1992 provisions. Second, federal and provincial legislation conferring secured creditor status on a Crown claim, other than in relation to claims where a non-Crown creditor would be entitled to claim a security interest, is made ineffectual in bankruptcy[62] unless the security interest is registered before the debtor's bankruptcy or the initiation by the debtor of reorganization proceedings under the BIA pursuant to a prescribed system of registration.

Even where the security interest is registered, it is subordinated to prior perfected security interests and is only valid with respect to the amount owing to the Crown at the time of registration.[63]

The third important set of changes are introduced in section 67 of the BIA. Section 67(2) denies deemed trust status to trusts created under federal or provincial legislation in favor of the Crown unless the property or funds would be treated as being held in trust in the absence of such legislation. Section 67(3) introduces an important qualification. This section retains deemed trust status for monies collected or deducted by the bankrupt on behalf of the Federal Crown pursuant to section 227(4) - (5) of the Income Tax Act, sections 23(3) - (4) of the Canada Pension Plan Act, or sections 57(2) - (3) of the Unemployment Insurance Act, and comparable provincial legislation.

It will be seen, then, that significant victories have been won by both parties to the dispute. Non-Crown creditors have been vindicated in their long-held position that a Crown debt should not be entitled per se to preferred treatment. Thus, if the Crown wants to achieve secured creditor status, the Crown will have to comply with the perfection requirements applicable to all other security interests and be governed by similar priority rules.

The Crown has secured an important victory in the adoption of section 67(3). Its effect is to reverse the Supreme Court's decision in *Henfrey Samson,* and to protect the Crown's superpriority claims against all assets held by the debtor at the time of bankruptcy for collected but not remitted taxes and for deductions made by the debtor. Since these, in addition to the goods and services tax (GST) claims,[64] are the most common form of Crown claims in

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ignores changes in priority affecting non-Crown claims, in particular the 30-day priority given unpaid suppliers of goods in §§ 81.1 and 81.2 of the BIA. The summary also omits the federal government's failure to resolve the Parliamentary deadlock over the best way of protecting the claims of unpaid wage earners. Bill C-22 contained a separate chapter for the establishment of a contributory wage earner protection fund, but it was strongly opposed by the government's own supporters as well as members of the opposition parties and was dropped in the final bill.

62. *See* BIA, ch. 27, § 86, 1992 S.C. 628-29 (Can.).

63. *Id.* § 87(2)(a)-(b), 1992 S.C. 629-30.

64. GST claims are not included in § 67(3) of the BIA—an important omission. *See* Skulski, *supra* note 58.

bankruptcy, secured creditors will have a smaller incentive to put the debtor into bankruptcy than heretofore.

The 1992 Act requires the Federal Parliament to review the BIA three years after the 1992 amendments come into effect.[65] The requirement was added to enable Parliament to receive a report from the government on operational experience under the 1992 amendments and to determine what further amendments are desirable to the parent Act. In May 1993 the Department of Industry established an advisory committee, known as BIAC, to assist the government in preparing its report to Parliament. Working groups, established by BIAC, have been busy assessing the position and preparing recommendations. It can be confidently predicted that, while victories have been won and defeats have been inflicted, the war is far from over. Consensual secured creditors and Crown claimants remain deeply antagonistic to each other and will continue to agitate for improvements in their respective positions.

But what of the constitutional position? Because the 1992 amendments do not discriminate between federal and provincial Crown claims, the amendments have masked the tension between provincial aspirations for superpriority status and the federal government's ultimate veto power as guardians of section 91(21) of the constitution. The provincial authorities' best hope must be that strong self-interest will continue to align the federal and provincial positions and that the secured creditors' lobby will not succeed in driving a wedge between them.

65. BIA, ch. 27, § 92, 1992 S.C. 659.