

DEEMED TRUSTS AND OTHER SUPER PRIORITIES

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**FOR "THE AGONY AND THE EQUITY OF ... MORTGAGES"
CANADIAN BAR ASSOCIATION NOVA SCOTIA CONFERENCE
SEPTEMBER 17TH, 2004
HALIFAX, NOVA SCOTIA**

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1. INTRODUCTION

Federal and Provincial governments have long attempted to legislate priority for payment of amounts owed to the Crown, Crown agencies and boards or bodies charged with collecting amounts on behalf of employees or statutory schemes such as workers compensation (referred to below as “Crown claims”). Priority is asserted by creating deemed trusts and statutory liens in the statutes containing the authority to collect these amounts. These liens and deemed trusts generally need not be registered to have priority over the security interests of mortgage lenders who take their mortgage security without knowledge of the unregistered Crown interests.

Apart from federal/provincial jurisdictional issues, Provincial legislatures clearly have the jurisdiction to create statutory liens and deemed trusts (referred to below as “Crown liens”) against real property of a person and have the power to legislate that Crown liens will rank in priority to other registered interests, even though the Crown liens are not required to be registered.²

Two of the objectives of the recently enacted *Land Registration Act* (“LRA”) are:

2. to provide certainty in ownership of interests in land; and,
3. to facilitate the economic and efficient execution of transactions effecting interests in land.³

Subsection 6(4) of the LRA states:

“Except as provided in Section 73, a lien in favour of Her Majesty in right of the Province pursuant to an enactment may not be enforced against any parcel registered pursuant to this Act unless the lien is recorded pursuant to this Act.”

Section 73 of the LRA is a short list of interests in land, usually referred to as overriding interests, which need not be registered or recorded to enjoy priority over registered and recorded ones. This paper examines only those overriding interests which secure Crown liens, which are generally of most concern to mortgage lenders.

¹ I would like to thank Tim Roberts, an associate at Coady Filliter, for his assistance in preparing material for this article.

² Re Black Forest Restaurant Ltd. (1981), 37 CBR (NS) 176 (NSTD), affirmed (1981) 126 DRL (3rd) 417.

³ Land Registration Act, SNS 2001, c. 6 s. 2 clause (b) and (c).

Section 73 appears to be a recognition that Crown liens ought to be registered in the same land registration office in which mortgages are recorded, so as to create certainty as to the state of ownership in land and the efficiency of having to search only one registry.

The paragraphs of section 73 relevant to this issue are:

“73(1) Notwithstanding anything contained in this Act, the following interests, whether or not recorded or registered, and no other interests, shall be enforced with priority over all other interests according to law:

...

- (b) a lien in favour of a municipality pursuant to an enactment;
- (g) any right granted by or pursuant an enactment of Canada or the Province

...

- (ii) to cover municipal taxes, duties, charges, rates or assessments by proceedings in respect of land,
- (h) a lien for assessments pursuant to the *Workers' Compensation Act*;
- (i) an interest created by or pursuant to a statute that expressly refers to this Act and expressly provides that the interest is enforceable with priority other than as provided in this Act.”

Regrettably, paragraph 73(1)(i) contemplates that the legislature may continue to create in other statutes unregistered Crown liens having priority over registered or recorded interests, if those other statutes refer to the LRA and specifically give priority other than on the LRA's basis of order of registration. One hopes the legislator will resist creating new Crown liens that are effective without recording or that would have priority over previously recorded private interests, as contemplated under paragraph 73(1)(i).

The current status of Crown liens created by Nova Scotia provincial legislation against interests in real estate is discussed below.

10. LIENS IN FAVOUR OF A MUNICIPALITY S. 73(1)(B)

Section 133 of the *Municipal Government Act*⁴ provides that different amounts, collectively called taxes, which are payable by a property owner, constitute first liens on real property and need not be registered. These include property taxes, capital charges, deed transfer taxes and change in use tax. Interestingly, the *Fire Safety Act*⁵, enacted after the LRA, was drafted so that the fire marshals and inspectors recover their costs from the municipality and the municipality recover

⁴ Municipal Government Act, SNS 1998 c. 18, as amended.

⁵ Fire Safety Act, SNS 2002, c.6, replacing the Fire Prevention Act.

the costs from the property owner which costs would constitute a first lien on the real property as taxes in order to take advantage of the lien in section 133 of *Municipal Government Act* and paragraph 73(1)(b) of the LRA.

Sub-paragraph 73(1)(g)(ii) of the LRA refers to procedures of municipalities to recover taxes. I interpret this sub-paragraph to recognize procedural rights, such as the right to sell a property as tax sale, but not the priority as to who obtains payment from the proceeds of that sale. Priority as to payment is governed by the provisions of the lien as recognized in paragraph 73(1)(b). The municipality must have a lien in order to have any status to claim priority for the sums recovered from a tax sale.

Section 132 of the *Municipal Government Act* provides for tax certificates, and state that such tax certificates are binding on the municipality. The tax certificate must relate to all charges collectible as taxes and thus appears to mesh with the nature of amounts which enjoy the priority of the lien under section 133. Any competent mortgage lender would recognize that full priority is accorded for liens for municipal taxes over mortgage security from time to time, although it is usual practice to order a tax certificate before advancing mortgage funds or to obtain title insurance to cover unpaid taxes existing at the time the mortgage is initially placed.

11. WORKERS' COMPENSATION ASSESSMENTS – s. 73(1)(H)

Paragraph 73(1)(h) of the LRA recognizes the first lien that the Workers' Compensation Board ("WCB") has under Section 147 of the *Workers' Compensation Act*⁶ on property of an employer to collect unpaid assessments. This lien is enforceable both against real and personal property used by the employer and ranks in priority to all other liens and encumbrances including previously recorded mortgages. This priority is to continue under the LRA without any requirement to record it in the land registration office.

Before advancing under a mortgage, a mortgage lender would want a clearance certificate from WCB in respect of the owner of the property being mortgaged where the owner is apparently engaged in commercial activities. Although I am not aware of any statutory binding effect that a clearance letter typically given by WCB carries, I understand it is WCB policy to respect its clearance letters.

Attached as Schedule "A" is a copy of a sample clearance letter given by WCB showing outstanding assessments. Note that WCB will not state the amount owing without express confirmation that the lawyer requesting the clearance represents the employer or providing a consent signed by the employer to release of the information about the status of the employer's account.

⁶ Workers' Compensation Act, SNS 1994-95, c. 10, as amended.

12. OTHER PROVINCIAL LIENS S. 73(1)(I)

At first blush, paragraph 73(1)(i) appears to reduce the number of statutory liens that could attach to real property. However, all it really does in my view is to require that the other statute creating the statutory lien refer to the LRA and set out the basis for the priority to be accorded to the lien. Thus if the other statute expressly refers to the LRA then the other statute should be analyzed with the following considerations:

- Does the other statute require the Crown claim to be registered or not?
- Does the lien commence upon recording or is recording merely a precondition of retroactive effect of the lien?
- What priority is granted to the lien over the interest of other interest holders?

A number of other Provincial statutes creating Crown liens affected by the consequential amendments in the LRA are summarized in Schedule “B” to this paper. Some provisions require a certificate of the lien be registered in the parcel registry and others be registered in the judgment roll. I have also summarized in Schedule “B” the priority language in those Acts.

The consequential amendments refer to the “registration” of a Crown lien in land registration offices. Although such interests may not be registered by virtue of subsection 17(1) of the LRA, subsection 17(3) of the LRA states that where another statute authorizes the registration of an interest and that interest is not registerable, the interest may be recorded.

Courts have narrowly construed the extent and priority given to legislation seeking priority for Crown liens over pre-existing third party property interests, as illustrated in *Industrial Relations Board v. Avco Financial Services Realty Ltd. et al*⁷.

In narrowly construing statutory liens and deemed trusts Courts have considered the following:⁸

- the courts determine when the lien arises, such as when the debtor collects tax or makes deductions, when the taxing authority makes an assessment, when steps are taken to enforce the lien or trust (e.g., notice to third parties);

⁷ *Industrial Relations Board v. Avco Financial Services Realty Ltd. et al* [1979] 2 SCR 699.

⁸ See Frank Bennett, *Bennett on Receiverships*, 2nd ed. (Scarborough, On: Carswell, 1999), chapter 8.

- what property the lien attaches (real or personal property), to the debtor's ownership of the property or to the debtor's equity in the property;
- the priority granted to the lien or trust over the interest of other security holders, and whether such security holders hold a fixed or floating charge.

Since most Provincial statutes creating Crown liens have by the LRA's consequential amendments been amended to specifically refer to the LRA, the necessary pre-condition for giving effect to the priority claimed by the statute is met. This may effectively result in Crown liens enjoying the same priority after the enactment of subsection 6(4) and section 73 of the LRA as they did before, with two possible restrictions, namely that the document on which the interest is based is not recorded (most of the consequential amendments require registration) or secondly, that the delaying of the effectiveness of the Crown lien until recording may not create priority against some prior security interests, which involves a careful study of the jurisprudence interpreting the language creating priority which differs among the other statutes.

4. EFFECT ON BANKRUPTCY ON PROVINCIAL STATUTORY LIENS AND DEEMED TRUSTS

There have been attempts by provincial legislatures to characterize monies owing to them or their agents as secured claims. However, federal legislation is paramount in determining priority for payment of claims in the bankruptcy of a debtor.⁹ In many cases, secured creditors cause a bankruptcy of a debtor/property owner to ensure that provincial Crown statutory liens are reduced in the bankruptcy to an unsecured status.

In 1997, the *Bankruptcy and Insolvency Act*¹⁰ ("BIA") provided in sections 86 and 87 that Crown liens including to those owed to WCB may avoid being relegated to unsecured status in a bankruptcy to the extent that they are registered before there is a bankruptcy filing in respect of the debtor/property owner (petition, assignment in bankruptcy, notice of intention to file a proposal or a proposal) pursuant to a general registry system in the province in which a priority is based on order of registration. Where so registered, the priority of the Crown claim will rank in accordance with the priority accorded to it by its order of registration, not by the deemed priority language in the legislation creating it.

The provisions of section 73 of the LRA are consistent with these requirements of sections 86 and 87 of the BIA. If the Crown and WCB before a bankruptcy filing record their orders and claims in the land registration offices under s. 47 of the

⁹ Deputy Minister of Quebec v. Rainville [1980] 1SCR 35, 33 CBR (NS) 301.

¹⁰ Bankruptcy and Insolvency Act, RSC 1985, c. B-3, as amended.

LRA, it will improve the Crown's priority, as against unsecured creditors in a bankruptcy and create priority with respect to other interests, based on the order of registration pursuant to s. 49 of the LRA.

Thus any retroactive priority that provincial Crown liens may be afforded by other statutes over previously registered or recorded interests may be defeated by the bankruptcy of the property owner, leaving the priority of those provincial Crown liens to be determined by their order of registration or recording as permitted by sections 86 and 87 of the BIA.

5. FEDERAL STATUTORY LIENS AND DEEMED TRUSTS

Where the mortgagor is an employer, the Crown represented by Canada Revenue Agency ("CRA") has a deemed trust and lien for all unremitted source deductions referred to in subsection 227(2) of the *Income Tax Act*¹¹ ("ITA") for income tax, Canada Pension Plan contributions and employment insurance premiums.

One of the biggest concerns to a mortgage lender is the priority of a deemed trust and lien created for employee deductions for income tax, Canada Pension Plan contributions and *Employment Insurance Act* premiums under Section 227 of the ITA. The rationale of this section is that amounts deducted by an employer and not remitted to the Crown constitute "trust funds" and should receive the highest priority. The Crown is not able to determine what amounts are not being deducted without doing an audit. The Crown is thus an "involuntary creditor". It is considered that secured creditors can become more familiar with the debtor's business and finances and protect themselves by them reviewing the status of source deductions or taking other applicable security. Various court decisions have noted that approximately 85% of tax revenues are generated through the payment of these source deductions and that the collection of such source deductions is a national priority. Amendments to section 227 of the ITA have been made to protect the priority intended by this section against the court decisions reducing the effectiveness of the deemed trust.

This rationale is not one shared by all secured creditors, since they can find their security substantially eroded when the Crown asserts a claim of deemed trust. The current version of the priority of the deemed trust and lien set out in subsection 227(4.1) gives priority to the Crown claim above all interests of third parties except to the limited extent of a prescribed security interest, defined in subsection 227(4.2) and Regulation 2201. A copy of the Regulation is attached as Schedule "C". The effect of this regulation is that the only priority that a registered mortgage will hold will be where:

¹¹ Income Tax Act, RSC 1985, (5th Supp), as amended.

- the mortgage is registered before any amounts become due under the deemed trust;
- the security is reduced by any payments made after the time at which the source deductions become due;
- the priority of the mortgage is reduced by the value of any other security which the mortgagee holds.

Thus, a mortgagee would likely have to look to his other security, for payment of any amount in excess of the amount deemed to be his prescribed security interest. These statutory provisions continue to apply after the mortgagor becomes bankrupt as they are contained in the federal legislation which expressly operates notwithstanding the BIA.

A similar deemed trust provision is contained in section 222 of the *Excise Tax Act*¹² (“ETA”) for HST collected but not remitted, except (1) it is not expressly stated to operate notwithstanding the BIA, and (2) no regulation has been yet enacted defining “prescribed security interest” so the HST deemed trust applies to all prior recorded interests, including recorded mortgages, but loses priority in the event that the mortgagor becomes bankrupt.

The deemed trusts created under the ITA have been interpreted to rank behind in priority to a security interest such as a conditional sales contract whereby a vendor transfers property, subject to a title retention clause, to a tax debtor.¹³ The same logic would apply to the deemed created under the ETA.

The provisions of the LRA, including s. 73, will not affect the priority of these federal deemed trusts and statutory liens.

Both Section 223 of ITA and Section 316 of ETA provide a second mechanism of securing Crown claims owing against real estate by the registration in the registry of deeds of a memorial, being the certification by the Federal Court of an amount stated by CRA to be assessed and owing by a tax debtor. However, this mechanism applies to all Crown claims in the ITA and ETA, not just the principal amount of source deductions or collected but unremitted HST. The recording of the memorial in the judgment roll creates a security interest against the land of

¹² Excise Tax Act, RSC 1985, as amended

¹³ DaimlerChrysler Financial Services (Debis) Canada Inc. v. Mega Pets Ltd., 2002 BCCA 242, 2002 Carswell BC 786, 33 CBR (4th) 44 (BCCA)
Minister of National Revenue v. Schwab Construction Ltd., 2001 SKQB 151, 2001 Carswell Sask 315, 31 CBR (4th) 75 (Sask CA)
Bank of Nova Scotia v. Turyders Trucking Ltd., 2001 Carswell Ont 4945, 32 CBR (4th) 14 (Ont SCJ).

the tax debtor. The priority of the charge is based on the order of registration. In both cases, the judgments continue to survive after bankruptcy as a secured charge because of the specific statutory language in the federal legislation and the permissive language of sections 86 and 87 of the BIA.

4. BANKRUPTCY – PRIOR REGISTERED JUDGMENTS THAT SURVIVE

When examining an abstract, one may consider that all judgments registered prior to the bankruptcy of the judgment debtor are discharged as encumbrances on the real property of the judgment debtor by reason of s. 70(1) of the BIA, except:

- judgments against a bankrupt who conveyed the property to a third party after the judgments and prior to bankruptcy (*Starratt v. Turner* (1989) 78 CBR (NS) 83 NSCA);
- judgments in favour of the federal or provincial Crowns or Workers' Compensation Boards which are registered in the Registry of Deeds or land registration office before a petition is filed against a debtor, a debtor makes an assignment, a debtor files a notice of intention to make a proposal or a debtor files a proposal if:
 - the judgment is for amounts owing under the *Income Tax Act* and registered on or after June 18th, 1998 (when s. 223(11.1) of the *Income Tax Act* was proclaimed);
 - the judgment is for amounts owing under the *Excise Tax Act* and registered on or after October 20th, 2000, when s. 316(10.1) of the *Excise Tax Act* was proclaimed;
 - the judgment is for amounts owing under the *Customs Act* and registered on or after November 29, 2001, when s.97.24(15) of the *Customs Act* was proclaimed; or
 - the judgment is for amounts owing under any other federal or provincial statutes after the date that such statute states the judgment is a secured claim in accordance with s. 86(2) and 87 BIA – this would include most of the statutes creating Crown liens that provide for registration of a memorial - see discussion in section 5 above.

2. SEARCHES

With the effective dates of the LRA for the remainder of the Province rapidly approaching, real estate lawyers placing mortgages will virtually be exclusively dealing with the LRA since each mortgage will be a triggering event requiring the property to be converted to the LRA system. For mortgagors engaged in commercial activities, a lawyer ought to consider requesting initial clearance letters from the bodies administering the Crown liens indicated in Schedule "C" which are applicable to that mortgagor because it may be a material risk to the lenders if there are significant Crown liens in existence at the time of advance of the loan. However, in the event the mortgagor becomes bankrupt, the priority of Provincial Crown liens will be relegated to that determined by their order of registration (except property taxes). Thus it would be appropriate to review the Crown liens to determine which clearance letters are appropriate in any given circumstance.

3. OPINIONS

Most mortgage lenders should be aware that Crown liens can arise and rank in priority over their security. Nonetheless it is useful for a lawyer to expressly state in a reporting letter that the priority of their mortgage security may be subject to the provisions of statutory liens and deemed trusts from time to time.