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A Mugging on Bay Street

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Case Commented On: *The RRSP Trust of James T. Grenon by its Trustee CIBC Trust Corporation v. Her Majesty the Queen*, 2025 FCA 129 (CanLII)

Most corporate lawyers avoid reading tax court decisions. Tax is a pretty specialized practice area, and for non-specialists the entire area of tax law gives off the insalubrious air of a dark alley in an unfamiliar city. Except worse, because in a tax case you know for a fact there is someone down that alley who wants to rob you of your money.

Corporate lawyers should make an exception, however, for the recent decision in *The RRSP Trust of James T. Grenon by its Trustee CIBC Trust Corporation v. Her Majesty the Queen (Grenon)* by the Federal Court of Appeal. This is because the court finds itself interpreting provincial securities laws in a way that would be very surprising to most non-tax lawyers. In fact, the way the court (i) interprets the term "principal" (found in many private placement exemptions), (ii) the consequences that it suggests follow from imprecise investor representations in subscription agreements, and (iii) the way the court determines what constitutes a "lawful" offering under RRSP rules, all violate long-established securities practice and threaten to destabilize private placements of all kinds.

The facts of the case are relatively straightforward. The individual taxpayer created several mutual fund trusts that were designed to be RRSP eligible. He contributed most of the money to the trusts ($300 million), but in order to obtain the requisite 150 holders of trust units (required under *Tax Act* Regulation 4801), he arranged for each of the trusts to distribute securities to third-party investors under the offering memorandum exemption. Most, if not all, of the investors bought a minimal number of trust units.

The offering memorandum exemption permits companies to issue shares without clearing a prospectus, provided investors receive a comprehensive disclosure document describing the investment called an "offering memorandum." Prospectus offerings are time-consuming and expensive, so they have gradually been disappearing as a financing mechanism throughout the developed world. They have been replaced by increasingly liberal private placement regimes, a trend the court in *Grenon* does its best to reverse.

The investments made by the trusts in *Grenon* were successful, the taxpayer received cash from the trusts into his RRSP completely tax free, and when the CRA realized what was going on they punched their fist through their hat and reassessed some tax returns. The reassessments have now been considered by the principal tax courts in the country: the Tax Court of Canada and the Federal Court of Appeal. There were many issues raised by the various parties, but by the time the case

was thoroughly masticated by the Federal Court of Appeal, the central issue turned out to be a matter of securities law.

Regulation 4801 under the *Income Tax Act* provides that a mutual fund trust must have made "a lawful distribution in a province to the public of units of the trust" and that at the relevant point in time there are "no fewer than 150 beneficiaries of the trust." The "lawful distribution" requirement is why the tax court ventured out of their normal dark tax alley and onto Bay Street, but the 150-holder requirement is what got them lost in unfamiliar surroundings.

The court analyzed the distributions and found two initial reasons why it felt the distributions were problematic: (i) not all the investors were, in fact, investing as "principals," a requirement for subscriptions under the offering memorandum exemption in National Instrument 45-106; and (ii) some of the subscribers were offside representations contained in the subscription agreement.

The Federal Court of Appeal summarized its view: "…an investor purchasing as principal is expected to advance their own funds, to act in a transaction entirely for their own account, and not on behalf of others and to make the full investment themselves" (at para 266). (It is not clear what work the third criteria of "full investment" is doing. It seems to just be a repetition of the first criteria of "own funds". The entire decision reads like this.)

The Problem with Principals

The offering memorandum exemption in place across Canada requires investors to "purchase the security as principal." The Federal trial court found that approximately 30 to 40 subscribers for units in each trust were minors (at para 237). Presumably the money that they were investing came from their parents (as, outside Victorian novels, children are rarely indulged by a mysterious benefactor). The court also found that a number of adult investors purchased their units with money from someone else, usually their spouses. Were these children and spouses purchasing as "principal"?

Most securities lawyers would assume that so long as the child or spouse bore the risks of owning the security (mainly that it may decline in value) and received its benefits, they were investing as principal. It doesn't really matter where the money came from and, in any event, this isn't information that is available to a company when accepting subscriptions.

The Federal courts decided, though, that for an investor to count as a "principal" under the offering memorandum exemption, the money had to originate from them. The scale of the labyrinth opened up by the tax court's reasoning is tremendous. How long does a child or spouse have to be in possession of money before it is "theirs" and not ascribable to the breadwinner? If I give my child a government savings bond for their fourth birthday, and seven years later we decide to rebalance their investment portfolio towards equities (specifically alternative growth investments), are they then investing as "principal"? What if the money is paid to the child for doing chores? What if the money is a loan the child must pay back? Lots of investors use leverage.

Spouses present even greater complications. What if I am the sole breadwinner, but my spouse and I treat my income as our common property (which, according to family law rules on the event of

divorce, it is)? What if the investment is made on behalf of my spouse from a joint bank account (so she is an "owner" of that money), but I am the source of all the money in that joint account? Even if my spouse and I jealously guard our respective financial assets from the other, if my spouse paid for my plane ticket last month and so I pay her back by writing a check to cover her investment in a mutual fund trust, is my spouse investing as principal? There is, of course, no way an issuer can know any of these sorts of details without dramatically changing the structure, and thus the economics, of private placements. This is particularly the case as private placement proceeds are normally delivered to the company or its agents through law firm trust accounts or brokerages, which obscure the precise sources of the funds.

The Federal Court of Appeal has another requirement for purchases made as "principal." The investor must execute the subscription agreement (and presumably any other relevant document) personally (at paras 231, 234, 250, 262). They may not use an agent. Once again, this will strike securities lawyers as absurd. Agents are used all the time in securities transactions. Investment managers and brokers routinely execute subscription agreements as agents for the beneficial holders of the securities. Lawyers routinely advance subscription proceeds from their trust accounts as agent for investors. There is no earthly reason to think that Canada's securities regulators, in National Instrument 45-106, meant to overturn centuries of commercial law that uncontroversially permitted individuals to appoint agents for almost any purpose. Indeed, incorporated entities (corporations, limited partnerships) all necessarily act through agents. No one believes this means an incorporated entity is unable to rely on a private placement exemption.

The Federal Court of Appeal doesn't produce any real legal authority for the definition of "principal" they accept. The question hasn't been much litigated except in circumstances in which the purchaser was an obvious front for a third party, who was clearly the "real" owner of the securities. These sorts of cases aren't much help because no one was claiming the children and spouses in *Grenon* were simple nominees funneling the money they received on their securities back to the parent or spouse who made the gift (or repaid a loan, or paid for chores, or who knows what).

The very absence of securities law decisions on facts like those in *Grenon* should, itself, have warned the court that, in its expanded definition of "principal" it was creating an issue that didn't exist before. Securities actors and regulators didn't address the question of whether the use of agents or the source of funds went to being a "principal" because it was obvious to everyone that it didn't. The lacuna around the definition of "principal" isn't an oversight of securities law, it's a problem invented in *Grenon* by the courts' mistaken understanding of securities law and practice.

The Problem with Subscription Agreements

The Federal Court of Appeal also reposed a great deal of importance on the fact that some investors didn't conform to the representations contained in the subscription agreement. Like every subscription agreement I have ever encountered in a long career as a corporate finance lawyer, the subscription agreements for the mutual fund trust included the following representations by the subscribers:

(i) they were purchasing as principal for their own account;

(ii) they had attained the age of majority and had the legal capacity and competence to execute the agreement; and

(iii) they had (in the words of the agreement) "such knowledge, skill and experience in business, financial and investment matters so that the [subscriber] is capable of evaluating the merits and risks of an investment in the [u]nits." (at paras 42, 231).

I have already discussed why investors who will be the actual owners of the securities, bearing the risk and enjoying the profits, are "principals," so that representation is probably fine. The other representations, however, don't fit minors, though they fit their guardians.

These representations are ubiquitous in subscription agreements to protect the company from someone trying to get their money back. They are probably worthless, as judges and regulators are comfortable looking past representations like these and focusing on the substance of a transaction. However, lawyers are paid to make things as difficult as possible for potential litigants and it doesn't hurt to be able to point to representations like this if an investor complains they were taken advantage of.

There are several delightful ironies in the way the Federal Court of Appeal handled these contractual representations. The first is that they took a totally ineffective shield and fashioned it into a very effective sword. Something intended to sort-of…maybe?…protect the mutual fund trust became, in the Court's hand, something to decapitate it.

The second irony is that the court spends no time considering the third representation (about "knowledge, skill and experience") beyond mentioning it. If they took their own approach seriously, they could have eliminated virtually the entire body of subscribers. I teach very bright law students interested in corporate finance, and they don't have the first idea about how to evaluate the "merits and risks of an investment." The Court probably could have produced a result that left the taxpayer as the sole lawful investor in the mutual fund trust. The fact they didn't do this suggests that they have some awareness about the absurdity of using strictly construed boilerplate representations to determine whether a financing is "lawful."

The final irony, and the one worth considering at greater length, is that the court decided that whether a financing is "lawful" under the regulations of the *Tax Act* ultimately depends on whether legally unrequired representations in a private contract are accurate. Is that possibly what the drafters of the regulations intended? Are we to believe the Federal cabinet felt it was important, as a matter of public tax policy, that all contractual representations entered into by third parties (not, it should be noted, the issuer or the taxpayer in question) be accurate? Even more importantly, how likely is it that the drafters of the regulation wanted to create a situation where information about the purchaser of securities that nearly always will lie outside the issuer's knowledge can blow up a carefully created tax structure?

The fact is, in the real world of capital markets (what I have been calling Bay Street in this essay), subscription agreements are not negotiated and drafted individually with each subscriber in mind. This would be absurdly expensive and time-consuming. A single subscription agreement for a deal

is generated and literally hundreds of copies of it are sent out everywhere. The subscription agreement representations exist in the form they do because they are applicable to most investors. They are, in short, boilerplate.

The existence of boilerplate representations in subscription agreements is not solely due to the absence of economically practical alternatives. It also owes its existence to the fact that everyone who works with subscription agreements understands their real audience is securities regulators. The main thing in a subscription agreement (aside from giving the investor's name, registration instructions, and the number of securities being purchased) is a series of representations that the purchaser conforms to the rules of a private placement exemption.

Aside from the already discussed "purchasing as principal" representation, the other representations that concerned the Court in *Grenon* have nothing to do with anything the securities regulators care about. So, unsurprisingly, lawyers also don't care. The representations are designed to protect the company, they probably won't work if a fight breaks out, so it is not obvious the benign neglect of the securities bar is wrong.

However, all this changes in the wake of *Grenon*. If these purchaser representations are capable of making an otherwise perfectly acceptable subscription "unlawful" (at least for tax purposes) then securities practice must change. It goes without saying that customizing subscription agreements will add considerable expense and bother without improving anything that we care about (like investor protection). If it has an effect at all, it will be to simply make retail investors even less attractive as a source of finance, which runs contrary to the direction of public policy in this country. The securities commissions of all Western countries, including Canada, have been liberalizing their private placement regimes for over a decade now to make private offerings easier. By requiring individual customization, the Federal Court of Appeal has decided to make retail offerings harder – maybe impossible at scale.

The Problem with the Tax Court's Approach

At the end of all its machinations, the Federal Court of Appeal is faced with a serious problem. The mutual fund trusts in *Grenon* had more than 150 beneficial holders of trust units. Most of those investors had purchased their units in conformity with securities law rules (let's call them "good investors"). Each trust had made a distribution that was – at least in respect of the good investors – "lawful" under Regulation 4801. Arguably, therefore, the requirements of Regulation 4801 were met.

The Court clearly dislikes this sort of analysis. It has discovered flaws in some of the subscriptions, and it clearly believes these flaws must produce consequences for the taxpayer. Getting from Bay Street to debtors' prison may be easy in real life, but as a legal matter it proves very complicated. As noted above, the Court believes that even if the trusts in *Grenon* have technically complied with Regulation 4801, there are many failures to comply with what the Court has decided is securities law (let's call these representation-ignorers, gift-receivers, and agent-users the "bad investors"). It is here that, like all good securities law cases, the Court starts getting into math.
The Court doesn't claim that all 150 beneficial holders have to be good investors. The 150-holder requirement is entirely separate from the "lawful distribution" requirement, which the court makes

clear is the only requirement of Regulation 4801 the trusts in *Grenon* violated (at para 287). The Court also understands that a single bad investor should not result in blowing up an expensive and otherwise acceptable tax structure involving many innocent third parties. In one place the Court writes:

> "I do not read the Tax Court as saying that a lawful distribution required that every investor who acquired units under the [offering memorandum] comply with the [offering memorandum exemption]. Were that so, a single non-complaint subscription would be sufficient to disqualify the entire distribution, regardless of the issuer's knowledge of the deviation. …[S]uch a conclusion could have ramifications beyond this appeal. " (at para 278)

It is hard not to love the sly use of the word "could" in that last sentence. The use of the studiously value neutral "ramifications" is also an artful dodge. While the Court is probably unaware of the chaos their interpretation of "principal" and subscription agreements will create in the market, it knows exactly the impact on the market of blowing up a RRSP structure following the retroactively-discovered existence of a single (or even a few) bad shareholders.

For one thing it will be very hard to sell RRSP-qualified products in the future. In the quote above, the reference to the "issuer's knowledge" is particularly obfuscatory. From a policy standpoint the issuer's knowledge is irrelevant. The important parties are the innocent trust unit subscribers. They are the taxpayers victimized by a RRSP structure falling apart years after they began relying on it. If it is implausible the issuer could discover the existence of every bad shareholder, it is flat-out impossible for other investors to discover them. As a result, who will trust their money to RRSP-qualified entities conducting private placements?

While the Court works to rhetorically minimize the problem through the judicious wordsmithing noted above, it is clearly aware of it. Any reader of the decision will naturally be very interested in how they solve the problem. I regret to say that they don't.

Immediately after identifying the problem in the paragraph quoted above, the Federal Court of Appeal goes on to discuss how it found fewer than 160 good investors, and this is ultimately the reason the distribution was "unlawful": the offering memorandum had established a minimum distribution requirement of 160 unitholders. (This is ten more holders than the 150 that Regulation 4801 requires, probably an attempt by the *Grenon* trusts to play it safe and ensure compliance with the Regulation – another delightful irony). It is not clear what relationship the unlawfulness of violating the offering memorandum exemption has with this additional "unlawfulness" of failing to meet the offering memorandum's condition of 160 holders.

The most charitable interpretation of the Court's reasoning goes as follows:

1. The "unlawfulness" that distinguishes the bad investors means that they should not count toward the 160 minimum set out in the offering memorandum. This is the case even though the Court also finds that the bad investors, through their subscriptions, actually became bona fide beneficial unitholders (at para 287).

2. The failure to meet the offering memorandum minimum threshold is another reason the distribution was "unlawful," except for reasons never explained, this type of unlawfulness is somehow sufficient to make the entire distribution unlawful, which the mere presence of many bad investors could not have done (at para 288-290).

It is difficult to see how this reasoning solves the problem. Every offering memorandum selling a security intended to be qualified for RRSP accounts is either explicitly or implicitly going to have a minimum subscription condition as Regulation 4801 requires 150 holders. The Court pretends at one point that you could avoid having a condition like this in your offering memorandum (at para 229), but no one will buy a RRSP-qualified security without a condition that the RRSP requirements will be met.

As a result, the Court's reasoning both smuggles the 150-holder requirement back into the analysis, which is something the Court repeatedly says it doesn't want to do (at paras 278, 285, 287), and it creates an unworkable guideline for future offerings.

The rule the court ends up creating (without ever being conscious they are doing so) runs as follows: "if you want to create a RRSP-eligible structure, you are virtually guaranteed at some later date to discover bad shareholders. (It will be at a later date, in the midst of discoveries with the CRA, because only then will you get details on the sources of funds, the use of agents, and the accuracy of subscriber representations). Your stated offering memorandum minimum condition should, therefore, be as low as possible (150 holders), but you should plan on having a *secret* minimum about thirty to forty percent higher than that, so the inevitable bad shareholders don't cause you to fall below the stated 150 subscriber minimum. Whatever you do, however, don't actually disclose this much higher minimum threshold for closing in the offering memorandum, because then it can be used against you by the tax courts." So, in other words, lie.

If you are an investor, you won't know about the secret minimum threshold. All you will know is that the stated minimum in the offering memorandum is 150 holders and that if the company closes (as is their right) once they reach that number, a single bad shareholder will be enough to disqualify your RRSP investment years from now when the tax consequences are particularly painful.

The *Grenon* decision will, if it stands, cause real problems in securities practice. The definition the Federal Court gives "principal" in the offering memorandum exemption (and thus, logically, in every exemption) contradicts long-established practice and create unfixable problems for future financings. Its conclusions about "lawfulness" in RRSP-eligible investments creates equally insuperable problems for private placements attempting to create these sorts of issuers. In all cases, the effect of the decision will be to significantly increase investor risk.

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