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Confused about CRA Compliance Clauses?

By Christopher Porter, MBA, CA•CIRP

It's a lot like watching a tennis game. On February 9, 2006, Registrar Scott Nettie in *Re McClory* WL 23120 (Ont. S. C. J.) held that the Canada Revenue Agency (CRA) compliance clause commonly included in many Division I proposals unfairly prejudiced the rights of future creditors. Since then, insolvency professionals have been watching subsequent related court cases volley back and forth.

The outcome of the McClory decision has significantly impacted the hundreds of proposals that trustees bring to the Toronto courts for approval every year—and could have repercussions well beyond this jurisdiction.

Ronald Michael McClory made a Division I proposal, which his creditors accepted. The largest creditor, CRA, insisted the proposal include a compliance clause requiring the debtor to stay current with CRA filings, remittances and quarterly instalments during the term of the proposal, failing which CRA could request an annulment of the proposal.

CRA often requires such compliance clauses in proposals when it is a major creditor, based on the premise that it is in the public interest that a debtor should not avoid tax obligations.

Registrar Nettie refused to approve the proposal, on the grounds that this compliance clause did not benefit the general body of creditors. He reasoned, "...it is clear to me that the paragraph (referring to the CRA

clause) has the effect of potentially prejudicing future creditors of the Proponent... the Proponent will almost certainly prefer CRA's future debts over any other future creditor, as a failure to do so may result in his deemed bankruptcy."

Registrar Nettie added: "This has the effect of providing a benefit to CRA, in the form of a preference, over those future creditors... Since I have found that the general body of creditors includes future creditors of the Proponent, I cannot find that a term such as paragraph 8.4 benefits the general body of creditors. I do not find the arguable rehabilitative effect of the paragraph to outweigh its negative impact on future creditors, especially when I consider the array of remedies uniquely available to CRA to enforce and realize upon any future indebtedness to it by the Proponent. Few other future creditors have such a panoply of remedies."

Characterizing the clause as, "offensive to commercial morality, and to the integrity of the insolvency system," Registrar Nettie declined to approve the proposal and McClory was deemed to have made an assignment in bankruptcy.

Until this case, the courts typically refused to approve proposals only in situations where they believed the debtor could not be financially rehabilitated. The test used by the courts is found in s.59 (2) of the *Bankruptcy and Insolvency Act (BIA)*, which states that the court shall refuse to approve a proposal if it is of the opinion that:

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- The terms of the proposal are not calculated to benefit the general body of creditors; and
- The debtor has committed an offence under ss. 198 to 200 of the Act (fraud, refusing to answer questions, falsifying or destroying records, etc.).

Registrar Nettie's decision called into question the interpretation of the first part of this "test" and immediately jeopardized Division I proposals filed in Toronto that included the typical CRA compliance clauses.

Just as it appeared that these clauses might be relegated to history,

reasonable. Mr. Justice Ground did not find that the CRA compliance clause would cause debtors to prefer CRA over other creditors as Registrar Nettie had indicated in *McClory*. He noted that Silbernagel was in tax arrears in the same year he had been discharged from bankruptcy and found that a compliance clause was reasonable from a rehabilitative perspective in the circumstances. He also accepted CRA's position that it is an involuntary creditor because it does not choose its debtors as does a commercial creditor.

Overall, Mr. Justice Ground held that the compliance clause benefits the general body of creditors, protects

the more limited compliance clause in the Looney Bazaar case would have a rehabilitative effect and would not jeopardize the rights of future creditors. He approved the proposal.

The ball was back in play.

In the aftermath of these three decisions, CRA wanted clearer guidance regarding the issues related to compliance clauses and worked with several trustees to achieve this. Three proposals, which CRA believed required such clauses, were scheduled to be heard by Registrar Nettie on the same day, July 20 2006: *Re Jaime Mallari Dalisay* (No. 32-154797), *Re Amar Deep Sharma* (No. 32-153996) and *Re*

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the ball was lobbed back into court. CRA appealed the *McClory* decision. The appeal was adjourned, however, pending the outcome of a similar case heard by Mr. Justice John Ground on April 11, 2006: *Re Silbernagel* (2006) WL 1130146 (Ont. S.C.J.).

The case was similar to that of *McClory*; Silbernagel had a large CRA debt from failing to remit income tax and GST payments. Silbernagel, however, was a previous bankrupt, whose first bankruptcy also resulted from tax issues. The proposal included a compliance clause that was very similar to the one in the *McClory* proposal.

Mr. Justice Ground reviewed previous case law, including *McClory*. He concluded that a future creditor is not a creditor as defined in the *BIA*. Therefore future creditors were not to be considered in determining whether the terms of a proposal were for the general benefit of creditors. However, the interests of future creditors could be considered in the first part of the test under S. 59(2) of the *BIA*, to assess whether the terms of the proposal were

future creditors from large CRA claims in the future, has a rehabilitative effect on the debtor in a tax-driven insolvency, and helps ensure the debtor lives up to his obligations as a taxpayer and citizen. Thus Mr. Justice Ground approved the proposal.

This decision, however, did not restore the proposal *status quo*. Since both Mr. Justice Ground and Registrar Nettie had "concomitant jurisdiction," these were parallel but opposite decisions in the Toronto court.

Lob back to Registrar Nettie.

On April 27 2006, Registrar Nettie heard *Re Chakib* WL 1315175 (Ont. S.C.J.) (the Looney Bazaar case). While this proposal also included a CRA compliance clause, unlike the *McClory* and *Silbernagel* clauses, this one required only that income tax returns be filed. It did not require remittances to be kept current.

While Registrar Nettie did not agree with Mr. Justice Ground's position in the *Silbernagel* case that the general body of creditors did not include future creditors, he was satisfied that

Lam Van Nguyen (No. 32-154108).

In *Re Jaime Mallari Dalisay*, Mr. Dalisay had been self-employed and had incurred a substantial tax debt by failing to remit his taxes. He was now, however, employed by a known, reputable employer, which would deduct and remit taxes on his behalf. Mr. Dalisay would no longer be personally reporting and remitting GST or income taxes. Thus Registrar Nettie questioned the need for a compliance clause and adjourned the case to allow the parties to reconsider the matter.

The second case involved Dr. Sharma, a medical practitioner who owed almost all of his debts to CRA. **[The author was the designated proposal trustee of Dr. Sharma - ed.]** Dr. Sharma had a history of non-compliance. In fact, prior to filing his proposal, he had been convicted of tax evasion and had paid the resulting fine.

Registrar Nettie agreed that in this situation, the requirements set out in the clause were justified because the debtor had previously failed to pay his taxes—to the extent of being con-

victed of tax evasion. He approved the proposal.

In the third case, Dr. Nguyen had incurred a substantial tax debt arising from a disallowed tax shelter. The Registrar distinguished this situation from that of Dr. Sharma in that the tax debt was the result of a single event and that there was no evidence that Dr. Nguyen had a history of avoiding his tax obligations. Further, he noted some factors that might limit the utility of a compliance clause. The Registrar

In the Toronto area, CRA has taken the position that it does not require compliance clauses in every proposal where it is a creditor. The agency will, however, provide affidavit evidence and attend approval hearings to argue its position when it believes that a compliance clause is warranted.

In the past, trustees often included “boilerplate” CRA compliance clauses in proposals, almost as “insurance”—if the clause applies, good, it’s there; if it doesn’t apply, no harm

the proposal—and will also be vigilantly monitoring the debtor’s ongoing filing and payment compliance. Thus, we need to inform debtors that CRA has powerful and swift remedies available under the *Income Tax Act*. Not only can the agency issue arbitrary assessments if returns aren’t filed, but it also has garnishment powers and can garnish a debtor’s bank account if the debtor has not remitted instalments to CRA.

To date, no appeals of the *McClory* decision have been scheduled. While it

CRA has also asked trustees to inform debtors that, as a creditor, CRA will be monitoring the performance of the proposal—and will also be vigilantly monitoring the debtor’s ongoing filing and payment compliance.

adjourned the case on the basis that insufficient evidence was presented to support the need for a compliance clause.

While the outcomes of these cases do not provide a “bright line” to determine when compliance clauses should be part of a proposal, they, and subsequent comments from CRA, do offer some guidance regarding how to draft successful proposals.

done. Now, rather than automatically including compliance clauses in proposals, trustees in the Toronto area must be proactive in communicating with CRA and be willing to adjourn creditors’ meetings to provide debtors the opportunity to file amended proposals when necessary.

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is unclear whether this decision will impact jurisdictions beyond the Toronto courts, all trustees should consider its implications. While we may still be confused about CRA compliance clauses, we have to be vigilant and proactive in dealing with both CRA and debtors for any proposals involving significant CRA debt. For now, the ball has been tossed back into the trustees’ court. ▀

Êtes-vous embrouillés au sujet des clauses de conformité de l’ARC?

Jusqu’à l’affaire *McClory* entendue par le registraire Scott Nettie, les tribunaux refusaient habituellement d’approuver les propositions uniquement dans des situations où l’on croyait que la réhabilitation financière du débiteur était impossible. Le registraire Nettie a toutefois décrété que la clause de conformité de l’Agence du revenu du Canada (ARC), couramment invoquée dans beaucoup de propositions de la Division 1, portait injustement préjudice aux droits futurs du créancier.

L’ARC en a appelé de cette décision. L’affaire a été ajournée en attendant la décision dans une affaire semblable entendue par le juge John Ground : *Re Silbernagel* (2006) WL 1130146 (Ont. S.C.J.).

Après avoir examiné la jurisprudence, y compris la décision rendue dans l’affaire *McClory*, le juge Ground a approuvé la proposition, décrétant que la clause de conformité de la *LFI* avantage l’ensemble des créanciers, protège les futurs créanciers contre d’importantes réclamations de l’ARC à l’avenir, a un effet de rétablissement sur le débiteur dans une affaire d’insolvabilité pour raisons fiscales et aide à garantir que le débiteur assume ses obligations.

La décision n’a toutefois pas rétabli le statu quo, étant donné que le juge Ground et le registraire Nettie avaient une « juridiction concomitante ».

Le 27 avril 2006, le registraire Nettie a entendu la cause *Re Chakib* WL 1315175 (Ont. S.C.J.) (l’affaire Looney Bazaar). Cette proposition comportait également une clause de conformité de l’ARC, exigeant seulement que les déclarations d’impôt sur le revenu soient déposées. Il n’était pas exigé que les remises soient tenues à jour.

Même si le registraire Nettie n’était pas d’accord avec le juge Ground dans l’affaire *Silbernagel*, il avait la conviction que l’affaire *Looney Bazaar* aurait une incidence de rétablissement et ne mettrait pas en péril les droits futurs des créanciers. Il a donc approuvé la proposition.

Dans la foulée de ces décisions, l’ARC voulait des instructions plus claires relativement aux clauses de conformité et a travaillé avec les syndicats à cette fin. Trois propositions, qui exigeaient de telles clauses, d’après l’ARC, devaient être entendues par le registraire Nettie. Bien que le résultat de ces affaires n’offre pas la plus grande clarté, elles constituent toutefois, conjuguées aux observations formulées ultérieurement par l’ARC, des éléments susceptibles de nous guider à cet égard.

La date de l’audition de l’appel de la décision *McClory* n’a pas encore été fixée.