Canada Revenue Agency: Abuser or Abused : Case Law Divided On Role Of CRA In Proposals in Bankruptcy,

By Fred Myers

Two very recent cases from the Bankruptcy Court provide a rare glimpse into starkly different judicial approaches toward Canada Revenue Agency ("CRA"). In Re Proposal of McClory, [2006] CANLII 4761, Registrar Nettie was prepared to infer that CRA had unreasonably exercised voting power to favour itself over other future creditors of the debtor. In Re Proposal of Silbernagel, (Unreported, Ontario Superior Court of Justice, April 26, 2006), the Honourable Mr. Justice Ground characterized CRA as an involuntary creditor representing the people of Canada , which was merely ensuring the rehabilitation of the debtor in seeking the very protection that Registrar Nettie had disallowed.

In both McClory and Silbernagel, debtors sought to compromise their debts and to avoid bankruptcy though the proposal mechanisms of the Bankruptcy and Insolvency Act. Generally, in a proposal, a debtor can compromise debts with the approval of a statutory majority of creditors and then Court approval is sought, to ensure that the terms of the proposal are both reasonable and calculated to benefit the general body of creditors. If the creditors or the Court refuse to approve the proposal, the debtor will be bankrupt. In both cases, the debtors made proposals to pay a portion of their debts over time and in both cases only the CRA and one or two other creditors even voted. In both cases, the debtor's proposal to creditors included a term requiring the debtor to remain current in its future tax installments while it paid off its proposal.

In McClory, Registrar Nettie found that the requirement that the debtor keep CRA current in future was an unfair preference of CRA over future creditors. That is, should the debtor fail in future, it would pay CRA before paying other creditors in order to avoid breaching the proposal. The Registrar was prepared to infer that CRA had required this term as a condition of voting in favour of the proposal. He held that the proposal therefore was not intended to "benefit the general body of creditors" but that it was "in fact, calculated (by CRA) to provide CRA with a Damoclean sword to ensure that for the duration of the Amended Proposal, the [debtor] prefers its indebtedness over any other creditor". The Registrar characterized this as being "offensive to commercial morality, and to the integrity of the insolvency system".

By contrast, Mr. Justice Ground noted that the CRA does not get to choose its debtors like a normal commercial creditor. He also noted that CRA represents the public purse. While agreeing that it is appropriate to consider the interests of future creditors in assessing the reasonableness of a proposal, Ground J. was not prepared to hold that the potential of future abuse outweighed the potential rehabilitative effect of requiring the debtor to meet its future obligations "as a taxpayer and as a Canadian citizen". Ground J. cited an absence of evidence that "CRA insisted on the inclusion of the compliance clause in order to gain an unfair advantage over prospective future creditors as opposed to ensuring future compliance by the debtor with his obligations as a taxpayer…". Absent such evidence, he was not prepared to condemn the proposal.

These cases seem to turn on the characterization of CRA's intention as drawn from its requirement of future payment of taxes. Is CRA so powerful that it can require existing creditors to sacrifice the positions of future creditors to buy CRA's current support? Or is CRA so

vulnerable to abusive debtors who run up tax debts instead of personally guaranteed bank debt, that it is appropriate to CRA to try to put an end to the debtor's tax abuse as a condition of allowing the debtor to rehabilitate? In this brief space, there is no room to do justice the arguments of either learned jurist. It seems clear that this is an important public policy debate that should continue. Watch this space…