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Justice Ground Restores the Status Quo: The Decisions in *McClory* and *Silbernagel*

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The decision of Registrar Nettie in *McClory (Re)*, [2006] O.J. No. 639 (Sup. Ct.), no doubt caused surprise and dismay to both the parties involved and the insolvency bar. Registrar Nettie's decision took umbrage with the power wielded by Canada Revenue Agency ("CRA") in the proposal process. The decision also threatened to have wider implications for all proposals, particularly those in which there is a dominant creditor who is granted certain benefits under its terms.

<u>The *McClory* Decision</u>

In *McClory*, the debtor negotiated and obtained approval of a Division 1 proposal with his creditors, including CRA. CRA was the debtor's largest non-contingent creditor and the cause of the debtor's insolvency was the significant arrears of personal income taxes. The proposal contained certain standard clauses that CRA usually requires in these types of proposals. On the unopposed application for court approval of the proposal, the Registrar refused to grant such approval for the reasons outlined below. None of the creditors, including CRA, appeared at the hearing, likely because they did not believe it was necessary to do so.

Under section 59(2) of the *Bankruptcy and Insolvency Act* ("BIA"), when the court is of the opinion that the terms of a proposal are either (i) not reasonable or (ii) not calculated to benefit the "general body of creditors", the court must refuse to approve the proposal. The Registrar found that the proposal in this case failed both prongs of the test. In the Registrar's view, the proposal was not reasonable because it required the debtor to execute an assignment of his future tax returns, which is prohibited under section 67 of the *Financial Administration Act.* The proposal therefore contained an illegal and unenforceable term. A proposal that contains an illegal term is itself illegal and, therefore, unreasonable.

The Registrar also found that the proposal was unfair to the general body of creditors, which he held included post-proposal creditors, and unfairly favoured CRA. The offending term required the debtor to keep regular filings and remittances to CRA current and provided that if he did not do so, the sole Inspector, who was appointed by CRA, could declare the proposal to be in default and have it annulled (the "compliance clause"). Registrar Nettie held that the compliance clause ensured that CRA would receive a form of preference over other creditors. The Registrar found this particularly repugnant given that CRA is capable of utilizing a unique set of remedies to realize on and enforce any future debt and called it "an example of the recklessness and carelessness of creditors" and a "Damoclean sword". In refusing to approve the proposal, Registrar Nettie stressed that the creditors' wishes are not determinative and that it is the Court that must ultimately decide whether or not to approve a proposal.

When a proposal is rejected by the Court, the debtor is deemed to have made an assignment in bankruptcy under section 61(2) of the BIA. The Court can only reject or approve a proposal. Under the Bankruptcy Rules, the Court does not have the ability to make "an alteration in

substance". If a proposal is not approved, the debtor or trustee can either appeal the Registrar's decision to a judge or make a new proposal.

The *Silbernagel* Decision

The decision in *McClory* was appealed by CRA. However, the appeal was adjourned pending the outcome of a similar case that was heard by Justice Ground on April 11, 2006, *Silbernagel (Re)* (April 26, 2006), Toronto 31-447102 (Sup. Ct.). The facts in *Silbernagel* were similar to those in *McClory,* in that the debtor had a large debt to CRA arising out of the debtor's failure to remit income tax and GST. However, the debtor in *Silbernagel* had previously made an assignment in bankruptcy due to a tax-related insolvency. The proposal contained a compliance clause that was substantially similar to the one in *McClory.*

In his decision, Justice Ground referred to the *McClory* decision extensively. In *McClory,* Registrar Nettie had concluded that the "general body of creditors" referred to in the second prong of the test for approval included post-proposal creditors. Justice Ground examined the language of the definition of "creditor" in the BIA and the definition of "claims provable in bankruptcy" under section 121(1) of the BIA and held that a person who may become a creditor at some future date is not a "creditor" as defined under the BIA. Justice Ground also reviewed the authorities relied upon by Registrar Nettie on this point and held that they did not support the proposition as stated by Registrar Nettie, but rather the proposition that the interest of future creditors should be taken into account under the first prong of the test, in determining whether the terms of the proposal are reasonable.

Justice Ground did not share Registrar Nettie's concern with respect to the CRA compliance clause and its potential ability to cause debtors to prefer CRA over other creditors. Justice Ground accepted CRA's submission that the inclusion of this clause was meant to redress certain inequities as between CRA and future creditors, since CRA is in effect an involuntary creditor. He also remarked that a debt to CRA "is a debt to the people of Canada." Justice Ground specifically disagreed with Registrar Nettie's finding that the inclusion of the compliance clause did not accord with commercial morality or the public interest.

While the decision in *McClory* raised some interesting issues about the court's role in supervising the proposal process through its power to ultimately approve (or not approve) the proposal and CRA's ability to require certain standard clauses in proposals, it appears that the status quo has been restored by the *Silbernagel* decision. *McClory* has been decisively overruled. CRA appears to be free to continue to require that its compliance clause be included as a term in proposals where it is a creditor. It also appears that interested parties should consider participating more fully in the court approval process for proposals so that they can address any concern the court may have in respect of provisions in a proposal and whether they comply with section 59(2) of the BIA.