COMMERCIAL INSOLVENCY REPORTER

National Editor: Linc Rogers, Blake Cassels & Graydon LLP

VOLUME 26, NUMBER 1 Cited as 26 Comm. Insol. R. OCTOBER 2013

• COMI OR NOT COMI: TIMING IS THE QUESTION (*IN RE FAIRFIELD SENTRY*) •

Karen S. Park
Schulte Roth & Zabel LLP

Enacted by Congress in 2005, Chapter 15 of Title 11 of the *United States Code* [*Bankruptcy Code*] was derived from the *Model Law on Cross-Border Insolvency* [*Model Law*][1] and governs ancillary and cross-border bankruptcy cases.[2] It is the U.S. equivalent of Part IV of the *Companies' Creditors Arrangement Act* [*CCAA*][3] and Part XIII of the *Bankruptcy and Insolvency Act* [*BIA*],[4] also progenies of the *Model Law*. The goal of Chapter 15 "is to incorporate the [*Model Law*] so as to provide effective mechanisms for dealing with cases of cross-border insolvency, while promoting international cooperation, legal certainty, fair and efficient administration of cross-border insolvencies, protection and maximization of debtors' assets, and the rescue of financially troubled businesses."[5]

Chapter 15 facilitates its stated goals by providing for recognition of a foreign insolvency proceeding by a United States bankruptcy court if certain requirements are met. Specifically, under s. 1517 of the *Bankruptcy Code*, the bankruptcy court is mandated to recognize a foreign proceeding if, among other requirements, the foreign proceeding is determined to be either a "foreign main proceeding" or a "foreign nonmain proceeding" within the meaning of s. 1502 of the *Bankruptcy Code*.[6]

• In This Issue •

COMMERCIAL INSOLVENCY REPORTER

The **Commercial Insolvency Reporter** is published bi-monthly by LexisNexis Canada Inc., 123 Commerce Valley Drive East, Markham, Ontario L3T 7W8

ISBN: 0-433-47336-3 ISSN: 0832-7688
ISBN: 0-433-47338-X (Print & PDF)
ISBN: 0-433-47337-1 (PDF)
Subscription rates: $355 per year (Print or PDF)
$465 per year (Print & PDF)

Please address all editorial inquiries to:

Boris Roginsky, Journals Editor
LexisNexis Canada Inc.
Tel. (905) 479-2665; Toll-Free Tel. 1-800-668-6481
Fax (905) 479-2826; Toll-Free Fax 1-800-461-3275
Internet e-mail: cir@lexisnexis.ca.

"Center of main interests" or "COMI" is not defined in the *Bankruptcy Code*.[7] The statute only establishes a rebuttable presumption in favour of the debtor's registered office.[8] The question of how to define COMI and where a debtor's COMI is located has been a source of considerable discussion and debate in courts and by commentators, legislators, and policymakers in the United States, Canada, and other jurisdictions that have implemented this concept in their respective national laws. As described further below, the U.S. courts' COMI determination can impact the substantive rights of creditors and other parties in a debtor's bankruptcy case.

Earlier this year, the United States Court of Appeals for the Second Circuit ("Second Circuit") weighed in on the discussion and affirmed a district court's decision to confirm that the COMI of a British Virgin Islands (BVI) fund in liquidation was the BVI and, therefore, that the liquidation was a foreign main proceeding within the meaning of Chapter 15.[9] The Chapter 15 debtor, Fairfield Sentry Limited ("Sentry"), was a feeder fund that, until the arrest of Bernard Madoff ("Madoff") in December 2008, had invested roughly 95 per cent of its assets with Bernard L. Madoff Investment Securities LLC ("BLMIS").[10]

Both the Second Circuit and the United States District Court for the Southern District of New York ("District Court") agreed that the United States Bankruptcy Court for the Southern District of New York ("Bankruptcy Court") had correctly analyzed Sentry's COMI as of the filing of the Chapter 15 petition and had properly considered the liquidation and administrative activities undertaken in the months prior to that filing.[11] As discussed below, the appellants—shareholders who had filed a derivative action in state court claiming that Sentry's management, directors, and others had breached their duties—

argued, among other things, that Sentry's COMI was New York, not the BVI.[12]

The Second Circuit's decision in this case provides guidance on how U.S. courts might make this important determination in cases where a debtor is subject to a liquidation or winding up in a foreign proceeding.

Facts and Background

Sentry was organized in 1990 as an international business company under the laws of the BVI.[13] Pursuant to its memorandum of association, Sentry administered its business interests during its operating history from the BVI, where its registered office, agent and secretary, and corporate documents were located.[14] Its day-to-day operations were handled by an investment manager based in New York.[15] Its three directors were residents of New York, Oslo, and Geneva, respectively.[16]

When Madoff was arrested in December 2008, all of Sentry's share redemptions were suspended, and the fund directed its efforts to winding down its business and preserving assets in anticipation of litigation and bankruptcy.[17] In February 2009, a litigation committee was constituted by certain of the directors with authority to consider, commence, and settle litigation to be taken by or against Sentry.[18] In May 2009, certain shareholders commenced a derivative action against Sentry's directors, management, and others in New York state court.[19] Two months later, in July 2009, upon an application to a BVI court ("BVI Court") by certain shareholders, Sentry's liquidation proceeding was commenced in the BVI ("BVI Proceeding") and a liquidator appointed ("Liquidator").[20]

In June 2010, 11 months after the BVI Proceeding was commenced, the Liquidator petitioned the Bankruptcy Court for recognition of the BVI Proceeding as a foreign main proceeding under Chapter 15.[21] As of the Chapter 15 petition date, Sentry's liquid assets were located in accounts in Ireland, the U.K., and the BVI.[22] Its other assets included various claims and causes of action, including claims against BLMIS under the *Securities Investor Protection Act*, claims against customers who had benefited from redemptions in New York and the BVI, and other claims asserted in proceedings in the Netherlands and the BVI.[23] All these claims were undertaken by the Liquidator under the supervision of the BVI Court.[24]

The Bankruptcy Court granted the Liquidator's Chapter 15 petition, determining that Sentry's COMI was the BVI and, therefore, that the BVI Proceeding was a foreign main proceeding pursuant to s. 1502 of the *Bankruptcy Code*.[25] In making its determination, the Bankruptcy Court examined Sentry's activities in the 18-month period from December 2008 (when Sentry stopped doing business) to June 2010 (when Sentry's Chapter 15 petition was filed).[26] Under s. 1520 of the *Bankruptcy Code*, the recognition of the BVI Proceeding as a foreign main proceeding imposed an automatic stay on any other proceeding against Sentry in the U.S., including the derivative action suit commenced by the shareholders.[27] The Bankruptcy Court concluded in the alternative that even if the BVI Proceeding were a foreign "nonmain" proceeding (in which case the stay would not be automatic), a stay of the lawsuit was nevertheless appropriate.[28]

The shareholders who had commenced the derivative action appealed the bankruptcy court's order to the District Court.[29] The District Court affirmed the Bankruptcy Court's decision.[30] More particularly, the District Court held that as of the Chapter 15 petition date, Sentry had no place of business, management, or tangible assets in the United States, and that it had been appropriate for the Bankruptcy Court

to consider the BVI-based Liquidator's activities in determining Sentry's COMI:

> Sentry effectively ceased doing business more than 18 months before its Chapter 15 Petition, and 7 months before the commencement of the BVI Proceeding. Upon the revelation of the Madoff fraud in December 2008, Sentry discontinued the transfer of funds for investment with BLMIS in New York, which comprised 95% of Sentry's investments. The board of representatives at the [investment manager] resigned shortly thereafter, and Sentry's contracts with [the investment manager] were severed in 2009, before the filing of the Petition. As a result, Sentry has no place of business, no management, and no tangible assets located in the United States. The BVI based Liquidators have been directing and coordinating Sentry's affairs since their appointment in July 2009. Accordingly, the Bankruptcy Court appropriately considered the Liquidator's activities in determining Sentry's COMI.[31]

The District Court also found that there was no clear error in the Bankruptcy Court's consideration of the evidence supporting its determination that Sentry's COMI was the BVI, which evidence included the following findings:

- Sentry was incorporated and maintained its registered office in the BVI.
- An independent litigation committee governed Sentry's affairs for several months leading up to the commencement of the BVI Proceeding, with the majority of that committee's administrative decision making originating in the BVI.
- The BVI-based Liquidators had been directing and coordinating Sentry's affairs since the commencement of the BVI Proceeding.
- Sentry's liquid assets ($17.5 million) were held in a BVI account.
- Sentry had BVI-resident employees and offices and had undertaken to transfer books and records to office space leased in the BVI.[32]

The appellants argued that there were a number of factors demonstrating that Sentry's COMI was, in fact, New York and not the BVI. They argued that Sentry's 18-year operational history was in New York, its charter significantly restricted activity in the BVI, it held little cash in the BVI, and significant claims asserted by and against Sentry were in New York.[33] The District Court disagreed, holding that while such evidence could rebut a presumption that Sentry's COMI was the BVI, the preponderance of the evidence looked at in its totality ultimately proved that the BVI was Sentry's COMI.[34]

The District Court also confirmed that the appropriate time for determining the COMI is the time that the Chapter 15 petition is filed.[35] The appellants suggested that the 11-month gap between the commencement of the BVI Proceeding and filing of the Chapter 15 Petition was designed to support an "opportunistic shift" of the COMI from the U.S. to the BVI, but the court found no evidence of "COMI manipulation."[36]

The Second Circuit's Decision

On further appeal, the Second Circuit upheld the District Court's ruling. The Second Circuit noted that "few courts [had] considered the meaning of COMI under Chapter 15, especially with respect to the time frame and the factors that bear on the question."[37] Central to the court's decision were three issues: (1) the relevant timeframe for COMI determination, (2) the relevant factors to consider in that determination, and (3) public policy concerns.

Timeframe for COMI Determination

On this question, the court considered three factors: (1) the text of the statute, (2) guidance from other federal courts, and (3) international sources.[38]

Text of Chapter 15

With respect to the text of the statute, the Second Circuit reviewed s. 1517(b) of the *Bankruptcy Code*, which provides,

> (b) [A] foreign proceeding shall be recognized–
>
> (1) as a foreign main proceeding if it *is pending* in the country where the debtor *has* the center of its main interests [emphasis added by the court].[39]

The Second Circuit concluded that the present tense used by s. 1517(b) in the emphasized terms supported the suggestion that a court should examine a debtor's COMI at the time the Chapter 15 petition is filed.[40] The court held, "[i]t […] matters that the inquiry under Section 1517 is whether a foreign proceeding '*is pending* in the country where the debtor *has* the center of its main interests [emphasis added by the court].'"[41] Thus, the court rejected the appellants' invitation to consider Sentry's entire history or to find that the statute compelled a COMI determination as of the date of the initiation of the *foreign proceeding* (which in this case had occurred 11 months before the Chapter 15 petition was filed).[42] ("A foreign proceeding '*is pending*' … only after it has been commenced [emphasis added by the court].") Accordingly, the court concluded that the filing date of the Chapter 15 petition was the "anchor" for the COMI analysis.[43]

Other Federal Courts

The court next found that nearly every other federal court had also determined that the COMI should be considered as of the time of filing of the Chapter 15 petition, including one court in a different circuit that had specifically decided the question.[44]

International Sources

Finally, the court considered international interpretations of the COMI, which is mandated by Chapter 15.[45] (Section 1508 of the *Bankruptcy Code* provides: "[i]n interpreting this chapter, the court shall consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions.")

The court examined European case law as well as prevailing European Union legislation and found that some of the language in the EU statute could suggest using a "broader time frame" to ascertain the COMI.[46] Ultimately, however, the court concluded that international sources were "of limited use in resolving whether U.S. courts should determine COMI at the time of the Chapter 15 petition or in some other way."[47]

COMI Factors

With regard to the factors relevant to locating the COMI, the Second Circuit held that "any relevant activities, including liquidation activities and administrative functions, may be considered in the COMI analysis."[48] The appellants had argued that the liquidation activities of the fund were irrelevant to the COMI determination.

The court first noted the rebuttable presumption created by Chapter 15 in favour of the debtor's registered office, which here was the BVI.[49] The court then observed that federal courts focus on a variety of factors, including the widely adopted, nonexclusive list developed in the Southern District of New York:

> Various factors, singly or combined, could be relevant to [the COMI] determination: the location of the debtor's headquarters; the location of those who actually manage the debtor (which, conceivably could be the headquarters of a holding company); the location of the debtor's primary assets; the location of the majority of the debtor's creditors or of a majority of the creditors who would be affected by the case; and/or the jurisdiction whose law would apply to most disputes.[50]

Interestingly, the Second Circuit also turned to international law and found that the EU Regulation's explanation of COMI—that it "should

correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties"—was informative and "underscore[d] the importance of factors that indicate regularity and ascertainability" despite the fact that it had held that the EU Regulation was not an appropriate analog for Chapter 15 with regard to the timing question.[51]

The court thus concluded that the COMI analysis could include liquidation activities and that the absence of a definition for COMI in the statute signified that the text is "open-ended" and "invite[d] development by court, depending on facts presented, without prescription or limitation."[52] The court held that the Bankruptcy Court had not erred in its factual findings and conclusions (as summarized above) that Sentry's COMI was the BVI at the time of the Chapter 15 petition.[53]

Public Policy

Finally, the appellants argued that the Bankruptcy Court had erred in not applying the public policy exception available under s. 1506 of the *Bankruptcy Code*, which provides, "Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be *manifestly* contrary to the public policy of the United States [emphasis added]."[54] The appellants argued that because the court files in the BVI Proceeding were sealed, it was "cloaked in secrecy" and, therefore, was contrary to U.S. public policy.[55]

The Second Circuit disagreed, holding that the language of s. 1506 only created an exception for actions that are *manifestly* contrary to United Stated public policy, not *all* actions.[56] Further, the court held that unfettered public access to court records was not an "exception and fundamental value" in the U.S. and, therefore, that recognition in this case would not be manifestly contrary to U.S. public policy:

> The confidentiality of BVI bankruptcy proceedings does not offend U.S. public policy. Although the BVI liquidation has proceeded under seal, Morning Mist's assertion that they are "shrouded in secrecy" is overwrought.
>
> In any event, Morning Mist cannot establish that unfettered public access to court records is so fundamental in the United States that recognition of the BVI liquidation constitutes one of those exceptional circumstances contemplated in Section 1506. "[T]he right to inspect and copy judicial records is not absolute."
>
> Important as public access to court documents may be, it is not an exceptional and fundamental value. It is a qualified right; and many proceedings move forward in U.S. courtrooms with some documents filed under seal, including many cases in this Court. *There is no basis on which to hold that recognition of the BVI liquidation is manifestly contrary to U.S. public policy* [emphasis added].[57]

Accordingly, the Second Circuit affirmed the District Court's decision to uphold the Bankruptcy Court's finding that Sentry's COMI was the BVI. The BVI Proceeding was thus a foreign main proceeding.[58]

Summary and Observations

The key points of the Second Circuit's decision as they relate to the COMI determination can be summarized as follows:

- The determination of a debtor's COMI is made at the time that the Chapter 15 petition is filed.
- A court may look at the period between commencement of the foreign proceeding and the filing of the Chapter 15 petition to ensure that a debtor has not "manipulated" its COMI in bad faith, but a debtor's entire operational history should not be considered.
- The factors that a court may consider in this analysis are not limited and may include the debtor's liquidation activities.[59]

This decision provides guidance to bankruptcy courts in interpreting a pivotal feature of Chapter 15: timing and factors for determination of COMI. As this holding confirms, courts must consider the nature of activities carried out at or near the time of the Chapter 15 filing. This can be particularly determinative in case of a liquidating offshore fund where the fund terminates operations for any given reason and is placed into liquidation or wind-up.[60] This case should thus provide additional guidance to U.S. courts when asked to lend assistance to their international counterparts in cross-border cases. Each case, however, will ultimately require determinations based on its particular facts and circumstances, which courts will generally look in totality in performing the COMI analysis.

[*Editor's note*: **Karen S. Park** is a senior associate in the Business Reorganization group at Schulte Roth & Zabel LLP ("SRZ") in New York and has appeared for parties in cross-border cases including under Chapter 15. Prior to joining SRZ, Karen practised insolvency law at a major Canadian law firm in Toronto. She gratefully acknowledges the assistance of Lucy F. Kweskin in the preparation of this article. Lucy is an associate in the Business Reorganization group at SRZ.]

---

1 The *Model Law* was promulgated by the United Nations Commission on International Trade Law.

2 See, generally, 11 U.S.C. §§ 1501-1532 ("Chapter 15").

3 *CCAA*, R.S.C. 1985, c. C-36.

4 *BIA*, R.S.C. 1985, c. B-3.

5 *Morning Mist Holdings Ltd. and Lomeli v. Krys* (*In re Fairfield Sentry Ltd.*), 714 F.3d 127, 132 (2d Cir. 2013) [*Fairfield Sentry (Second Circuit)*] (aff'g *In re Fairfield Sentry Ltd.*, 2011 WL 4357421 (S.D.N.Y 2011) [*Fairfield Sentry (District Court)*] (citing 11 U.S.C. § 1501(a)).

6 See 11 U.S.C. § 1517(a); *Fairfield Sentry (Second Circuit)*, *ibid*. at 132. Section 1502 of the *Bankruptcy Code* defines "foreign main proceeding" as a "foreign proceeding pending in the country where the debtor has the center of its main interests." 11 U.S.C. § 1502(4); *Fairfield Sentry (Second Circuit)*, *ibid*. at 133.

7 The *CCAA* and *BIA* do not define the term either.

8 See 11 U.S.C. § 1516(c) ("In the absence of evidence to the contrary, the debtor's *registered office* […] is *presumed* to be the center of the debtor's main interests" [emphasis added]).

9 See *Fairfield Sentry (Second Circuit)*, *supra* note 5 at 129–30.

10 *Ibid*. at 130.

11 *Fairfield Sentry (Second Circuit)* at 130 and *Fairfield Sentry (District Court)* at *6, *supra* note 5.

12 The court's determination of COMI was critical for the appellants because of the resulting impact on their ability to pursue their state court lawsuit. If the COMI were determined to be in the BVI, where the foreign proceeding in that case was pending, then that proceeding would be recognized as a foreign *main* proceeding. Upon such recognition, s. 1520 of the *Bankruptcy Code* provides for certain automatic and nondiscretionary relief, including a stay of all proceedings (which would necessarily include the shareholders' lawsuit); 11 U.S.C. § 1520; *Fairfield Sentry (Second Circuit)* at 133, *ibid*. As discussed below, however, the Bankruptcy Court found that even if the foreign proceeding were not a foreign main proceeding mandating an *automatic stay*, a *discretionary* stay would nevertheless be appropriate in this case.

13 *Fairfield Sentry (Second Circuit)* at 130, *ibid*.

14 *Ibid*.

15 *Ibid*.

16 *Ibid*.

17 *Ibid*.

18 *Ibid*.

19 *Ibid*.

20 *Ibid*. at 131.

21 *Ibid*.

22 *Ibid*.

23 *Ibid*.

24 *Ibid*.

25 *Ibid*.

26 *Ibid*.

27 *Ibid*.

28 *Ibid*. Section 1521 of the *Bankruptcy Code* provides the bankruptcy court with discretion upon recognition of either a foreign main or nonmain proceeding to grant "any appropriate relief" at the request of the petitioner, including a stay of actions and proceedings. See 11 U.S.C. § 1521(a).

29 *Ibid*. at 132.

30 *Ibid*.

31 *Fairfield Sentry (District Court)*, *supra* note 5 at *5.

32 *Ibid*. at *7.

33 *Ibid*.

34 *Ibid*.

35 *Ibid*. at *6 (citations omitted).

36 *Ibid*.

37 *Fairfield Sentry (Second Circuit)*, *supra* note 5 at 133.

38 *Ibid*.

39 *Ibid*. at 133 (citing 11 U.S.C. § 1517(b)).

[40] *Ibid*. at 133–34.
[41] *Ibid*. at 134 (citing 11 U.S.C. § 1517(b)(1)).
[42] *Ibid*.
[43] *Ibid*.
[44] *Ibid*. (citing *In re Ran*, 607 F. 3d 1017, 1025 (5th Cir. 2010)).
[45] *Ibid*. at 136.
[46] *Ibid*. at 136–37. In particular, Council Regulation (EC) No 1346/2000 of 29 May 2000 ("EU Regulation") provides that "the 'centre of main interests' should correspond to the place where the debtor *conducts the administration of his interests on a regular basis* and *is therefore ascertainable by third parties*." *Fairfield Sentry (Second Circuit)*, *ibid*. at 136 (citing EU Regulation, at Preamble ¶ 13). The court speculated that the reference to "administration on a regular basis" could mean that the court should expand the time frame for the COMI analysis to, presumably, historical periods.
[47] *Ibid*. at 137. On this point, the court found that the prevailing EU Regulation did not operate as an appropriate "analog" to Chapter 15, because the EU Regulation provides for *automatic* recognition of a main insolvency proceeding commenced in one EU member state by all other member states; *ibid*. at 136. The court observed that because of this framework, the EU has no need for a recognition petition, such as that provided under Chapter 15. And because the U.S. and BVI were not parties to an agreement and were not otherwise governed by a common legal framework (such as the EU Regulation), the court concluded that the EU Regulation was a poor analog to Chapter 15 (at least for purposes of the timing question). There is no indication that the court considered the jurisprudence of any other country.
[48] *Ibid*.
[49] *Ibid*. (citing 11 U.S.C. § 1516(c)).
[50] *Ibid*. at 137 (citing *In re SPhinX, Ltd.*, 351 B.R. 103, 117 (Bankr. S.D.N.Y. 2006)).
[51] *Ibid*. at 138 (citing EU Regulation, at Preamble, ¶ 13).
[52] *Ibid*.
[53] *Ibid*. at 139.
[54] *Ibid*. (quoting 11 U.S.C. § 1506).
[55] *Ibid*. The BVI Court had ordered that the BVI Proceeding be sealed because Sentry's applications included information, including explanations of litigation strategy, which was protected by attorney-client privilege. See *Fairfield Sentry (District Court)*, *supra* note 5 at *9.
[56] *Fairfield Sentry (Second Circuit)*, *Ibid*.
[57] *Ibid*. at 140 (internal citations omitted).
[58] *Ibid*.
[59] *Ibid*. at 138.
[60] For another example of a liquidating offshore fund where a bankruptcy court granted recognition of a foreign proceeding as a "foreign main proceeding," see *Revised Order Recognizing Foreign Proceeding*, *In re Saad Investments Finance Co. (No.5) Ltd.*, Case No. 09-13985 (KG) (Bankr. D. Del. Dec. 17, 2009) [Docket No. 47] (recognizing Cayman Islands proceeding of a fund in liquidation as foreign main proceeding). The author represented the liquidators of that fund in their Chapter 15 petition.

• THE LONG AND WINDING ROAD: WHERE INSOLVENCY AND INCOME TAX INTERSECT •

Peter P. Farkas
Duff & Phelps Canada Restructuring Inc.

With deference to the Beatles, "The Long and Winding Road" is not only a famous song title. These same words describe the road an insolvency practitioner sometimes has to take to make a distribution that satisfies both the demands of creditors and the provisions of the *Income Tax Act* [*ITA*].[1]

Insolvency practitioners do not tend to pay much attention to non-deemed trust tax obligations—the conventional thinking being that the existence of large loss carry-forwards, or perhaps a shortfall to secured creditors, eliminates claims of tax authorities.

But in a small number of insolvencies, this may not be a correct analysis. For example, a practitioner needs to analyze more deeply in the following circumstances:

- There is a significant distribution to ordinary creditors. This may indicate that tax loss carry-forwards may not be large enough to offset tax claims.

- There are non-income tax liabilities owing to the CRA, such as non-resident withholding taxes or GST/HST; these cannot be offset by tax loss carry-forwards.
- All creditors have been paid, and there is a distribution to equity holders? While unusual, this does happen from time to time.

The method by which a receiver, liquidator, or similar court officer can avoid liability is to comply with s. 159.(2) of the *ITA*, which states:

> 159.(2) Every legal representative (other than a trustee in bankruptcy) of a taxpayer shall, before distributing to one or more persons any property in the possession or control of the legal representative acting in that capacity, obtain a certificate from the Minister, by applying for one in prescribed form, certifying that all amounts
>
> (a) for which the taxpayer is or can reasonably be expected to become liable under this Act at or before the time the distribution is made, and
>
> (b) for the payment of which the legal representative is or can reasonably be expected to become liable in that capacity
>
> have been paid or that security for the payment thereof has been accepted by the Minister [emphasis added].

If s. 159.(2) is not complied with, the CRA has the power to assess practitioners personally, as set out in s. 159.(3):

> 159.(3) If a legal representative (other than a trustee in bankruptcy) of a taxpayer distributes to one or more persons property in the possession or control of the legal representative, acting in that capacity, without obtaining a certificate under [subsection 159.(2)] in respect of the amounts referred to in that subsection,
>
> (a) the legal representative is personally liable for the payment of those amounts to the extent of the value of the property distributed;
>
> (b) the Minister may at any time assess the legal representative in respect of any amount payable because of this subsection; and
>
> (c) the provisions of this Division (including, for greater certainty, the provisions in respect of interest payable) apply, with any modifications that the circumstances require, to an assessment made under this subsection as though it had been made under section 152 in respect of taxes payable under this Part [emphasis added].

Section 159.(3.1) clarifies that an appropriation of property is a distribution for purposes of ss. 159.(2) and (3):

> 159.(3.1) For the purposes of subsections 159.(2) and 159.(3), an appropriation by a legal representative of a taxpayer of property in the possession or control of the legal representative acting in that capacity is deemed to be a distribution of the property to a person.

A literal interpretation of s. 159 would have the "legal representative" personally liable even for a distribution to a secured creditor, since the wording states "distributes to one or more persons"; there is no distinction based on the type of creditor to whom the distribution is made. But such an interpretation would be absurd, since secured creditors' claims trump the unsecured claims of the CRA (and provinces) pursuant to federal and provincial legislation. Of course, valid deemed trust claims have to be paid in priority to other creditors.

The *ITA*, in general, is not designed to deal with insolvency matters; its focus is going concern entities. So, obtaining a clearance certificate sounds simple enough. However, in the CRA world, obtaining a clearance certificate can take a long time, especially if multiple CRA departments are involved—each department has to issue a clearance certificate. Generally, there is no quarterback of the process within the CRA. Understandably, other creditors and stakeholders of an estate are not prepared to wait for extended periods to get a distribution.

The root of the problem is that the *ITA* has no time limit within which the clearance certificate has to be issued. This is evident when dealing with *CRA* personnel who have to be sensitized that an insolvency case has to be handled differently from a going concern matter.

In a bankruptcy situation, the *Bankruptcy and Insolvency Act* [*BIA*][2] does put time limits on the CRA to deal with any claims it may have. The *BIA* also provides protection to the trustee in various forms.

Section 159.(3) of the *ITA* specifically excludes a trustee in bankruptcy—arguably an indication that the *BIA* framework, not the *ITA*, is to deal with CRA claims in bankruptcy.

Section 124(1) of the *BIA* stipulates that all creditors, including the CRA, have to file a claim in order to participate in a distribution. Sections 149(2) and (3) of the *BIA* state that the CRA has up to 90 days to do so after receiving a notice under s. 149(1) from the trustee. This is assuming all tax filings are up to date. If tax filings are not up to date, then the 90 days only starts running from the date the tax returns are filed. The court can extend filing deadlines, but nevertheless, in a bankruptcy, there is a timeline to which the CRA must adhere.

Assuming the CRA has filed a proof of claim, or has not done so notwithstanding that it was asked to, section 41(8) of the *BIA* protects the trustee. Section 41(8) reads as follows:

> The discharge of a trustee discharges him from all liability
>
> (a) in respect of any act done or default made by him in the administration of the property of the bankrupt, and
>
> (b) in relation to his conduct as trustee,
>
> but any discharge may be revoked by the court on proof that it was obtained by fraud or by suppression or concealment of any material fact.

So, a discharge of the trustee generally relieves it from all liabilities including that of the CRA.

There is an open issue regarding the interaction between s. 41(8) of the *BIA* and s. 128(1)(e) of the *ITA* that reads as follows:

> 128(1) Where a corporation has become a bankrupt, the following rules are applicable:
>
> (e) if, in the case of any taxation year of the corporation ending during the period the corporation is a bankrupt, the corporation fails to pay any tax payable by it under this Act for any such year, the corporation and the trustee in bankruptcy are jointly and severally, or solidarily, liable to pay the tax, except that
>
> (i) the trustee is only liable to the extent of the property of the bankrupt in the trustee's possession, and
>
> (ii) payment by either of them discharges the liability to the extent of the amount paid [emphasis added].

Section 128(1)(e) is addressing tax liabilities incurred by the bankrupt estate post-bankruptcy, not claims provable in bankruptcy. There is no reference in this section excluding the trustee from liability on its discharge. There is no case law on the issue of which federal statute prevails; that is, does s. 41(8) of the *BIA* clear the trustee of liability for these types of tax claims? It would seem that based on the clear intent of s. 41(8) of the *BIA* in barring claims against the trustee (thus allowing for estates to be closed), if this conflict were tested, the *BIA* should prevail.

So, as long as the trustee has not concealed any material facts, the scheme of the *BIA* arguably supports a trustee in bankruptcy having statutory protection against any post-discharge claims by tax authorities.

What about a Receiver or Other Court Officer?

The common practice is for a receiver to ask for a distribution order from the court. A provision is usually inserted into this type of order, barring tax authorities from making any claim against the receiver, following the distribution. It is rare that a tax authority objects to the order, and the relief requested is usually granted.

In addition to the comfort of a court order, if a secured creditor is getting all the proceeds, there

is little risk to the receiver in not obtaining a clearance certificate for two reasons.

First, the CRA would not be entitled to a payment in any event, since it is an unsecured creditor. Second, if the secured creditor is taking a loss, then there should be a large pool of tax losses that would offset any income tax obligations. A word of caution as noted before: tax losses that can be used to eliminate income tax obligations cannot be used against other amounts that may be owing to the CRA.

But does such a court order really protect a receiver against a liability arising from not complying with s. 159.(3) provision of the *ITA*?

It is well accepted that a court order cannot override a statute that is directly on point on the issue in question; that is, where the court is not being asked to invoke its judicial discretion. There is no ambiguity in s. 159.(3)(a) of the *ITA*—the legal representative is personally liable for unpaid tax liabilities, up to the value of the distributed property, if a clearance certificate is not obtained.

There is no case law where the CRA challenged an order in favour of a receiver, barring post-distribution tax claims.

As an aside, one might ask, given the risks, why not have all surplus monies be distributed by a trustee? For one thing, there might not be a bankruptcy in place. Second, a distribution by a trustee attracts a levy under s. 147 of the *BIA*.

What about cases involving the *Companies' Creditors Arrangement Act* [*CCAA*]?[3] The Ontario case of *Sapphire Tower*[4] specifically dealt with this issue.

In this case, the monitor conducted a claims process. The CRA audited regarding GST and determined that it had no claim for GST notwithstanding that it had filed a placeholder claim of $1. However, no clearance certificate was issued by the CRA. A distribution was to be made to creditors.

In an endorsement, the court held that the CRA was bound by the *CCAA* and that any claim of the CRA had to be established in the claims process, specifically by the claims bar date. In its endorsement of May 26, 2009, the court stated:

> The right of CRA and MOF [Ontario Ministry of Finance] to share in any distribution or to claim any priority in any deemed trust has been negated by reason of the failure of CRA and MOF to establish a valid claim in the claims bar process.

The CRA did not appeal the order. So, whether the order or s. 159 of the *ITA* would prevail remains untested.

In the case of *Metcalfe & Mansfield* [*Metcalfe*],[5] the *CCAA* sanction order under the plan of arrangement stated:

> This Court orders and declares that any distributions under the Plan and this Order shall not constitute a "distribution" for the purposes of section 159 of the Income Tax Act (Canada), section 270 of the Excise Tax Act (Canada) and section 107 of the Corporations Tax Act (Ontario) and any party in making any such payments is not "distributing," nor shall be considered to have "distributed", such funds, and shall not incur any liability under the above-mentioned statutes for making any payments ordered and is hereby forever released, remised and discharged from any claims against it under section 159 of the Income Tax Act (Canada), section 270 of the Excise Tax Act (Canada) and section 107 of the Corporations Tax Act (Ontario).

The concept in *Metcalfe* was that the distributions under that *CCAA* plan were not distributions for purposes of the *ITA*. This provision in the *Metcalfe Order* was not for the benefit of the monitor; however, a monitor should not be subject to s. 159, since the debtor's property is not in a monitor's "possession or control." In this context, presumably s. 159 exposure is an issue only for any "legal representative" with such possession or control.

So What Should a Practitioner Do?

If the facts warrant it, the best protection for a receiver, a chief restructuring officer, or a liquidator is to get a clearance certificate. If for practical reasons this is not possible, the second best way to proceed is to manage the estate through a trustee, distribute under the *BIA*, and pay the levy. The discharge of the trustee arguably should bar any claim by tax authorities although there is no case law on this point.

It would be good if the ambiguity between the *BIA* and *ITA* could be clarified. Ideally, either one could be amended to say that if a court officer has conducted a court approved claims process, then the CRA is bound by such a process and cannot assert a tax claim against the court officer.

In terms of administrative assistance, it would be good if the CRA designated insolvency specialists on staff who dealt with these matters and could steer these files through the CRA labyrinth.

In the meantime, practitioners should give one last thought about tax obligations before hitting the Send button on the distribution cheques.

[*Editor's note*: **Peter Farkas** is a Managing Director at Duff & Phelps, specializing in restructurings. He has been involved in many cases including those with complex tax implications. He is a CPA, CA, CBV, and CAIRP.

The author wishes to thank Kathleen Hanly of Fasken Martineau DuMoulin LLP for her invaluable assistance.]

---

1 *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) [*ITA*].
2 *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 [*BIA*].
3 *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 [*CCAA*].
4 *Sapphire Tower Development Corp.*, 07-CL-7109 (Ont. Sup. Ct.).
5 *Metcalfe & Mansfield Alternative Investments II Corp. et al. (Re)*, Court File No. 08-CL-7440 (Ont. Sup. Ct.– Commercial List).

INVITATION TO OUR READERS

Have you written an article that you think would be appropriate for *Commercial Insolvency Reporter*?

Do you have any ideas or suggestions for topics you would like to see featured in future issues of *Commercial Insolvency Reporter*?

Please feel free to submit your articles, ideas, and suggestions to the National Editor Linc A. Rogers at <linc.rogers@blakes.com> or <cir@lexisnexis.ca>.

We look forward to hearing from you.