

UNIFORM LAW CONFERENCE OF CANADA

CIVIL LAW SECTION: COMMERCIAL LAW STRATEGY

**A JOINT PROJECT WITH THE LAW REFORM COMMISSION OF
SASKATCHEWAN**

**REFORM OF
FRAUDULENT CONVEYANCES AND FRAUDULENT PREFERENCES LAW
(Transactions at Undervalue and Preferential Transfers)**

**PART 1: TRANSACTIONS AT UNDERVALUE & FRAUDULENT
TRANSACTIONS**

SUPPLEMENTARY REPORT OF THE WORKING GROUP

Submitted by Tamara M. Buckwold, Chair
Faculty of Law, University of Alberta
Edmonton, Alberta

Winnipeg
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INTRODUCTION

[1] The final report of the working group on Part 1 of this project addressing transactions at undervalue and fraudulent transactions was accepted by the Conference at its 2010 annual meeting in Halifax (hereafter the “Part 1 Final Report”). Comments made by Conference delegates were reported to and fully considered by the working group. In addition, the following efforts were made to obtain input on the recommendations advanced in the report:

- The report was sent for comment to the Canadian Association of Insolvency and Restructuring Practitioners (CAIRP), the Insolvency Institute of Canada (IIC) and the Canadian Bar Association. In the latter instance, input was requested of the Business Law Section but the chair of the working group was advised that it would be forwarded to the Bankruptcy and Insolvency Section. None of these organizations have offered comment.
- The report was published as an article in the *Banking and Finance Law Review*, IIC Annual Symposium on Insolvency Law. Readers were invited to comment and contact information was provided but no response has been received.
- The chair of the working group presented the report at a Law Faculty seminar at the University of Alberta. Comments offered by members of the faculty were reported to and considered by the working group.
- The chair of the working group was contacted by one Vancouver lawyer to discuss the implications of the recommendations proposed in the working group progress report of 2009, published on the Conference website. The suggestions advanced were considered by the working group.

[2] The comments received raised the four significant questions identified in the next section of this report, all of which were considered carefully. The recommendations that follow include proposed revisions to the Part 1 Final Report in response to the first question. In addition, the group’s work on development of recommendations dealing with preferential payments in Part 2 of the project prompted it to propose some largely technical revisions to the recommendations in the Part 1 Final Report.

[3] The membership of the working group during 2010-11 is set out in the final report of the working group report on Part 2: Preferential Payments, which is being delivered to the Conference in conjunction with this report.

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QUESTIONS RAISED BY INPUT ON PART 1 FINAL REPORT

1. *Should the recommendations relating to transfers of exempt property be revised?*

[4] The working group is persuaded that a different approach to transfers of exempt property is appropriate. The revised recommendations are set out below.

2. *Should the recommendations relating to the limitation period be revised to conform to the Uniform Limitations Act?*

[5] The working group recognizes the desirability of a uniform approach to limitation periods but concluded that a departure from the standard 2 year rule is necessary. There are fundamental policy reasons for the 1 year limitation period in this context.¹

[6] The legislation recommended by the working group is designed to balance two important competing interests. On one side is the legal right of creditors to resort to their debtors' property to enforce their claims. The legislation promotes the ability of creditors to challenge transactions that impinge on this right by clarifying the rules that govern relief and, in particular, by removing the substantial obstacle of requiring positive proof of a debtor's intention to hinder creditors when the debtor is insolvent and minimal or no consideration is given for value withdrawn from the debtor's estate.

[7] On the other hand, the law must respect the need for finality of transactions and should not expose those who deal with debtors to excessive risk of loss. Transaction costs are likely to increase and commercial exchange may be impeded if the potential for after-the-fact reversal of a transaction is substantial. A 2 year limitation period makes transactions vulnerable to challenge for too long, even if the cause of action or the rules of standing could be designed to allow only creditors whose claims arise within 1 year of the transaction to recover. Creditors may be expected to be reasonably diligent in monitoring debtors' affairs and in pursuing claims. Under a 2 year limitation period, a creditor whose claim arose within 1 year of the transaction could defer action to challenge it for many months. The 1 year limitation period in effect circumscribes the cause of action and the risk imposed by the law on transferees. It is an important factor in balancing the interests of creditors and those who deal with their debtors.

[8] While the approach adopted by the BIA is not a perfect parallel, the fact that it allows the trustee to challenge arm's length transactions only if they occur within one

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year prior to bankruptcy confirms the policy supporting a limited period of exposure.² Although the trustee is not obliged to take action under the BIA within a defined period of time after bankruptcy occurs, a person who has dealt with a bankrupt within one year prior to the initiation of bankruptcy proceedings will be aware of and can assess and respond to the risk that a transaction may be avoided. The bankruptcy in effect hoists a red flag; the equivalent outside of bankruptcy is notice of litigation.

3. *Do the Part 1 recommendations subject “bona fide purchasers” to undue risk?*

[9] As noted above, the legislation recommended is designed to balance competing interests without sacrificing one to the other. Unsecured creditors can do little to prevent debtors from dealing with their property in a way that defeats creditors’ claims short of invoking bankruptcy proceedings. They have limited ability to manage the risk of loss resulting from creditor avoidance measures. Under the proposed legislation, a person who purchases property from a debtor is at risk only if the debtor is insolvent or verging on insolvency and the consideration given is *conspicuously* less than the value of the property. While the purchaser may not be fully conscious that the transaction will deprive creditors of their rights of enforcement, the fact that the property is being sold for much less than it is worth should incite suspicion and a corresponding degree of caution. Bona fide purchaser rules are designed to protect those who are not in a position to recognize the risk of competing claims to the property in question. A person who acquires property under a transaction that is subject to challenge under the proposed Act does so in the face of an obvious risk of competing claims; they are in a position to assess and manage that risk. Even if the transaction is successfully challenged, the legislation is designed to allow the transferee to recover the value invested in the property purchased. The risk to transferees is further limited by the short limitation period, discussed above. The working group believes that the recommendations advanced achieve a fair balance between the rights of creditors and those of transferees.

4. *Should the legislation include a “due diligence” defence barring the recovery of relief by a creditor whose claim arose after the date of a challenged transaction?*

[10] The question addresses the argument that those who lend money or advance credit should be expected to exercise “due diligence” in making the credit decision. On this view, a diligent creditor will not rely on assets that the prospective debtor no longer owns as a source of recovery. Creditors who proceed with knowledge of the debtor’s current

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asset base or without properly investigating the debtor's financial affairs should not be permitted to launch an after-the-fact challenge to a transaction to recover assets previously alienated by the debtor. A transferee should be able to defend a claim to assets acquired from the debtor if he or she can prove that the creditor or creditors challenging the transaction acquired their claims after the transaction occurred and knew or should have known the debtor's financial circumstances. In evaluating this argument the working group considered possible formulations of a due diligence defence. It concluded that such a defence was not necessary or appropriate for the following reasons:

- Creditors whose claims arise after the date of a transaction are entitled to relief only if they can prove that (a) the debtor's primary intention in entering into the transaction was to hinder or defeat creditors whose claims existed or were reasonably foreseeable at the date of the transaction, (b) the transaction had the intended effect, and (c) the transferee gave no consideration or conspicuously less than the value received under the transaction or was complicit in the debtor's intention to defeat creditors. This offers a very limited scope for challenge by post-transaction creditors.
- The claims of involuntary creditors such as spousal claimants, tort claimants, the victims of a post-transaction breach of contract and others should not be barred by actual or imputed knowledge of the debtor's financial circumstances and should not be subject to a potential due diligence defence. The distinction between voluntary and involuntary claims is difficult to define.
- Transferees who are complicit in a debtor's intention to avoid creditors and those who have given conspicuously less than the value received under a transaction are aware of the risk of the transaction.
- The risk faced by transferees is circumscribed by the 1 year limitation period (above) and those who are not complicit in the debtor's intention may recover consideration given for property received (above).
- The availability of relief where property is transferred to avoid potential future creditors is consistent with established law.³
- A due diligence defence would require courts and parties to engage in the inherently uncertain exercise of assessing what a creditor should have known when he or she dealt with the debtor. This would significantly undermine the certainty that reform of the law in this area seeks to achieve.

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SUPPLEMENTARY RECOMMENDATIONS FOR PART 1

[11] The format used in the Part 1 Final Report is adopted in the following paragraphs. Explanation and discussion appears in ordinary text. Recommendations are highlighted in indented and bolded text. Some of the commentary refers to proceedings under the *Reviewable Transactions Act*, which is the title recommended for the uniform Act in the Part 1 Final Report at paragraph [8]. The Act would apply to preferential payments as well as transactions at undervalue and fraudulent transactions (see further Part 2 Final Report at paragraphs [5] and [6]).

A. Exempt Property

[12] In its Part 1 Final Report, the working group recommended that a “transaction” subject to challenge should not include a transfer or disposition of property that is exempt from judgment enforcement measures before the transfer or disposition is made (at paragraph [42]). The recommendation was based on the stated view, largely accepted in the case law, that “there are few cases in which creditors are materially hindered by a transfer of exempt property since they will not have lost property that could have been reached to satisfy their claims if the transfer had not occurred.” However, concerns were raised when the report was delivered at the 2010 annual meeting of the Conference regarding the potential for inconsistent outcomes in relation to pre-judgment and post-judgment dealings with exempt property. If a writ or judgment attaches to exempt property, it can be enforced against the property in the hands of a transferee from the debtor. If the same property is transferred before judgment is obtained, it cannot be reached under judgment enforcement law and could not be recovered from the transferee under the proposed statute. The potential for inconsistent outcomes of this kind varies among jurisdictions depending upon the scope of exemptions law and the effect of a judgment or writ on exempt property. The working group discussed the problem at length and concluded that revision of our original recommendation is warranted. Our new recommendation is supported by the additional policy argument that property should be treated as exempt only while the debtor continues to use it for the purpose attracting the exemption. If a debtor elects to transfer away exempt property, he or she has implicitly abandoned the exemption. The result of the recommendation that follows is that a transfer of exempt property may be challenged under the ordinary causes of action like any other.

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Recommendation (1) in paragraph [42] of the Part 1 Final Report should be deleted and replaced with the following:

A “transaction” includes a transfer of exempt property.

[13] If adopted without qualification, the rule advanced above would allow creditors to challenge a transfer of exempt property even if, after ownership is transferred, the debtor continues to use the property for the purpose that attracted the exemption. For example, an insolvent debtor may transfer an exempt homestead to her child but continue to live on the property. If the transfer is successfully challenged as a transaction at undervalue, the homestead might be made subject to judgment enforcement measures under an order for relief granted against the transferee and the debtor would lose the right to remain in her home. Existing case law in Saskatchewan (noted in the Part 1 Final Report at footnote 12) deals with this problem by allowing the court to declare the transfer of an exempt homestead void as a fraudulent conveyance subject to the condition that a writ registered against title to the property cannot be enforced as long as the debtor remains in occupation. The working group recommends that a similar approach be adopted in relation to exempt property generally.

- (1) Where relief is granted in relation to a transfer of property that was exempt in the hands of the debtor and the debtor continues to use the property in the manner that that attracted the exemption, the court may suspend enforcement of the judgment until such time as the debtor ceases to use the property in that manner.**
- (2) Where enforcement of a judgment is suspended under paragraph 1, the court may order that a writ (or judgment) be registered against the transferee or the property of the transferee.**

[14] The revised recommendations relating to exempt property affect one of the recommended “forms of order” that may be granted by way of relief, listed in paragraph [77] of the Part 1 Final Report. Clause (i) provides for “an order declaring that property that would otherwise be exempt as against creditors is subject to judgment enforcement measures where the property was acquired under the transaction giving rise to the entitlement to relief.” This formulation reflected the original proposal that a transaction involving a transfer of exempt property by the debtor could not be challenged as a

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transaction at undervalue or fraudulent transaction. However, a transaction under which a debtor exchanges non-exempt for exempt property could be challenged if the grounds for relief are established. With the expansion of the cause of action to allow a transaction involving a transfer of exempt property to be challenged, a broader form of remedial order is required:

Clause (i) of the Forms of order listed in paragraph [77] of the Part 1 Final Report should be deleted and replaced with the following:

- (i) An order declaring that property that would otherwise be exempt against creditors is subject to judgment enforcement measures.**

B. Remedies: Intersection of Remedy with Creditors' Relief Legislation

[15] The benefit of a judgment in an action under the *Reviewable Transactions Act* would not be limited to the plaintiff or plaintiffs in the proceeding. The Part 1 Final Report includes, in paragraph [81], a recommendation designed to ensure that the value recovered under an order for relief in an action challenging a transaction at undervalue or fraudulent transaction is channeled into the creditors' relief system for distribution among all creditors who qualify to share in the proceeds of judgment enforcement measures taken against the property of the debtor. The same provision should apply to an action challenging a preferential payment. However, the use of the word "creditor" in the recommendation as formulated creates difficulties in relation to a preferences action because the term carries a different meaning in that context. The following reformulation does not change the substance of the recommendation but is designed to overcome the definitional problem, making the provision appropriate to all actions under the *Reviewable Transactions Act*.

The recommendation in paragraph [81] of the Part 1 Final Report should be amended as follows:

An order shall be made in such terms or subject to such conditions as may be necessary to make money payable or the value of property to be transferred under the order available for distribution to the persons ~~all creditors of the debtor who are~~ qualified under [insert name of provincial creditors' relief

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statute] to share in the proceeds of judgment enforcement measures taken against the debtor.

[16] The recommendation above assumes but does not state that while a plaintiff in an action challenging a transaction need not have judgment against the debtor to commence proceedings (see paragraph [74] of the Final Report), he or she must obtain judgment to share under the creditors' relief distribution rules. This should be made explicit. The plaintiff's right to recover from a person's property as a creditor depends on formal validation of the existence and extent of the plaintiff's claim through a judgment or court order. The plaintiff must do more than simply assert that he or she is a creditor for the amount claimed.

The following should be added to the Part 1 Final Report recommendations:

The plaintiff must obtain judgment against the debtor in order to share in money or property obtained under an order for relief.

C. Standing to Seek a Remedy under the Act

[17] The recommendations in paragraph [75] of the Part 1 Final Report are designed to allow a plaintiff to take proceedings to obtain judgment against the debtor before an order for relief granted under the *Reviewable Transactions Act* takes effect. The following recommendation does not substantively change those recommendations but clarifies the procedure that may be invoked to that end by the plaintiff. As noted in the Final Report, provisions of this kind may not be required where the procedures contemplated are already available under the rules of court or other law of the enacting jurisdiction.

The recommendations in paragraph [75] of the Part 1 Final Report should be deleted and replaced with the following:

When a plaintiff does not have judgment against the debtor in relation to the plaintiff's claim,

- (a) the plaintiff may make the debtor a defendant in the action and the court may,**

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- (i) grant judgment against the debtor for the amount of the plaintiff's claim proven in the proceedings or not contested by the defendant, or**
 - (ii) direct a separate trial to determine the plaintiff's claim against the debtor.**
- (b) the court may grant a stay of proceedings or suspend the operation of a remedy until such time as judgment is obtained on the plaintiff's claim against the debtor in the proceedings or in another action and may make such supplementary orders as may be appropriate, including but not limited to an order**
 - (i) restraining the defendant or another person from dealing with property,**
 - (ii) giving directions as to the manner in which property is to be dealt with, or**
 - (iii) appointing a receiver of property.**

D. Remedies: The Qualifying Factors

[18] The Part 1 Final Report includes recommendations relating to the remedies available in an action to challenge a transaction at undervalue or fraudulent transaction. The court is directed to take into account identified factors, referred to as the “qualifying factors”, in granting an order for relief pursuant to the general principle articulated. The qualifying factors are set out in recommendations (1) and (2) in paragraph [86]. In the course of its work on the remedies provisions that apply to preferential payments, the working group recognized a deficiency in recommendation (2). It provides that a court order requiring a debtor to pay money to a transferee in compensation for value given by the transferee under the transaction (i.e., the purchase price paid), or in recognition of investments made by the transferee that have increased the value of property received under the transaction, may be secured against property of the debtor, and a priority rule is given for a security interest so granted. The priority rule does not differentiate between the two types of case contemplated and is appropriate only in the first. An interest

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securing recovery of the purchase price paid by a transferee should have priority over all creditors except one who had a perfected security interest in the property transferred under the transaction while it was in the hands of the debtor. The rationale for the rule is explained more fully in paragraph [84] of the Part 1 Final Report. A different priority rule should be provided for a security interest securing recovery of investments made by a transferee that have increased the value of the property transferred. The security interest should have priority over all other security interests, including one held by a creditor who had a security interest in the property before it was transferred, because the increased value of the property may be seen as property of the transferee. The secured party will realize a windfall at the transferee's expense if the prior security interest attaches to the improved asset and has priority over the transferee.⁴ The revised recommendations set out below provide an appropriate rule.

[19] The recommendation in paragraph (4) is prompted by the fact that, if the debtor becomes bankrupt, a security interest in personal property granted by the court could be defeated by the debtor's trustee in bankruptcy under the priority rules of the *Personal Property Security Act*. Under the new rule proposed, the security interest will be treated as a perfected PPSA security interest and will have priority over the trustee in bankruptcy if it is registered in the personal property registry. Complementary amendments to the legislation governing registration of PPSA security interests (and possibly changes in registry procedures) will be required to give effect to this provision. Registration is not required to assert a security interest in land against a trustee in bankruptcy.

[20] The somewhat complex rules that follow only come into play when the order for relief makes the property available to creditors by revesting it in the debtor. The court may avoid the problems addressed by a different formulation of the order for relief. In most cases, the better approach would be to order that the property transferred be sold and the transferee reimbursed from the proceeds of sale for the price paid or investments that have improved the value of the property. The remaining funds would be available to creditors entitled to share. Alternatively, the court could order the transferee to pay a sum equivalent to the value received under the transaction net of the purchase price. The transferee would keep the asset, retaining the value of any improvements made.

Recommendation (2) in paragraph [86] of the Part 1 Final Report should be deleted and replaced with the following:

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- (2) Where the court orders that property transferred by the debtor under the transaction or its proceeds be vested in the debtor, the court may grant the transferee a security interest in the property securing**
 - (a) the value given by the transferee under the transaction, and**
 - (b) expenditures and non-monetary investments made by the transferee that have increased the value of property received under the transaction, to the extent of the expenditures or the value invested.**

- (3) A security interest granted in favour of a transferee under clause (2) has the priority status that follows:**
 - (a) To the extent of an amount secured under clause (2)(a), the security interest has priority over the rights of creditors of the debtor in relation to the property other than a creditor holding a perfected security interest that attached to the property before the transaction occurred, and**
 - (b) To the extent of an amount secured under clause (2)(b), the security interest has priority over the rights of all creditors of the debtor in relation to the property, including secured creditors.**

- (4) A security interest granted under (2)**
 - (a) may be registered in the *Personal Property Registry*, and**
 - (b) if the security interest is registered before the date of bankruptcy of the debtor, the security interest has the status of a security interest perfected under the *Personal Property Security Act* at the date of bankruptcy as against the trustee in bankruptcy.**

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MOTION

[21] The working group seeks a motion of the Conference that the Supplementary Report on Part 1: Transactions at Undervalue and Fraudulent Transactions is accepted.

¹ The period may be extended to a maximum of 5 years when evidence is concealed.

² Avoidance of the transaction requires proof both that the debtor was insolvent and the debtor intended to defeat a creditor. Non-arm's length transactions that occur more than 1 year but less than 5 years before bankruptcy may be avoided if it is proven that the debtor was either insolvent or intended to defeat a creditor.

³ While that proposition is challenged by a recent Ontario case, the decision fails to acknowledge Supreme Court of Canada authority and other cases that confirm it. See *McGuire v. Ottawa Wine Vaults Co.* (1913), 48 S.C.R. 44.

⁴ These recommendations may be better understood by considering an example. Assume that Debtor, who is insolvent, transfers to Transferee a widget worth \$400,000 for \$100,000. Transferee invests money or effort in the widget, increasing its value by \$50,000. A creditor of Debtor challenges the transaction and is entitled to a remedy under cause of action #1 in the Part 1 Final Report. If the court orders that the widget revert in Debtor so that it is available to creditors under judgment enforcement law, it should order that Debtor is liable to Transferee to the extent of the \$100,000 paid by Transferee and the \$50,000 increase in value produced by Transferee's investment. These obligations should be secured by a security interest in the widget. The security interest granted Transferee to secure the \$100,000 paid should have priority over any other security interest in the widget except a perfected security interest that already existed before the widget was transferred; the prior secured party should not lose out to Transferee. The security interest granted Transferee to secure the \$50,000 invested in the widget should have priority over all competing security interests. The Transferee is entitled to recover the value invested as against competing claimants.