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Attacking Creditor Proofing Schemes

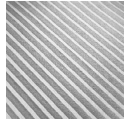
Maurice V. Fleming

Miller Thomson LLP

416.595.8686

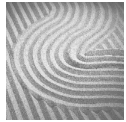
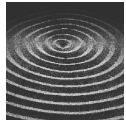
mfleming@millerthomson.com

Thursday, June 11, 2009



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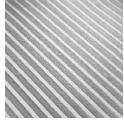
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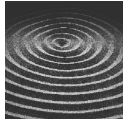
Attacking Creditor Proofing Schemes

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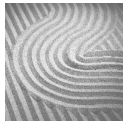
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Introduction

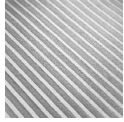


- It is usually better to attack these schemes than it is to defend, although cost is a factor

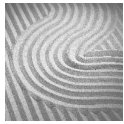
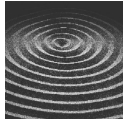


- Creditor proofing schemes are best undertaken at commencement of a business venture

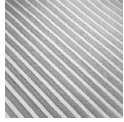




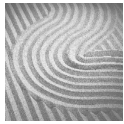
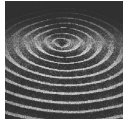
Introduction (Cont'd)



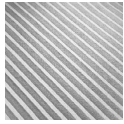
- Alternatively creditor proofing schemes are best undertaken at a time when the business is solvent and not experiencing financial difficulties
- Schemes implemented to limit financial exposure in case of financial difficulty are legitimate as long as they are perfected at the proper time and the proper way



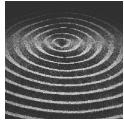
Introduction (Cont'd)



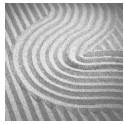
- There are a wide range of statutory and common law remedies available to creditors in their attack on such schemes
- Most attacks on such schemes are successful if the business is in financial distress or where there was an intent to defeat, hinder, or delay creditors



Statutory Scheme



- Provincial Statutes



- *Assignments and Preferences Act*, R.S.O. 1990, C.A.33

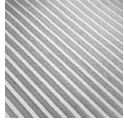


- *Fraudulent Conveyances Act*, R.S.O. 1990, C.F.29

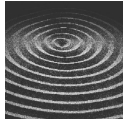
- *Absconding Debtors Act*, R.S.O. 1990, C.A.2

- *Business Corporations Act*, R.S.O. 1990, C.B.16

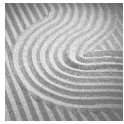
- *Bulk Sales Act*, R.S.O. 1990, C.B.14



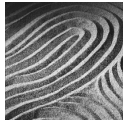
Statutory Scheme (Cont'd)



- Federal Statutes



- *Canada Business Corporations Act*, R.S.C. 1985, C.C.- 44



- *Bankruptcy and Insolvency Act*, R.S.C. 1985, C.B.- 3

- *Criminal Code*, R.S.C. 1985, C.C.- 46



Likely Parties to Attack the Structure

- Secured creditors
- Preferred creditors including CCRA
- Provincial revenue authorities
- Other preferred creditors including landlords



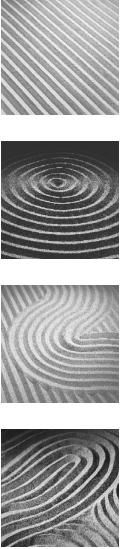
Likely Parties to Attack the Structure (Cont'd)

- Trade creditors and other unsecured creditors
- Suppliers of goods and claimants under s.81.1 of the *Bankruptcy and Insolvency Act* including 30 day goods suppliers
- Employees
- Other shareholders
- Crown prosecutors



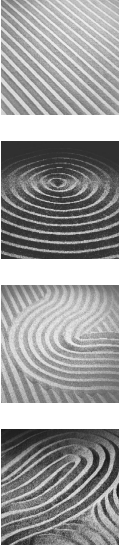
Beware: Criminal Code of Canada

- There is some potential liability for those who go too far in creating and implementing creditor proofing schemes, and those parties who advise them, such as accountants and lawyers



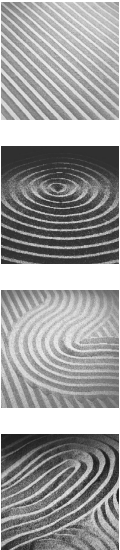
Beware: Criminal Code of Canada (Cont'd)

- Section 21 of the *Criminal Code* of Canada provides that everyone is a party to an offence who actually commits it, or aids and abets in the commission of the offence, and where two or more persons form an intention in common to carry out an unlawful purpose and to assist each other to that end



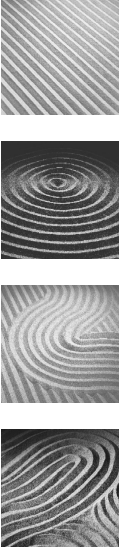
Beware: Criminal Code of Canada (Cont'd)

- Section 392 of the *Criminal Code* provides that everyone who, with an intention to defraud his creditors, as a gift, conveyance, assignment, sale, transfer or delivery of property, or conceals property with the intent to defraud creditors is guilty of a indictable offence and liable to imprisonment for two years



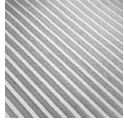
Beware: Criminal Code of Canada (Cont'd)

- Section 366 of the *Criminal Code* deals with forgeries and the making of false documents
- Section 368 of the *Criminal Code* provides that anyone who knowingly uses a forged document as if the document were genuine commits an indictable offence

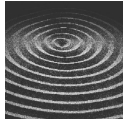


Beware: Criminal Code of Canada (Cont'd)

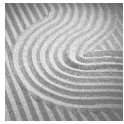
- These offences are not predicated on the party making the offence being insolvent or in eve of insolvency, and professional advisors should use extreme caution in advising clients in these matters



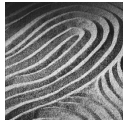
Fraudulent Conveyances

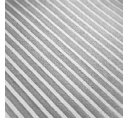


- Available in bankruptcy and non-bankruptcy situations

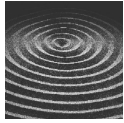


- Supplementary to the remedies of the trustee in bankruptcy under the Bankruptcy and *Insolvency Act*

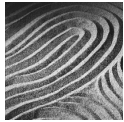
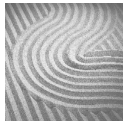


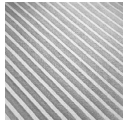


Fraudulent Conveyances (Cont'd)

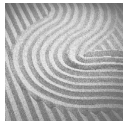
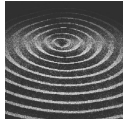


- Aggrieved party must prove the following:
 - gift by way of a conveyance
 - with an intent to defeat, hinder, or delay creditors





Fraudulent Conveyances (Cont'd)



- It is not critical to prove that the entity is insolvent at the time of the conveyance, and this remedy is available before during and after insolvency
- There is no time limit to bringing an action for a fraudulent conveyance, a finding of a fraudulent conveyance will survive discharge on bankruptcy under s.178 of the *Bankruptcy and Insolvency Act*



Proving Intent for Fraudulent Conveyances

- Intent is the key provable element, there is no need to show in fact that the creditors were hindered, defeated, or delayed, but only that the intent of one or both of the grantor and grantee in the transaction had such an intent.
- Voluntary (no consideration) conveyances: must only prove intent of the grantor.



Proving Intent for Fraudulent Conveyances (Cont'd)

- Other fraudulent conveyances (for good and valuable consideration): must show fraudulent intent of both grantor and grantee
- “Badges of fraud” create a presumption of intent, and are the following:
 - financial condition of grantor
 - transactions between related parties
 - grantor continues to show ownership of the asset after the purported transfer
 - retention of an interest in the property transferred by the grantor after disposition



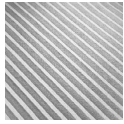
Proving Intent for Fraudulent Conveyances (Cont'd)

- “Badges of fraud” (Cont'd)
 - where the effect of the transaction is to defeat, hinder, or delay creditors
 - where grantee knows that consideration is non-existent or inadequate
 - secrecy in the transaction
 - effect of the transaction is to strip assets of the grantor from the reach of its creditors
 - payment in cash and not cheque

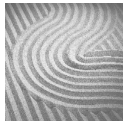
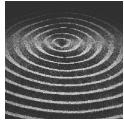


Proving Intent for Fraudulent Conveyances (Cont'd)

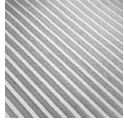
- no change in location of assets after transfer
 - unusual haste in the closing
 - misrepresentation as to the date of the conveyance
 - transfers under defect of trust arrangements
 - falsification of documents or complete lack of documentation
- The presence of one or all of the above noted badges of fraud will raise a presumption of intent against the parties which may be rebutted



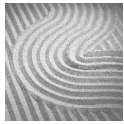
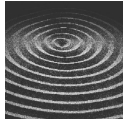
Fraudulent Preferences



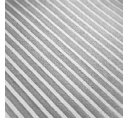
- General principals of the Act are that all creditors must rank equally, except where provide otherwise under the *Bankruptcy and Insolvency Act* (section 136 of the BIA)
- Remedy available in insolvency situations under sections 95 and 96 of the *Bankruptcy and Insolvency Act*



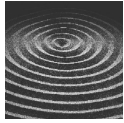
Fraudulent Preferences (Cont'd)



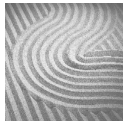
- Remedy also available in both insolvency and non-insolvency situations under the *Assignment and Preferences Act*
- Used to attack:
 - conveyance or transfer of property
 - charge/mortgage on property
 - payments to other equal ranking or subordinate creditors



Fraudulent Preferences (Cont'd)



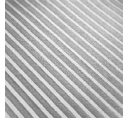
- Time Limits:



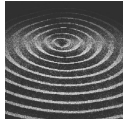
- section 95 BIA: within three months of the date of bankruptcy in the event of arms length transactions



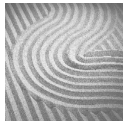
- section 96 BIA: within one year of the date of bankruptcy for related transactions between related parties non-arm's length



Fraudulent Preferences (Cont'd)



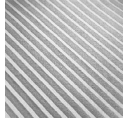
- Remedy is against creditors of the defendant or the insolvent entity, as well as the defendant or insolvent entity itself



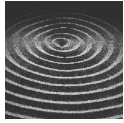
- Plaintiff must prove:



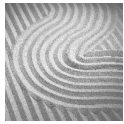
- there was a conveyance, transfer, charge, or payment to a creditor
- with the intent to defeat, hinder, or delay other creditors
- at the time of the transaction, the transferor/debtor is insolvent, unable to pay their debts as they come due, or knew they were on the “eve of insolvency”



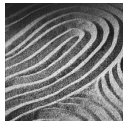
Fraudulent Preferences (Cont'd)

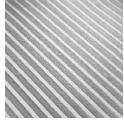


– transaction occurred with a “view to giving the creditor a preference” on the part of the debtor (no need to prove intent of creditor receiving the benefit)

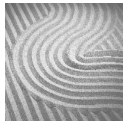
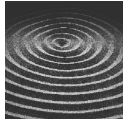


- If all 4 elements of proof are achieved, a presumption is created under 95.2 of the *Bankruptcy and Insolvency Act* that a “view to prefer”, exists, which must be rebutted by the creditor receiving the preference, and the transferor.

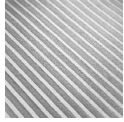




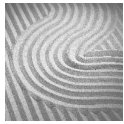
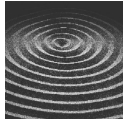
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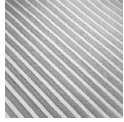
- Effect of successful action under either *Bankruptcy and Insolvency Act* or *Assignment and Preferences Act*:
 - judgment will be assessed against the creditor for the amount of the prejudice created to other creditors as a result of the transaction



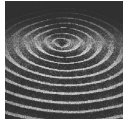
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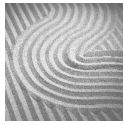
- if goods are available, return of the goods may be ordered to the trustee in bankruptcy under the BIA
- costs
- set off of any claim entered in the estate in bankruptcy by that creditor to the estate of the bankrupt, if the claim is otherwise valid



Fraudulent Preferences (Cont'd)



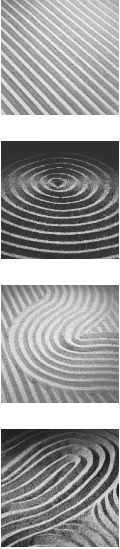
- Saving Provisions:



- payment made in the “ordinary course of business”

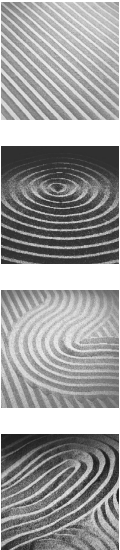


- payment made to secure other goods, to allow the company to remain in business



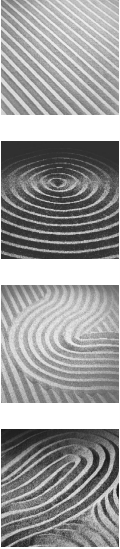
Settlements Under S.91 of the *Bankruptcy and Insolvency Act*

- This is a remedy available only in insolvency situations under the *Bankruptcy and Insolvency Act*



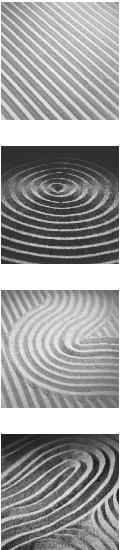
Settlements Under S.91 of the *Bankruptcy And Insolvency Act* (Cont'd)

- What are settlements?
 - gifts, transfers, contracts, designations of beneficiaries, covenants, or other obligations entered into and includes:
 - property transferred must remain in its original condition (in specie), or in traceable form, not to be used by the transferee in their complete discretion



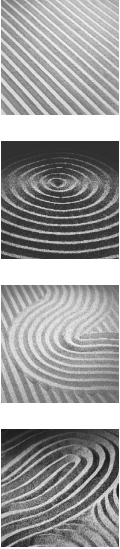
Settlements Under S.91 of the *Bankruptcy and Insolvency Act* (Cont'd)

- this transactions is not an exhausted list and there may be other types of that get included
- the transfers or obligations are entered for nominal consideration or are entirely gratuitous



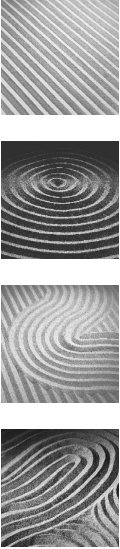
Settlements Under S.91 of the *Bankruptcy and Insolvency Act* (Cont'd)

- Timing:
 - must occur within one year of the date of bankruptcy whereupon it is void against the trustee
 - any settlement occurring within five years of the date of bankruptcy is void against the trustee where:
 - the settler are unable to pay its liabilities without the aid of the property comprised in the settlement: or
 - interest of the settler did not pass on execution thereof (ie. conditional transfers)



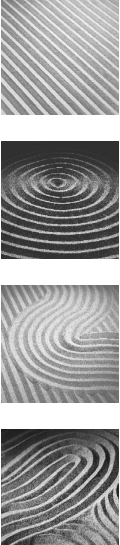
Settlements Under S.91 of the *Bankruptcy and Insolvency Act* (Cont'd)

- Effect of Settlement:
 - voidable: part of bankruptcy
 - void: on issuance of a receiving under the *Bankruptcy and Insolvency Act* (i.e. date of bankruptcy)



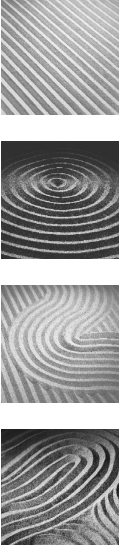
Settlements Under S.91 of the *Bankruptcy and Insolvency Act* (Cont'd)

- property is returned to the estate, or the traceable property is returned to the estate with any deficiency charge as a judgment against the parties in the settlement
- Saving Provisions:
 - to a purchaser or encumbrancer for valuable consideration, in good faith without notice
 - burden of proof that this saving provision is on a beneficiary or a doner



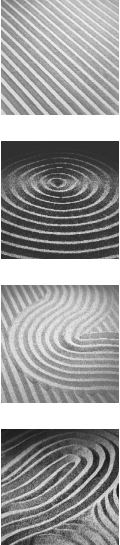
Settlements Under S.91 of the *Bankruptcy and Insolvency Act* (Cont'd)

- Transaction between the bankrupt and a related person (not at arm's length)
- Where consideration for the transaction was conspicuously greater or less than fair market value of the property or services concerned



Settlements Under S.91 of the *Bankruptcy and Insolvency Act* (Cont'd)

- Within one year of the date of bankruptcy
- Elements of proof:
 - No need to prove fraud or an intent to defeat or prefer creditors, nor does a trustee need to prove that the bankrupt was insolvent or on the verge of insolvency at the time of the transaction. Good faith or bad faith of the parties are not relevant in determining whether fair market value was provided



Settlements Under S.91 of the *Bankruptcy and Insolvency Act* (Cont'd)

- Effect of a finding of “reviewable transaction”:
 - other parties to the transaction are liable to the trustee for the fair market value deficiency or over payment as the case may be
 - pre-judgment interest from the day to day appointment of the trustee relevant in most cases



Inquiry into Dividends and Redemption of Shares

- Section 101 of the *Bankruptcy and Insolvency Act*
- Section 31(3) and 38(3) of the *Business Corporations Act*
- Transactions attacked:
 - stripping of excess cash by either redemption of shares or declaration of dividends
 - within one year of the date of bankruptcy



Inquiry into Dividends and Redemption of Shares (Cont'd)

- Required Elements of Proof:
 - company insolvent at time of declaration of dividend or redemption of shares
 - monies must be paid within the one year of date of bankruptcy
 - company rendered insolvent by the dividend or redemption, if not insolvent before



Inquiry into Dividends and Redemption of Shares (Cont'd)

- directors did not act on reasonable grounds, or in the interest of the company
- Directors will be held jointly and severally liable the trustee in bankruptcy, except for where they are on record as objecting to the authorization of the dividend or redemption, and must file a protest in respect of the board decision.



Inquiry into Dividends and Redemption of Shares (Cont'd)

- Shareholders will also be liable to the extent that they receive the funds, which liability will accrue to the directors, (for relief over) as well as to the trustee in bankruptcy (under the BIA)
- Saving provisions:
 - corporation is not insolvent at the time of the decision
 - declaration and payment of funds did not cause the company to become insolvent



Inquiry into Dividends and Redemption of Shares (Cont'd)

- director had reasonable grounds to act
- *633476 Ontario Inc. v Salvati* (1990) 73 O.R. (2D)(774): provides that dividends declared and paid to shareholders, which is subsequently loaned back as a secured loan to the company will not stand up to protect the shareholder loans against unsecured and preferred creditors



Other Remedies and Procedures Available to Creditors

- Mareva Injunction:
 - used to prevent the dissipation of assets in the jurisdiction or removal of assets from the jurisdiction
 - can be obtained *ex parte* or on notice, but are generally granted *ex parte* with a strict evidentiary proof



Other Remedies and Procedures Available to Creditors (Cont'd)

- Anton Pillar Orders:
 - usually obtained *ex parte* and constitute an extraordinary remedy for the production of information and documentation where improper corporate acts in fraud or alleged to have occurred and continue to occur



Other Remedies and Procedures Available to Creditors (Cont'd)

- Oppression Remedy/Breach of Fiduciary Duty:
 - available under section 248 of the *Ontario Business Corporations Act* in the corresponding *Canada Business Corporations Act* provision
 - statutory remedies expand the duty of directors not just to the company as a whole, but also to the shareholders, employees, and other stakeholders in the corporation, including creditors
 - supplements the common-law duty of directors towards creditors (fiduciary duty), when a company is insolvent or near insolvency

Other Remedies and Procedures Available to Creditors (Cont'd)

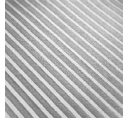
– fiduciary obligations in Canada tend to be drifting toward the broader scope of liability against directors in the United States, although Canada is still principally in an oppression remedy jurisdiction. The corporate veil will be pierced where directors have acted in a high handed or fraudulent manner:

- *Baltimore Aircoil of Canada Inc. v The Process Cooling Systems Inc. et al* (1994) 16 O.R. (3D) (324)
- *Central Guaranty Leasing Inc. v Biderman* (unreported) November 27, 1991 (summarized 30 ACWS (3D) (188))
- *Prime Computer of Canada Ltd. v The Jeffrey and Robinson & Jeffrey Ltd.* 6 O.R. (3D) (733)
- *Re: Peoples Department Stores Ltd. (1992) Inc., re 23 C.B.R* (4th 200)

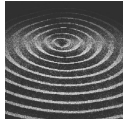


Other Remedies and Procedures Available to Creditors (Cont'd)

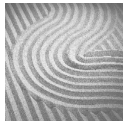
- Trusts:
 - trust law is sometimes used in oppression cases to protect debtors who have fully paid for an asset, but the asset is placed in the name of a third party. In those cases the oppression remedy is sometimes used to provide that the debtor corporation holds the asset in trust including profits derived on the asset or enterprise transferred

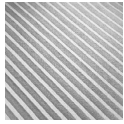


Bulk Sales Act

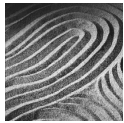
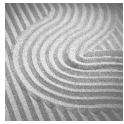
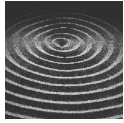


- Applies to sales of assets of the corporation out of the usual course of business or trade of the seller

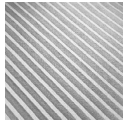




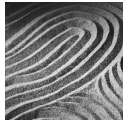
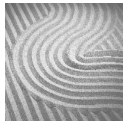
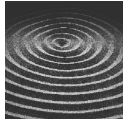
Bulk Sales Act (Cont'd)



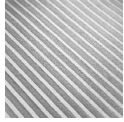
- The effect of a finding of a sale in bulk is to void the transaction as against the trustee in bankruptcy or another creditor aggrieved, and to impose liability on the buyer of the assets to account to all creditors of the seller of the goods and assets (meaning that the purchaser pays twice, once to the seller and once to the creditors of the seller)



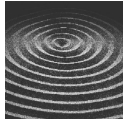
Bulk Sales Act (Cont'd)



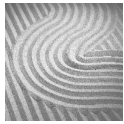
- Compliance with the detailed procedures under the *Bulk Sales Act* is required in order to protect a bulk sale:
 - appointment of a trustee under the *Bulk Sales Act*
 - obtaining a court order
 - written consent and approval of all creditors



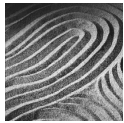
Bulk Sales Act (Cont'd)



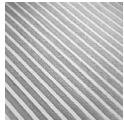
- Cases:



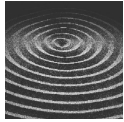
- see article of Jeffery C. Carhart enclosed with materials page 59 re *Canadian Red Cross Society* case



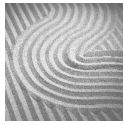
- creative use of a court order for an exemption of otherwise unavailable under the act reviewed by Mr. Carhart



Bulk Sales Act (Cont'd)

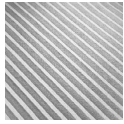


– *Sidaplex-Plastic Suppliers Inc. v The Elta Group Inc. et al* (1998)

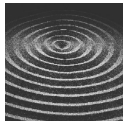


- this is a finding of a sale of bulk to a third party, who acted in good faith and without notice, but nevertheless bore the burden of paying the creditors of the sellers notwithstanding the purchaser's lack of culpability in the transaction

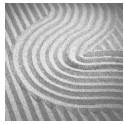




What Works to Defend An Attack



- Forward planning



- For valid business purposes

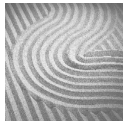
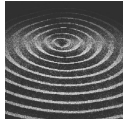
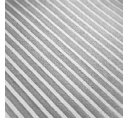


- Before the company is insolvent or on the eve of insolvency
- For good consideration, and at fair market value
- All transactions to non-arm's length parties



What Doesn't Work to Defend an Attack by Creditors

- When a company is in financial difficulty or insolvent or on the eve of insolvency
- With intent to defeat, hinder, or delay creditors, as evidence by “badges of fraud”
- Sales in bulk
- Oppressive and high-handed activities by the directors in anticipation of or on the eve of or during or after an insolvency



Maurice V. Fleming
Miller Thomson LLP
Scotia Plaza, 40 King St. W.,
Toronto, Ontario
416.595.8686
mfleming@millerthomson.com

**MILLER
THOMSON** LLP

Barristers & Solicitors
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