SOME BANKRUPTCY LAW ISSUES AFFECTING DIVISION OF ASSETS AND SUPPORT UNDER THE *FAMILY LAW ACT*

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INTRODUCTION

This paper is intended to discuss some issues arising as a result of the interplay between the *Family Law Act*, SBC 2001, c. 25 (the "FLA"), and the *Bankruptcy and Insolvency Act*, RSC 1985, c.B-3 (the "BIA").

Both the FLA and BIA purport to provide fairly comprehensive codes for regulating their respective fields. However, there are several issues that can arise when their fields of influence overlap.

Two of such issues of importance to family law practitioners are with respect to the division of property, and support obligations.

The BIA underwent considerable amendments in 2009, though most of its provisions relating to this interplay with family law have not been substantially amended. However, the family law regime has been considerably altered by the FLA, which has only been in effect for a little over one year. Therefore, much of the case law discussed below considered the effects of the former *Family Relations Act* (the "FRA"). In some respects, the existence of the FLA may not change much of this interplay, while in other respects, it may. Only time will tell.

BASIC BANKRUPTCY CONCEPTS RELEVANT TO DIVISION OF PROPERTY AND SUPPORT ISSUES

Before considering various scenarios involving the interplay between the division of property and support issues under the FLA and bankruptcy, it is useful to understand some relevant basic concepts of bankruptcy law that affect the consideration of those issues.

How Does Bankruptcy Occur?

In most family law contexts, bankruptcy occurs in one of three ways:

1. **An Assignment for the General Benefit of Creditors** – Under section 49 of the BIA, an insolvent person can make an assignment of his property by going to a licensed trustee in bankruptcy and filing an assignment form. The person must be a “insolvent person”, which the BIA defines as a person who is not already bankrupt, who resides, carries on business or has property in Canada, whose liabilities to eligible creditors equal at least $1,000, and

(a) who is for any reason unable to meet his obligations as they generally become due;

(b) who has ceased paying his current obligations in the ordinary course of business as they generally become due; or

(c) the aggregate of whose property is not, at a fair valuation, sufficient to enable payment of all his obligations, due and accruing due.

The process for making an assignment in bankruptcy can be carried out quickly.

2. **A Failed Proposal** – The BIA allows insolvent persons to make proposals to their creditors. An individual can qualify to file a Division II Consumer Proposal if his debts, excluding a mortgage on his principal residence, are less than $250,000. Consumer Proposals' procedures are more streamlined than other proposals. Typically, a BIA proposal is made to negotiate debts with one's acknowledged creditors, and if the proposal succeeds, bankruptcy is avoided. However, for general proposals to succeed, the insolvent person must obtain the approval of a requisite majority of his creditors, and then obtain the court's approval. Additionally, once approved by the creditors and the court, the insolvent person must carry out the terms of the proposal. If the proposal is not approved by the creditors or the court, or the proposal is annulled due to the failure of the insolvent person to subsequently perform his obligations under the proposal, the insolvent person is deemed to have made an assignment in bankruptcy.

3. **Petition by Creditors** – One or more creditors can petition the court to make a bankruptcy order against an insolvent person. There are a number of conditions that must be met to obtain a bankruptcy order; however, generally speaking, a creditor who is owed more than $1,000 and can prove that the person is insolvent and has committed an act of bankruptcy can cause a person to be ordered bankrupt. The typical act of bankruptcy relied upon is ceasing to meet liabilities generally as they become due.

Date of Bankruptcy

The date of bankruptcy can be an important factor in determining a spouse's interest in family property, as discussed below. The date upon which a person becomes bankrupt is determined by the way in which his bankruptcy occurred:

(a) Assignment – The date of bankruptcy is the date of the filing of the assignment;

(b) Failed Proposal – The date of the creditors' rejection of the proposal is the date the person is deemed to have made an assignment in bankruptcy. If the creditors approve the proposal, but the court rejects it, the date the court rejects the proposal is the date the person is deemed to have made an assignment in bankruptcy. If the proposal is accepted by the creditors and the court, but the proposal is later annulled, the date of the bankruptcy is the date of the order of annulment.

(c) Petition for Bankruptcy Order – The date of the bankruptcy is the date the bankruptcy order is made.

Bankrupt's Property upon Bankruptcy

Upon a bankruptcy, the bankrupt's property vests in the trustee in bankruptcy, pursuant to section 71 of the BIA:

> 71 On a bankruptcy order being made or an assignment being filed with an official receiver, a bankrupt ceases to have any capacity to dispose of or otherwise deal with their property, which shall, subject to this Act and to the rights of secured creditors, immediately pass to and vest in the trustee named in the bankruptcy order or assignment, and in any case of change of trustee the property shall pass from trustee to trustee without any assignment or transfer.

This provision is of special significance to issues regarding the division of property under the FLA, as described below.

Role of Trustee

Generally speaking, the trustee's role in a bankruptcy is to collect up and liquidate the bankrupt's property, and divide it among the established, or "proven", unsecured creditors of the bankrupt. To do so, the trustee has to assess the validity of claims of any secured creditors, whose remedies are generally exercised by the secured creditors themselves. The trustee's role is to recover, for the benefit of the proven unsecured creditors, the bankrupt's assets. The trustee is empowered to advance claims in the name of the bankrupt for the benefit of his unsecured creditors. The bankrupt is entitled to keep a statutorily prescribed amount for basic living expenses, but must pay over to the trustee any surplus income he may receive while bankrupt.

Discharge

Discharge from bankruptcy can occur as soon as approximately nine months after the bankruptcy commenced, although many factors can prolong the process. Upon his discharge

from bankruptcy, a bankrupt is released from most claims. However, as discussed below, certain support claims are not released upon the bankrupt's discharge.

Federal Element

Bankruptcy is a matter of federal jurisdiction, so the BIA applies across the country. Therefore, while bankruptcy cases involving family law issues in other provinces have common bankruptcy elements, the difference in family law regimes across the country make some, but not all, of those cases applicable in British Columbia. As well, the doctrine of paramountcy can come into play in bankruptcy matters where they may conflict with provincial legislation. There are also differences in terminology and legislative policy between the federal BIA and the provincial FLA.

DIVISION OF PROPERTY ISSUES

Scenario: Bankruptcy Occurs <u>After</u> Separation

1. Effect of Separation on Bankrupt's Property Interests

As a result of section 71 of the BIA (noted above), the bankrupt's property interests vest in the trustee in bankruptcy. Section 81 of the FLA provides that, on separation, each spouse has a right to an undivided half interest in all family property as a tenant in common.

If family law proceedings, or a separation agreement, have already determined the interests of the bankrupt by the time his bankruptcy occurs, the interests that vest in the trustee should be determinable: the bankrupt's property interests that vest in the trustee are only those which the FLA regime has already determined. However, if family law proceedings have not already divided the spouses' property interests before bankruptcy of one spouse, issues can arise respecting the ability to reapportion property as a result of the bankruptcy.

Under the former FRA regime, the typical concern was the non-bankrupt spouse's ability to reapportion once property has vested in the trustee. Presumably, similar issues will arise under the FLA's powers to order an unequal division of family property under section 95. By virtue of a long, and somewhat inconsistent, series of cases,[1] the following propositions have been generally established:

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[1] *Biedler v. Biedler and Henfry & Company Ltd.* (1983), 33 R.F.L. (2d) 336 (BCSC); *Baker v. Baker*, [1990] B.C.J. No. 1553 (QL) (S.C.); *Pigeon v Pigeon* 1993 CanLII 2583 (BCSC), (1993), 81 B.C.L.R. (2d) 100, 18 C.B.R. (3d) 100 (S.C.); *Re Thompson* 1993 CanLII 1036 (BCSC), (1993), 82 B.C.L.R. (2d) 22, 20 C.B.R. (3d) 158 (S.C.); *Taylor v Taylor*, [1996] B.C.J. No. 147 (QL) (S.C.), rev'd in part on

(a) the undivided one-half interest of the insolvent spouse arising upon the triggering event vests in his trustee upon his bankruptcy; and

(b) there is no subsequent ability for the court in the FRA proceedings (and presumably the FLA proceedings) to reapportion (or order an unequal division of) the one-half interest that has already vested in the trustee, subject to the effect of a restraining order (discussed below).

These propositions flow from the principle that the bankrupt's property interests vest in the trustee for the benefit of the bankrupt's creditors, and are no longer available to be reapportioned or unequally divided in matrimonial proceedings on the application of the non-bankrupt spouse. Accordingly, the fact of the bankruptcy has a significant effect on limiting the prospects of recovery for a non-bankrupt spouse, even if other factors would support an unequal division of family property in favour of the non-bankrupt spouse.

One of the enumerated factors the Court may consider in an application for an unequal division of family property under s. 95 of the FLA is whether one spouse, while not acting in good faith, disposed of, transferred or converted property that is or would have been family property, causing the other spouse's interest in the property or family property to be defeated or adversely affected: section 95(2)(g)(ii). While the legal effect of an assignment in bankruptcy is to cause the bankrupt's property to vest in the trustee, it is questionable whether an assignment in bankruptcy would constitute the transfer of property as contemplated by that section. In any event, the power of the Court under the FLA would still only apply to those assets which have not already vested in the trustee as a result of the assignment in bankruptcy.

2. Effect of Restraining Order

Likely due to the perceived unfairness to a non-bankrupt spouse of the propositions noted above, courts have sought to find ways to distinguish the applications of such propositions. The primary means of distinguishing those propositions has been reference to a restraining order.[2] So significant is the effect of a restraining order that Burnyeat J., in *Beninger*, considered at

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other grounds 1998 CanLII 6096 (BCCA), (1998), 50 B.C.L.R. (3d) 212, 157 D.L.R. (4th) 701 (C.A.); *Verbeek v. Craig* 1998 CanLII 1683 (BCSC), (1998), 2 C.B.R. (4th) 274, 37 R.F.L. (4th) 143 (B.C.S.C.); *Stasiuk v. Stasiuk* 1999 CanLII 6100 (BCSC), (1999), 9 C.B.R. (4th) 182, 46 R.F.L. (4th) 382; *Bankruptcy of Beninger*, 2003 BCSC 1790; *Ken Glover & Associates Inc. v. Irwin*, 2005 BCSC 1364 (CanLII), 2005 BCSC 1364, 25 R.F.L. (6th) 207; *J.A.H. v. R.H.*, 2005 BCSC 1713; *Rodenkirchen v. Peters*, 2006 BCSC 1021; *Montalban v. Montalban*, 2007 BCSC 1266

[2] See, for example, *Re Thompson*, 1993 82 BCLR (2d) 22 (SC); *Taylor v. Taylor* [1996] BCJ (QL) No. 147 (SC); and *Re Bankruptcy of Beninger*, 2003 BCSC 1790 ("*Beninger*")

length whether correspondence created an "informal restraining order", so as to allow him to distinguish the cases and avoid the effect of the propositions.[3]

However, the cases which rely upon the existence of a restraining order do not explain in theory why such restraining orders change the effect of the BIA's vesting of property in the trustee in bankruptcy. Breach of a restraining order would, presumably, give rise to remedies such as contempt. However, it is unclear why the breach of an order would necessarily prevent the BIA's provisions from applying.

Instead, if a bankrupt spouse breached a restraining order, it may provide a basis for an order in the bankruptcy proceedings to annul his subsequent bankruptcy. Section 181 of the BIA allows the bankruptcy court to annul an assignment or bankruptcy order if it "ought not to have been made". That result has occurred in various cases.[4] In those cases, the annulment had the effect of re-vesting the property in the bankrupt, and therefore, making it available to be reapportioned in the matrimonial proceedings. However, annulment of a bankruptcy can be difficult to obtain, especially if there is a large body of creditors who may be prejudiced, and an abuse of process may have to be proven.

3. Trustee's Claim for Unequal Division

Another scenario that can occur where the bankruptcy arises after the separation is an application by the trustee that a reapportionment, or unequal division, should be made in favour of the bankrupt spouse, such that the trustee will obtain further assets from the non-bankrupt spouse for the benefit of the bankrupt's creditors.

Such an application by the trustee is consistent with the trustee's right to advance claims in the name of the bankrupt and take proceedings to recover assets for the benefit of the bankrupt's estate.[5] Assets in the name of the non-bankrupt spouse are available to be reapportioned, or unequally divided, at the application of the trustee. Mr. Justice Burnyeat, in *Beninger,* held that even though property vested in the trustee is insulated from reapportionment, the non-bankrupt spouse's property interests are vulnerable to a claim by the trustee. He held as follows:

> I am satisfied that it is appropriate to deal differently with family assets in the name of the spouse who subsequently becomes bankrupt and family assets which were in the name of the non-

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[3] *Beninger*, at paras. 25-36

[4] See, for example, Re *Fuller*, 1990 CanLII 672 (BCSC); *Stasiuk v. Stasiuk* (1999) 9 C.B.R (4th) 182 (BCSC); *Warner v. Warner*, 2013 ONSC 1726

[5] See section 30, BIA

> bankrupt spouse but subsequently becomes subject to the interest of the bankrupt spouse and, upon bankruptcy, his or her trustee. The interest which vested in the Trustee in this case was the interest of [the bankrupt spouse] which was subject to the possibility of reapportionment.[6]

It will remain to be seen whether the factors the court may consider in determining unequal division of family property under section 95 of the FLA may include the fact of a bankruptcy when the claim for unequal division is made by the trustee. Section 82 of the FLA specifically provides that nothing in Part 5 affects the rights and remedies of a spouse's creditors. Presumably, a trustee will rely upon that section in advancing a claim in favour of a bankrupt to an unequal division of property. To date, no cases have interpreted that section under the FLA.

The FLA appears to have a less distinct definition of a triggering event than did the FRA. The event giving rise to the entitlement of each spouse to an undivided half-interest in family property occurs "on separation" which, under s. 3(4) of the FLA, may be indistinct. A trustee may argue, therefore, on behalf of a bankrupt spouse, that separation did not occur prior to bankruptcy, if the result of that sequence of events means that a greater amount of property vested in the trustee for the benefit of the creditors.

4. Strategies for Non-Bankrupt Spouse

There are strategic concerns for a non-bankrupt spouse dealing with an insolvent spouse who may become bankrupt after the separation. The primary strategy is to use a restraining order. Section 91(2) of the FLA sets out the type of restraining order the court may make. Although it does not specifically refer to the BIA, it prevents a spouse from "disposing of, transferring, converting or exchanging into another form" property, for the purpose of protecting the applicant's interest in the property from being defeated or adversely affected. Arguably, that includes an insolvent spouse making an assignment in bankruptcy, by which he assigns to the trustee his property interests. However, to avoid uncertainty, it would seem useful for any restraining order to specifically prohibit making an assignment in bankruptcy.

Further, the wording of s. 91(2) of the FLA, preventing the disposing, transferring, converting or exchanging of property, would not appear to necessarily prohibit a spouse from filing a proposal to his creditors under the BIA. Under a proposal, the assets do not vest in the trustee; instead they remain with the insolvent spouse making the proposal. However, since a failed proposal results in a bankruptcy, it would be useful to specifically seek to prohibit a spouse from also filing a proposal under the BIA in any restraining order.

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[6] *Beninger*, at paragraph 41

The resolution of a settlement agreement before an imminent bankruptcy would also be advisable, since such agreements will usually be binding on a trustee (unless a preference, undervalue transaction or fraudulent conveyance is established). Therefore the non-bankrupt spouse should ensure any settlement is demonstrably fair and immune from attack by the trustee or the creditors in a subsequent bankruptcy.

Finally, commencing FLA proceedings swiftly may be advantageous. Burnyeat J., in *Beninger*, adopted the following proposition from a leading bankruptcy commentary:

> If property is in the wife's name and proceedings have been commenced before bankruptcy for division of family property, the trustee in bankruptcy of the husband is not entitled under the *Family Relations Act* of British Columbia to one-half of the family property: The Trustee takes the husband's interest subject to the power of the court to vary such distribution as it finds to be unfair. It is appropriate, therefore, to permit the proceedings for division of the family property to proceed in the ordinary civil courts so that the proper division can be made . . . .[7]

Thus, commencing FLA proceedings before an imminent bankruptcy may preserve an opportunity to divide assets, despite a subsequent bankruptcy.

Scenario: Bankruptcy <u>Before</u> Separation

1. Property Vesting in Trustee

Where a bankruptcy occurs before the triggering effect of a separation under the FLA, the property that vests in the trustee as a result of section 71 of the BIA is those property rights that exist unaffected by the FLA regime. That is, a spouse's right to an undivided half interest in family property that arises upon separation has no effect on the property interests vesting in the trustee if separation has not yet occurred. In that case, the trustee simply acquires the pre-FLA interests of the bankrupt.

Since the specific date of separation may be indistinct, pursuant to section 3(4) of the FLA, factual issues may arise as to whether the date of bankruptcy predated the separation. In the case of a bankruptcy arising due to a failed proposal, the effective date of the bankruptcy may be well after the proposal proceedings began, as noted above.

Where family property has vested in the trustee because such property had been in the name of the bankrupt spouse, FLA proceedings cannot be used to divide property vested in the trustee. However, where family property is in the name of the non-bankrupt spouse, the court should have the power to divide such property once separation occurs, based on decisions made under

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[7] *Beninger*, citing Holden and Morawetz, *Bankruptcy and Insolvency Law of Canada, 3rd Ed.*, at paragraph 40

the FRA.[8] Thus, where the bankrupt has been discharged before reapportionment became an issue (as in *J.A.H.*), or where the trustee advances the claim for reapportionment on behalf of the bankrupt (as in *Montalban*) the non-bankrupt spouse's interests can be affected.

2. Separation Agreement

If a separation agreement is entered into while a spouse is bankrupt, the effect of section 71 of the BIA renders the agreement a nullity.[9] Section 71 of the BIA provides that a bankrupt ceases to have any capacity to dispose of or otherwise deal with his property; therefore, the bankrupt lacks capacity to make a legally binding separation agreement during the currency of his bankruptcy. This would be the result even if the non-bankrupt spouse was unaware of the bankruptcy, since capacity does not depend on a counterparty's knowledge.

3. Non-bankrupt Spouse's Perspective

Where separation occurs during the bankruptcy, the bankrupt's property interests have already vested in the trustee. Therefore, most of the bankrupt spouse's assets may already be liquidated and distributed to his creditors, or in the process of being liquidated. Further, if the non-bankrupt spouse holds title to family property, the bankruptcy will not insulate him from claims by the trustee during the currency of the bankruptcy, or from a spouse who has been discharged from bankruptcy. However, the benefits of bankruptcy for a proven creditor may still be worthwhile for the non-bankrupt spouse in an effort to recover assets. For example, the trustee's investigatory powers may uncover assets that would not have been available outside of bankruptcy, as described below.

SUPPORT ISSUES

1. Provable Claim

A non-bankrupt spouse's entitlements to child and/or spousal support payments under the FLA will likely be recognized within the scope of the BIA's term, "alimony", or the following provision:

> Any debt or liability arising under a judicial decision establishing affiliation or respecting support or maintenance, or under an agreement for maintenance and support of a spouse, former spouse, former common-law partner or child living apart from the bankrupt.[10]

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8 See, for example, *J.A.H. v R.H.* 2005 BCSC 1713; *Montalban v. Montalban*, 2007 BCSC 1266

9 *J.A.H. v R.H.* 2005 BCSC 1713

10 BIA, section 178(1)(b) and (c)

If a spousal or child support claim fits within that definition under the BIA, and is payable under an order or agreement made before the assignment in bankruptcy or filing of a proposal,[11] and when the spouse, former spouse, former common-law partner or child was living apart from the bankrupt, it is considered a “provable claim” under the BIA. A provable claim is a claim that is accepted as valid and quantified by the trustee and under which the creditor may participate in the bankruptcy process.

2. Effect of Being a Proven Creditor

Having a provable claim can be important in a family law context. Proven creditors can engage with the trustee and seek the trustee's assistance using its considerable investigatory powers. A trustee can demand documents and conduct examinations from a variety of parties, including the bankrupt's accountants, business partners, and even his solicitors. A trustee can bring certain claims, or use certain evidentiary presumptions that are unavailable to ordinary litigants. In some circumstances, creditors can take an assignment of a trustee's claim and advance claims themselves in the name of the trustee. Further, a proven creditor can be appointed an inspector under a bankrupt's estate, and provide direction and supervision to the trustee in that capacity. Having a provable claim also allows a creditor to petition the court to make a bankruptcy order.

Proven spousal and child support claims can be given a priority status in a bankruptcy. Under s. 136(1)(d.1) of the BIA, a spouse's claim for spousal or child support for periodic payments accrued in the year before the date of the bankruptcy, plus any lump sum amount that is payable, are "preferred" claims under the BIA. A preferred claim is paid out in advance of ordinary unsecured claims (but after secured claims). Therefore, there is a much better prospect of recovery in the bankruptcy for such proven spousal and child support claims.

The periodic payments that may not qualify as a preferred claim because they are more than a year old can still be provable as an ordinary unsecured claim. Note that the lump sum payment is not required to have been payable in the year before the bankruptcy to qualify as a preferred claim under s.136(1)(d.1) of the BIA.

Trustees, or other creditors, can challenge separation agreements negotiated on the eve of bankruptcy where a lump sum support payment is made. They can argue that doing so created

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[11] See definition of "date of the initial bankruptcy event" in BIA, section 2, as used in section 121(4)

a preference for the non-bankrupt spouse, to the prejudice of the other creditors.[12] Therefore, care should be taken in drafting support obligations in an agreement where a bankruptcy may occur. An order would likely be safer.

3. Survival of Claim after Discharge

Normally, upon the bankrupt's discharge, creditors' claims against the bankrupt are released. However, an exception to that general rule applies to spousal and child support payments.

Under s. 178(1)(c) and (d) of the BIA, obligations to make spousal and child support payments under an agreement or order are not released upon discharge of the bankrupt. Therefore, if any balance remains owing after receipt of dividends (either as a preferred creditor or as an ordinary unsecured creditor) in the bankruptcy, those claims will continue to exist after the bankrupt's discharge.

Since the purpose of releasing debts upon a bankrupt's discharge is the financial rehabilitation of the bankrupt – an important goal in bankruptcy law – scrutiny may be made of the nature of the support obligation to see whether it is properly one which survives the bankruptcy. The Court of Appeal, in *Van Norman* held that it is a question of fact in each case whether a debt or liability arises under an agreement for maintenance and support. The Court of Appeal held that a lump sum payment made expressly "in lieu of" maintenance favoured the position that the obligation was not discharged under the BIA.[13]

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[12] See, for example, *Re Muzlera*, 2011 ONSC 4531

[13] *Van Norman v. Van Norman* (1993) 18 CBR (3d) 123 (BCCA)