Reform of Fraudulent Conveyances and Preferences Law - Progress Report 2007

Proceedings

Upcoming Meeting

CIVIL LAW SECTION

REFORM OF FRAUDULENT CONVEYANCES AND FRAUDULENT PREFERENCES LAW

(Transactions at Undervalue and Preferential Transfers)

Progress Report

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Charlottetown, Prince Edward Island, Sept., 2007

BACKGROUND AND WORK TO DATE

[1] At its 2005 annual meeting, the Conference approved a project for reform of the provincial and territorial law of fraudulent conveyances and preferences on the basis of an offer of funding by the Law Reform Commission of Saskatchewan. The project strategy proposed by the writer was endorsed at the 2006 annual meeting and the delivery to the Conference of the Introduction and Part I of the contemplated study paper represents the first step in its implementation.

[2] Although the unitary expression “fraudulent conveyances and preferences” is commonplace, the subject under study in fact encompasses the two distinct though related topics of fraudulent conveyances and fraudulent preferences. The Introduction and Part I of the study paper introduces the joint subject and addresses fraudulent conveyances.[1] Part II, which is in progress, addresses fraudulent preferences. Completion of Part II is anticipated by the end of 2007.

SUBJECT OF REFORM

[3] The unifying theme of fraudulent conveyances and fraudulent preferences law is that both are addressed to circumstances in which a debtor has dealt with his or her property in a manner that obstructs or defeats the right of one or more of his or her creditors to satisfaction through resort to the debtor’s assets. As traditionally defined, a fraudulent conveyance is a transfer of property intended by a debtor to place property that would otherwise be available to creditors beyond their reach. The injured class is creditors who might have received proceeds of judgment enforcement measures under which the transferred property could have been seized had it not been conveyed to the transferee. A fraudulent preference involves a transfer of property by a debtor to one of his or her creditors with the intention of satisfying that creditor at the expense of others who, had the transfer not occurred, could have claimed a portion of the property in satisfaction of their claims. The injured class is therefore those creditors whose ability to recover is diminished by the loss of their proportionate share in the property as that share could have been realized from the proceeds of judgment enforcement measures.[2]

[4] The primary feature distinguishing fraudulent conveyances from fraudulent preferences is the character of the party whose interests are in competition with those of the injured creditor or creditors. In the case of a fraudulent conveyance it is a person who has received property from a debtor on an entirely or partially gratuitous basis; that is either by way of gift or in return for consideration worth significantly less than the value of the property received. In the case of a fraudulent conveyance it is a creditor who has received no more than what is justly due on a legitimate debt, but in circumstances in which the consequence of the transaction is that other creditors will receive less than they

otherwise would. The factors relevant to whether a gratuitous transferee should be protected as against creditors challenging a transaction will differ materially from those relevant to whether a creditor receiving payment of a debt should be protected.

[5] The theme that unifies fraudulent conveyances and preferences means that some of the policy and technical issues that must be addressed are the same in cases of both kinds. However, the definition of creditors' rights as against third party transferees raises issues that are distinct from those involved in defining the rights of creditors as among themselves. Therefore, while the objective of this project is the creation of a single draft statute governing both types of transaction the achievement of that objective will involve the integration of two related but distinct bodies of work.

[6] A word on terminology is required before the project is described further. Although generalizations in this area of law are invariably subject to exception, it is reasonably accurate to say that the primary substantive basis upon which creditors may currently challenge a transaction under either of these branches of law is the debtor's intention to defeat creditors, whether a particular creditor or creditors generally. Therefore the type of transaction that gives rise to a remedy is designated as a "fraudulent" transaction, in that it is purposely designed to defeat and thus to defraud creditors. The fact that a transaction has the effect of defeating or obstructing the ability of creditors to recover has not historically been recognized as grounds for challenge in the absence of fraudulent intent. However, modern thinking about transactions of this kind and some systems of modern legislation have moved from this position.

[7] A number of commentators and some legislative bodies have adopted the view that the law should be primarily concerned with the actual effect on creditors of a debtor's dealings with his or her property, rather than with whether the debtor intended to prejudice their rights. Subject to certain qualifications creditors should, on this view, have a remedy if the effect of a transaction is to diminish the pool of assets that would otherwise be available to satisfy their claims. The terminology used in relation to transactions of this kind has changed to reflect this shift in approach and to more accurately represent the full range of transactions that might fall subject to statutory regulation.

[8] In the context of what has to this point been called fraudulent conveyances, the harm is that the debtor has engaged in a transaction in which value is given by the debtor without reciprocal exchange, with the result that the net value of the debtor's exigible asset base available to creditors is reduced. The term used in the study paper to refer to that type of transaction is "transaction at undervalue." The term parallels that used by others in this context. Hence while the overall title of the study paper references fraudulent conveyances, Part I of the paper is called "Transactions at Undervalue."

[9] In the context of what are traditionally called fraudulent preferences, the harm is that one creditor is given preferential treatment in that the transaction puts that creditor in a position to recover proportionately more than can others. The term used in the study paper to describe that type of transaction, again reflecting the terminology used by others, is “preferential transfer,” the subject of Part II.

THE STUDY PAPER – INTRODUCTION AND PART I: TRANSACTIONS AT UNDERVALUE

[10] A study paper addressing transactions at undervalue (fraudulent conveyances) has been delivered to the Conference and, as at the date of writing, awaits translation. The paper has three primary components, each with a number of sub-parts. They are:

A. Summary of Current Law

B. Policy Considerations in the Regulation of Transactions at Undervalue

C. Issues for Determination

The content of each of these components is outlined below under their respective headings.

A. Summary of Current Law

[11] The law in this area is rooted in the Statute of Elizabeth, sometimes called the Fraudulent Conveyances Act, an English statute enacted in 1571 that remains operative to this day in Canadian common law jurisdictions, either as received law or by way of the statutory re-enactment of its essential provisions. Most jurisdictions have also enacted separate legislation governing transactions of this kind, often along with fraudulent preferences. In many (though not all) jurisdictions that statute is called the Fraudulent Preferences Act, notwithstanding that it applies to fraudulent conveyances as well as fraudulent preferences. Where provincial legislation of this kind is in place creditors may challenge a transaction as a fraudulent conveyance under either the Statute of Elizabeth or the provincial statute.

[12] Under both the Statute of Elizabeth and the provincial statutes, creditors may challenge a transfer of property by a debtor on the substantive basis that it was intended by the debtor to defeat creditors, a transgression the nefarious quality of which is captured by the preamble to the Statute of Elizabeth. The Act is declared to be;

For the Avolishing and Abolishing of feigned, covinous and Fraudulent [conveyances of property] devised and contrived of Malice, Fraud, Covin, Collusion or Guile, to the End, Purpose and Intent, to delay, hinder or defraud Creditors and others [of their rights] not only to the Let or Hinderance of the due Course and Execution of Law and Justice, but

also to the Overthrow of all true and plan Dealing, Bargaining and Chevisance between Man and Man, without the which no Common wealth or civil Society can be maintained or continued.

[13] The provincial statutes also require proof that the debtor was insolvent or on the verge of insolvency at the time of the transaction in question. Although the Statute of Elizabeth does not impose that requirement, proof of insolvency will raise either an irrebuttable or a rebuttable presumption of fraudulent intention, depending on the judicial stance adopted.

[14] Although the problems associated with proof of a debtor's fraudulent state of mind are difficult enough, an even more troublesome issue under current provincial and territorial law is the question of whether a plaintiff creditor must also prove that a transferee who has given some measure of consideration in return for a conveyance of property knew of or shared the debtor's culpable intention. Depending upon the statutory provisions in play and the interpretation adopted by the court, relief may not be granted unless the challenging creditor can prove what is often called a "dual intention" to defeat creditors.

[15] The picture is further complicated by the fact that, if the debtor ultimately becomes bankrupt, provisions of the federal Bankruptcy and Insolvency Act (the BIA) governing transactions that prejudice the rights of unsecured creditors come into play. The pertinent provisions are those governing what are called settlements and reviewable transactions. Notably, whether the debtor entered into a transaction with the intention of defeating his or her creditors is not directly relevant in either context. The focus of the Act in its current form is on the *de facto* removal of property from the pool of assets available to the trustee in bankruptcy for satisfaction of creditors' claims. However, amendments currently before Parliament as part of Statute C-47 (formerly Bill C-55)[3] would introduce an intention test in some circumstances, depending on the relationship between the parties to the transaction.

[16] It is also worth noting that a trustee in bankruptcy may challenge a transaction that does not run afoul of the BIA provisions by resort to provincial law.[4] For this and other reasons the harmonization of provincial and federal law in this area is a goal worth pursuing, though one that is likely to be elusive given the longstanding and continuing difficulties involved in federal bankruptcy law reform.

B. Policy Considerations in the Regulation of Transactions at Undervalue

[17] The study paper suggests that the current state of confusion and uncertainty in the law governing transactions at undervalue is in large part due to the absence of a clear and consistent policy foundation. The fundamental though not the only policy question

that must be addressed in the reform process is whether or not the substantive basis for intervention in a debtor's freedom to deal with his or her property and commercial services should be the intention accompanying a given transaction. The paper identifies the policies underlying the various systems of law governing transactions that affect creditors' rights in aid of the formulation of a response to that and related questions through reformed legislation.

[18] The more modern legislation that has been adopted in other jurisdictions, notably the United States and the United Kingdom, abandons the intention of the debtor as the primary basis for provision of a remedy to creditors. The foundational policy objective underlying those systems is to restore to creditors the value of property lost to them as a result of a transaction through which an insolvent debtor diminishes the value of the asset pool that would otherwise have been available to satisfy their claims.

[19] Though this policy might be accepted as the central goal of reformed Canadian legislation, it cannot be pursued to the exclusion of other important policies; most notably the protection of those who deal with a debtor, notwithstanding that the transactions in question may prejudice creditors' rights. The need to accommodate the legitimate interests of persons who, for the sake of simplicity, may be called transferees is a product of the fact that any remedy granted will be a remedy against them. A transaction contrary to current law is void as against affected creditors, which means that the transferee will lose what he or she has received from the debtor in favour of the creditors. However, modern statutes offer a much more flexible remedial regime. It is therefore possible to factor the policy of protecting transferees into the legislation either through the provision of a defence or in the design of the remedy.

[20] While movement from an intention-based cause of action to an objective test holds considerable appeal, the paper identifies other policy considerations that must be addressed in the reform process, including the potential relevance of fraudulent intention on the part of the debtor and of a transferee's knowledge of the debtor's intention or circumstances. Whatever the right policy mix may be, it must be clearly understood and implemented through legislation that produces predictable, consistent and defensible outcomes. A reform effort that does not proceed on the basis of well-defined policy choices is destined to produce unsatisfactory results.

C. Issues for Determination

[21] The study paper presents an extensive list of specific issues that must be decided in the design of reformed legislation, falling under five general headings:

1. Transactions within the Scope of the Act

2. Standing: Who may Claim a Remedy under the Statute?

3. Grounds for a Remedy (Bases for Challenging Transaction)

4. Defences and the Protection of Third Parties

5. Remedies

These issues and the discussion of alternative approaches to their resolution are drawn largely from a review of existing proposals for reform in this area and an examination of current statutory regimes in place in cognate legal systems; namely, those of the United Kingdom, Australia and the United Statutes.

[22] The study paper is designed to provide the working group with a framework that will assist it in the development of reformed legislation. Accordingly, it does not offer specific recommendations in relation to the issues identified, on the view that those recommendations must be produced by the working group itself. However, advantages and disadvantages associated with alternative approaches are identified.

NEXT STEPS

[23] The next steps in this project are (a) the completion of Part II of the study paper addressing Preferential Transfers, (b) the procurement of an ancillary report addressing Quebec law and (c) the establishment of a working group to move towards the project towards its completion. The following observations may be made in relation to each of those points.

(a) Part II of the Report: Preferential Transfers

[24] As indicated earlier, completion of this project in its entirety will involve the production of a single statute governing both transactions at undervalue and preferential transfers. However, the working group may commence its work on the basis of Part I of the report, adding Part II to its agenda as work progresses. Given the expectation that Part II will be completed before the end of 2007, this will not delay the advancement of the project.

(b) Report on Quebec law

[25] At its 2006 annual meeting the Conference confirmed that its bijural approach to law reform should be incorporated in this project, though it was recognized that the inclusion of provisions governing transactions of this kind in the new Civil Code of Quebec may have left little perceived need for legislative change in that province. Nevertheless, any potential for advancing the goal of national harmonization should be realized insofar as possible in the reform process. In light of the limitations of the project's budget, its timeframe and the project leader's acquaintance with Quebec law it was decided that the Quebec perspective could be incorporated appropriately through the recruitment of a person with suitable expertise to prepare a report ancillary to the main study paper. That report would provide an overview of the manner in which the issues identified in the study

paper are addressed by the law of Quebec, identify those in relation to which there may be a need for legislative reform and possibly assess the extent to which proposals for reform emanating from this project might be relevant to Quebec. The participation of the report's author as a member of or consultant to the working group would be highly desirable though not essential. The input of Conference representatives in the identification and recruitment of a person able to write this report and potentially to participate in the working group will be sought at the Charlottetown meeting.

(c) The Working Group

[26] Having participated in the Conference's working groups on Civil Enforcement and Secured Transactions Law Reform, the author of this report has agreed to chair the working group that will be assembled to move this project to completion. The members of the Conference will be called upon to assist in the identification and recruitment of individuals who might further populate the working group. Two expressions of interest have already been received and, with the endorsement of the Conference, will be pursued by the Chair.

[27] Subject to the direction of the Conference and its own decision, the working group will proceed on the basis of the study paper and ancillary report to:

- identify the issues of policy and approach that require input from the legal profession and stakeholders,
- devise an appropriate consultation process, including a consultation document,
- decide the issues of policy and approach involved in the formulation of legislation, and
- draft a uniform statute.

FOOTNOTES

[1] The Introduction and Part I is 86 pages in length inclusive of endnotes, not including the appendices.

[2] Since unsecured creditors may enforce payment of a debt through seizure of their debtors' assets under provincial or territorial law only by reducing their claim to judgment and invoking judgment enforcement measures, the reference here is to recovery by those means. However, if a debtor becomes bankrupt recovery through realization against the debtor's property is accomplished by the trustee acting as the representative of creditors

under federal bankruptcy law. In both contexts, the harm addressed is the loss of assets that would otherwise have been available to satisfy creditors.

[3] *An Act to Establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies Creditors' Arrangement Act and to make consequential amendments to other Acts*, S.C. 2005, c. 47.

[4] *Kozan Furniture (Yorkton) Ltd. (Trustee of) v. Countrywide Factors Ltd.; sub nom Robinson v. Countrywide Factors Ltd.*[1978] 1 S.C.R. 753.

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