
Reform of Fraudulent Conveyances and Fraudulent Preferences Law: Transactions at Undervalue and Preferential Transfers

Working Group Final Report on Part 1:
Transactions at Undervalue & Fraudulent Transactions
Uniform Law Conference of Canada
Halifax: 2010

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Reform of Fraudulent Conveyances and Fraudulent Preferences Law

- **Part 1:** Transactions at Undervalue & Fraudulent Transactions (Fraudulent Conveyances)
 - **Part 2:** Preferential Transfers (Fraudulent Preferences)
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The Working Group

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Dissemination of the Report

- Banking and Finance Law Review (Osgoode Hall Law School): Insolvency Institute of Canada symposium issue
 - Insolvency Institute of Canada (IIC)
 - Canadian Association of Insolvency & Restructuring Professionals (CAIRP)
 - Canadian Bar Association National Business Law Section
 - ULCC website
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Substance of the Report

- A. Title of Act
 - B. Underlying Policies of Reformed Law
 - C. General Policies in the Design of a New Statute
 - D. Grounds for a Remedy: Definition of the Causes of Action
 - E. Scope of the Act: Transactions falling subject to the Act
 - F. Standing to Seek a Remedy under the Act
 - G. Remedies
 - H. Limitation Period
 - I. Law Repealed
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A. Title of Act

The Act should be called

The Reviewable Transactions Act

The two dimensions of the Act should be designated as:

- Transactions at Undervalue and Fraudulent Transactions
 - Preferential Transfers
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The Problem

- Debtor owes \$500,000 to Creditor or to multiple creditors on an unsecured basis.
 - Creditor does not have a security interest in Debtor's property to secure repayment, therefore has no direct recourse against Debtor's assets in the event of default.
 - Creditor's only means of recovery in law is to (1) obtain a judgment ordering Debtor to pay a monetary sum and (2) if Debtor persists in non-payment, enforce the judgment under provincial judgment enforcement law.
 - Judgment enforcement law is the means by which property may be seized and sold or, if in liquid form (e.g. accounts) collected and the proceeds distributed to judgment creditors. In most provinces, "creditors' relief" law requires sharing of proceeds among qualifying judgment/unsecured creditors.
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The Problem

- If Debtor becomes bankrupt, creditors' rights of enforcement will merge in Debtor's trustee in bankruptcy (sharing principle continued by different means). Federal law governs. Trustee may use provincial law as well as BIA provisions to challenge transactions that prejudice creditors.
- Creditors are prejudiced when the value of Debtor's asset base is diminished by a transaction, since the result is to reduce the pool of property available to satisfy a judgment (or claims asserted in bankruptcy).

Assets = \$400,000 with Debts = \$500,000 → Recovery at max 80%

Debtor sells property worth \$100,000 to Transferee for \$50,000

Net gain to Transferee = Net loss to creditors = \$50,000 → Recovery at max 70%

- When should a transaction that has that result be subject to challenge, and what remedies should be provided?
- Since nothing more can be recovered from Debtor, the remedy must require Transferee to restore to Creditors the benefit lost under the transaction.

B. Underlying Policies of Reformed Law

1. Interference with creditors' rights of recovery is wrong and warrants redress (*whether or not the interference was intentional*).

Interference = transaction that results in depletion of debtor's asset base available to satisfy creditors through judgment enforcement measures.

2. The law should deter transactions that interfere with creditors' rights of recovery.

Persons dealing with debtor should be in a position to respond to the risk of a proposed transaction. Transferee bears the loss associated with a remedy.

3. Reasonable reliance on finality of transactions should be recognized.
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D. Grounds for a Remedy: Definition of the Causes of Action

[26] **Cause of action #1**: Defined by paragraphs 1(a) and (b) above (insolvency + conspicuously inadequate consideration/asset depletion)

- 1(a): Debtor receives no consideration for value given or receives consideration that is worth **conspicuously** less than the value given by debtor.
 - 1(b): Debtor is insolvent at the time of the transaction, becomes insolvent as result of the transaction or enters into the transaction when insolvency is a foreseeable risk, if insolvency in fact ensues within 6 months of the transaction.
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D. Cause of Action #1

Situation contemplated:

- Debtor is insolvent (assets worth less than liabilities or unable to pay debts as they fall due) at date of the transaction or as a result of the transaction, or foreseeable insolvency occurs within 6 months.
- Removal of value from asset base necessarily diminishes creditors' recovery – i.e. less is available to satisfy unsecured/judgment debts.
- Transferee gives “conspicuously less” than value received so takes benefit in whole or part for free.

Cause of action provides a remedy against the transferee and thereby:

- Provides redress for interference with creditors' rights.
- Enables transferee to recognize risk of the transaction – receives value for free or for *conspicuously* less than it's worth, or “You don't get something for nothing.”
- Deters transferee and/or debtor from engaging in transaction.

D. Grounds for a Remedy: Definition of the Causes of Action

- [28] **Cause of action #2:** Defined by paragraphs 2(a), (b) and (c)(i) above (debtor intention to hinder + conspicuously inadequate consideration/asset depletion)
- 2(a): Debtor enters into transaction with the intention of hindering or defeating a creditor or creditors.
 - 2(b): The transaction in fact materially hinders creditors' ability to recover.
 - 2(c)(i): The transferee gave no consideration for value received or gave consideration worth **conspicuously** less than the value received from Debtor.
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D. Cause of Action #2

Situation contemplated:

- Debtor fraudulently **intends*** to defeat or hinder creditors (whether or not insolvent). That objective is the dominant motive though transaction may be intended to have ancillary benefits (e.g. provide for family, achieve tax benefit).
- Transaction has intended effect – asset base available to creditors is depleted.
- Transferee gives “conspicuously less” than value received so takes benefit in whole or part for free.

Cause of action provides a remedy against the transferee and thereby:

- Provides redress for interference with creditors’ rights.
- Enables transferee to recognize risk of the transaction – receives value for free or for *conspicuously* less than it’s worth, or “You don’t get something for nothing.”
- Deters transferee and/or debtor from engaging in transaction.

* *Proof of intention – factors listed (revised “badges of fraud”)*

D. Grounds for a Remedy: Definition of the Causes of Action

[30] **Cause of action #3:** Defined by paragraphs 2(a), (b) and (c)(ii) above (shared intention or “conspiracy” to hinder)

- 2(a): Debtor enters into transaction with the intention of hindering or defeating a creditor or creditors.
- 2(b): The transaction in fact materially hinders creditors’ ability to recover (whether or not any or adequate consideration is received by Debtor).
- 2(c)(ii): The transferee knew of Debtor’s intention and intended to assist in its achievement.

D. Cause of Action #3

Situation contemplated:

- Debtor fraudulently **intends*** to defeat or hinder creditors (whether or not insolvent). That objective is the dominant motive though transaction may be intended to have ancillary benefits (e.g. provide for family, achieve tax benefit).
- Transaction has intended effect – asset base available to creditors is depleted.
- Transferee **intended*** to assist Debtor to achieve desired result (regardless of value of consideration given).

Cause of action provides a remedy against the transferee and thereby:

- Provides redress for interference with creditors' rights.
- Enables transferee to recognize risk of the transaction – knows of Debtor's intention.
- Deters transferee and/or debtor from engaging in transaction.

* *Proof of intention* – factors listed (revised “badges of fraud”)

Finality of Transactions:

B. Underlying policies =
D. Causes of Action +
H. Limitation Period

B. Policy: Reasonable reliance on finality of transactions should be recognized.

D. Causes of action: Allow transferee to recognize and assess risk of transaction. Transferee does not reasonably rely on finality where transaction entails apparent risk.

H. Limitation period:

1 year from date of transaction, subject to concealment by transferee.

Date of transaction is:

- date property or benefit is transferred, created or conferred.
 - Where transaction is provision of services over time or a series of *closely related* events, date the services or events are substantially completed.
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H. Limitation Period

- **Basic rule:** 1 year from date of transaction.
 - **Concealment by transferee:** If transferee conceals or assists in concealment of the transaction or material facts, 1 year from the time claimant knew or ought reasonably to have known of the transaction or material facts, but not later than 5 years from date of transaction.
 - **Bankruptcy of debtor within limitation period:** Special rule where debtor becomes bankrupt within 1 year of date of transaction and trustee relies on provincial law. Trustee may challenge transaction that occurs within 1 year prior to date of bankruptcy, but must commence proceedings within 1 year after date of bankruptcy.
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D. Causes of Action: Court Orders

[57] Where the events constituting a transaction are effected by court order or by operation of law, an order for relief will be available only when the conditions of liability comprising cause of action #2 or #3 are satisfied; namely,

- (a) debtor's primary intention is to hinder or defeat creditors
- (b) the ability of creditors of the debtor to recover was materially hindered,
and
- (c) the transferee
 - (i) *cause of action 2*: gave no consideration or gave consideration worth conspicuously less than the value received from the debtor, or
 - (ii) *cause of action 3*: knew of the debtor's intention and intended to assist the debtor by entering into the transaction.

D. Causes of Action: Family Breakdown

[64] Where the parties to a transaction are or were in a **spousal relationship*** and the transaction is effected by

- (a) a **separation agreement*** or
- (b) a **court order** for the division of property and financial resources or for support arising from the breakdown of the spousal relationship,

an order for relief may be granted only where the conditions of liability comprising cause of action #3 are satisfied; namely,

- (i) The debtor's *primary* intention was to hinder or defeat creditors,
- (ii) the ability of a creditor or creditors of the debtor to recover satisfaction of their claim or claims was materially hindered as a result of the transaction, and
- (iii) the transferee knew of the debtor's intention and intended to assist the debtor by entering into the transaction.

** defined term*

D. Causes of Action: Family Breakdown

- Avoids the need to value consideration given by benefitting spouse.
 - Intention may be proven by listed circumstantial evidence, including non-disclosure of debts that may be affected by a court order.
 - Avoids the need for a situation-specific cause of action and implements a “good faith” or “bona fides” test consistent with current jurisprudence.
 - Recognizes need for emotional and financial closure.
 - No provision exempting routine transactions (allowances, reasonable gifts, informal services) but remedies provisions allow Court to refuse an order where the transferee has acted in reasonable reliance on the finality of a transaction, provided he or she did not know that the transaction was designed primarily to defeat creditors.
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F. Remedies

1. **Statement of principle:** Restoration of value to creditors.

Where grounds for relief are established the court shall make such order or orders as may be necessary to make available to the creditor the property or value transferred or conferred under the transaction to the extent of the creditor's claim against the debtor, taking into account the factors identified in [the provision defining the "qualifying factors", below].

2. **Forms of order:** List includes *inter alia* restoration of property, order for payment of money, compensation for income earned on property transferred, other...

3. **Creditors' relief:** Order tailored to feed benefit or remedy into creditors' relief law for distribution to creditors of the debtor.

F. Remedies

4. Qualifying factors: Court may refuse order or adjust terms in recognition of:

- Value paid by transferee.

e.g. Transferee pays \$5,000 for \$15,000 car. Order is either:

- Car reverts in debtor with order for debtor to return \$5,000 to transferee. (Debtor's obligation may be secured by security interest in property of debtor, including car.)
 - Transferee pays \$10,000.
- Investments in property or costs incurred to generate income stripped under order.
 - Other actions in reasonable reliance on the finality of the transaction.

Provided that no adjustment may be made where transferee knew that the transaction was intended to defeat creditors.

F. Remedies

5. Relief not precluded by statutory priority rules

- Prevents inconsistent outcomes where transactions occur before or after registration of writ or judgment.
- Will *rarely* result in remedy against transferee otherwise protected by a priority rule.
- Leads to fair result in the few cases in which issue arises.

E.g. Alberta buyer purchases a car as “consumer goods” for a purchase price less than \$1,000. Statutory rule gives buyer priority over writ of enforcement – i.e. judgment creditor cannot seize the car from the buyer. However the car is worth \$10,000 and seller is insolvent at the date of the transaction. Therefore a remedy is available under the Reviewable Transactions Act (cause of action #1: insolvency + conspicuously inadequate consideration).

F. Remedies

6. Order against secondary transferees

i.e. Debtor transfers to A, who transfers to B

A remedy is available against B (subject to the qualifying factors) if either:

- B did not give reasonable consideration for the property (gave *conspicuously* less than it was worth), or
 - B knew or should reasonably have known that the property derived from a transaction
 - entered into by a prior party for the primary purpose of defeating creditors, or
 - entered into by a prior party who was insolvent and who received conspicuously less than the value of the property
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Next Steps

- Receive comment and suggestions in relation to report on Part 1
 - Begin work on draft Act, incorporating revisions thought appropriate on the basis of comment and suggestions received
 - Develop recommendations on Part 2
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Motion requested

The working group seeks a motion of the conference that:

- a. The report of the working group on Part 1: Transactions at Undervalue and Fraudulent Transactions is accepted;
- b. The working group is directed to report to the Conference at the annual meeting of 2011 regarding comments and suggestions received in relation to the report on Part 1;
- c. The working group is directed to develop recommendations on Part 2: Preferential Transfers, and to deliver a report to the Conference at the annual meeting of 2011;
- d. The working group is directed to initiate work on the drafting of a Uniform Reviewable Transactions Act, and in so doing may taking into account comments received in relation to the report on Part 1.

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