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Judicial Expansion of the Concept of Arm's Length Transactions under the Bankruptcy and Insolvency Act

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INTRODUCTION

Fraudulent conveyances have been prohibited in Ontario since the 1800s. But during the last 8 years or so, there has been a slow but profound expansion in its availability and effectiveness for business (and all other) creditors.

I'm certain that most of the participants in this program have received phone calls or emails from clients asking for help in collecting their receivables. And I am equally certain that at some point in our practices, each of us has heard the dreaded news from a client that its customer (who owes the client significant amounts) has just gone bankrupt. And that bankruptcy was usually fatal to the collection of that debt.

But all is not lost. In the words of the Nobel laureate, Bob Dylan, *"For the times they are a-changin'"*. A 2009 amendment to the Bankruptcy and Insolvency Act (the "**BIA**") and 3 new cases interpreting section 96 of the BIA in the last couple of years have opened a new door in a debt collector's arsenal; the fraudulent conveyance action – or using the BIA's nomenclature, a section 96 'Transfer at Undervalue' action.

FRAUDULENT CONVEYANCES/TRANSFERS AT UNDERVALUE

The Fraudulent Conveyances Act (the "**FCA**") declares any transfer or conveyance of property to be void if made "with intent to defeat, hinder, delay or defraud" a creditor. While section 96 of the BIA sets out three scenarios giving rise to a 'fraudulent conveyance' (transfer at undervalue) remedy. Both the FCA and the BIA give the Court the power to declare void (or order damages paid) if a debtor has transferred or conveyed property to a third party for either no consideration or for inadequate consideration.

The technical rules defining a BIA transfer at undervalue differ, depending on the timing of the transfer and the relationship between the (bankrupt) transferor and the recipient transferee, as follows:

A. if the bankrupt and the recipient transferee were *dealing with each other at arm's length*, then the impugned transfer can be voided if the transfer took place within 1 year of bankruptcy[1]; and both

- i) the bankrupt was insolvent or rendered insolvent by the transfer; and
- ii) the bankrupt intended to defraud, defeat or delay a creditor.

B. however, if the bankrupt and the recipient transferee were *not dealing with each other at arm's length*, then the impugned transfer can be voided if either:

- i) the transfer took place within 1 year of the bankruptcy, or;
- ii) the transfer took place between 1 and 5 years before the bankruptcy; and either
  - the bankrupt was insolvent or rendered insolvent by the transfer; or
  - the bankrupt intended to defraud, defeat or delay a creditor.

Section 96 of the BIA expands upon the 'fraudulent conveyance' prohibition set out in the FCA by not only looking at when the impugned transfer took place (whether 5 years before the bankruptcy – or just one year prior to the bankruptcy) but equally importantly, it provides different tests depending on whether the bankrupt transferor and the recipient transferee were dealing with each other at arm's length or not at arm's length.

Transfers between Arm's Length Persons

There is a strict one year limitation under the BIA when looking at transactions between persons who deal with each other at arm's length. And if a transfer at undervalue did take place within this one year period, then the transfer has to meet a two part test to be voidable under the BIA. It would have to have been made by the transferor when the transferor was insolvent (or the transfer itself must have made the transferor insolvent). And, in addition, the bankrupt transferor must have intended to defraud, defeat or delay a creditor.

Transfers between Non-Arm's Length Persons

The BIA has imposed two limitation periods for transactions between non-arm's length persons. The first, being the one year period before the initial bankruptcy event, imposes an almost 'strict liability' prohibition. In the words of Myers, J in ***Re Lee*** *2017 ONSC 388 at para 16 …… "Section 96 imposes a strict test to remedy non-arm's length transfers ………. in my view, on proof of the requisite facts, relief should be granted at the amount calculated in accordance with* [the] *statute, in all but the most exceptional circumstances. This is especially so in the case of a non-arm's length transaction that is attacked within one year…….* [which] *transaction may be avoided without any consideration or proof of an intention to defraud, to prefer, or any*

[1] s. 96 of the BIA provides that this period starts one year before the *Initial Bankruptcy Event* - which is defined in s. 2 of the BIA

other fact other than the simple existence of the transaction at an undervalue. In my view, judgment should be nearly automatic in such cases."

The other limitation period is for transfers at undervalue between non-arm's length persons occurring more than one year but not more than five years before the initial bankruptcy event. In these circumstances, the transfer will be voidable if one of two preconditions is met. Either, the transfer must have been made by the transferor when the transferor was insolvent (or the transfer itself must have made the transferor insolvent), or, alternatively, the bankrupt transferor must have intended to defraud, defeat or delay a creditor. It is not necessary to meet both of these tests. The statute is written so as to allow either precondition to make the transfer at undervalue voidable.

INTENTION TO DEFRAUD, DEFEAT OR DELAY A CREDITOR

The Courts have long recognized the difficulty of attempting to determine a person's intention – as the Courts are often asked to determine what a party's intention may have been many years prior to the start of the proceeding before the Court. Clearly, that is not an exercise that lends itself to accuracy or to judicial consistency.

But there are two recent decisions of the Superior Court that assist this determination. First, Wilton-Siegel, J held in ***Juhasz Estate v Cordiero*** *2015 ONSC 1781* that a party only needs to prove that the bankrupt transferor had the prohibited intention (among other intentions) – rather than being obligated to prove that the prohibited intention was the only or even the primary intention of the bankrupt transferor. And Myers, J took this view one step further in ***National Telecommunications*** *2017 ONSC 1475* when he said that this prohibited intention only needs to be to defraud, defeat or delay '*a creditor',* but not necessarily all of the creditors generally or as a group.

RELATIONSHIP OF THE PARTIES - ARM'S LENGTH/NOT AT ARM'S LENGTH

The primary reason that I wrote this article is to highlight the new definition of what constitutes a 'non-arm's length' relationship under the BIA – and to discuss how this might impact our practices. The statutory assistance provided by the BIA is to be found in subsections 4(4) and 4(5):

- **Question of fact**

  (4) It is a question of fact whether persons not related to one another were at a particular time dealing with each other at arm's length.

- **Presumptions**

  (5) Persons who are related to each other are deemed not to deal with each other at arm's length while so related. For the purpose of paragraph 95(1)(b) or 96(1)(b), the persons are, in the absence of evidence to the contrary, deemed not to deal with each other at arm's length.

One must remember that in all transfers at undervalue litigation, the relationship of the transferor and transferee governs both the time frame within which one can look for an impugned transfer (be it one year or up to five years before the initial bankruptcy event), and also, the test that the creditor has to meet to have the transfer at undervalue declared void (strict liability or both insolvency and prohibited intention or either insolvency or prohibited intention). A review of section 96 of the BIA indicates just how important the relationship of the parties is in this determination. For if it can be shown that the transferor and transferee were not dealing with each other at arm's length, then the test governing transfers at undervalue are significantly easier to meet. The Court will hold that when the bankrupt and the recipient transferee were *not dealing with each other at arm's length*, the impugned transfer can be voided if either:

i) the transfer took place within 1 year of the bankruptcy, or;

ii) the transfer took place between 1 and 5 years before the bankruptcy; and either
   - the bankrupt was insolvent or rendered insolvent by the transfer; or
   - the bankrupt intended to defraud, defeat or delay a creditor.

This means that all transfers at undervalue between non-arm's length parties can be voided by the Courts if the transfer occurs within one year immediately before the initial bankruptcy event. And, additionally, for transfers at undervalue between non-arm's length parties that occur between one and five years immediately before the initial bankruptcy event, the creditor only needs to show that *either* the bankrupt was insolvent or rendered insolvent by the transfer or, *alternatively*, the bankrupt intended to defraud, defeat or delay a creditor. And with the *Juhasz* and the *National Telecommunication* decisions to assist creditors, neither of those two tests appears to be particularly difficult to prove in most cases.

But it is the transfer made on the eve of bankruptcy (within one year of the initial bankruptcy event, to be precise) that is the game changer here. For section 96 of the BIA allows the Court to set aside or to order damages resulting from all transfers within the one year period immediately prior to the initial bankruptcy

event if the parties to the transfer were not dealing with each other at arm's length - without further enquiry. There is no need to prove insolvency nor to prove any intention.

Judicial Expansion of the concept of 'Not at Arm's Length'

As previously stated, the BIA provides that related persons do not deal with each other at arm's length. Thus transfers at undervalue within one year of the initial bankruptcy event between spouses, their siblings or their children are easily voided by section 96 of the BIA. Likewise, transfers between a corporation and the person who controls that corporation are also easily voided for the same reason.

But what about transfers to business partners or associates? Traditionally, (at least under the BIA) these persons were considered to be dealing with each other at arm's length. Until the *Juhasz* decision, that is. Wilton-Siegel, J. (in the *Juhasz* decision) imported into the BIA a broad and flexible definition of 'not at arm's length' that is regularly used under the *Income Tax Act*. Specifically, he held that the 'common mind' principle ought to govern, stating at paragraph 40:

"……… the "common mind" principle, [is one] in which parties act in concert in respect of a transaction of material interest, and the absence of separate economic interests ……….. It also refers to a key factor being "whether there are separate economic interests which reflect ordinary commercial dealing between parties acting in their separate interests"."

And again at paragraphs 41 and 42 where Wilton-Siegel, J. said:

".....the concept of a non-arm's length relationship is one in which there is no incentive for the transferor to maximize the consideration for the property being transferred in negotiations with the transferee. It addresses situations in which the economic self-interest of the transferor is, or is likely to be, displaced by other non-economic considerations that result in the consideration for the transfer failing to reflect the fair market value of the transferred property.

While I do not think that the existence of a partnership or joint venture relationship is sufficient on its own to establish a non-arm's length status, I consider that the absence of any economic interest of a transferor at the point of termination of a business relationship, together with evidence of accommodation of the wishes of the transferee, can support a finding that there was a non-arm's length relationship."

And thus, in the *Juhasz* decision, the transferor (who was on the verge of bankruptcy) and her former business partner transferee were declared by the Court not to be acting at arm's length when the transferor literally 'walked away' from a joint investment by transferring her interest in that property to her partner (for significantly less than its fair market value) on the eve of her bankruptcy.

Mr. Justice Myers took this concept one step further earlier this year in the *National Telecommunications* decision when he looked at the relationship between a bankrupt corporation and a third party recipient of hundreds of thousands of dollars. The bankrupt corporation had been paying this third party (non-relative)

for months and months prior to the bankruptcy, but neither the bankrupt corporation nor the third party recipient were able to show the Court any business purpose for the payments. Accordingly, Myers, J. decided that:

"I cannot find that a company that agrees to pay someone more than it pays its owner, for doing nothing, and keeps paying that person until it is in the very last throes of a fatal insolvency was dealing with that person at arm's length. While the court does not know the full facts of the relationship between the bankrupt and Mr. Coones and never will, it is clear that there were other incentives at play that deprived their relationship of normal commercial imperatives like maximizing one's own value and even preserving one's own going concern. As such, I find that they were not dealing at arm's length."

CONCLUSION

With this judicial expansion of the definition of 'non-arm's length', lawyers no longer need be the bearer of bad news that a customer's bankruptcy makes collection of its receivables impossible. Because there is now a much improved chance of finding a recovery for your client if the bankrupt party 'judgment proofed' itself or otherwise gave away assets with no business purpose to family or friends and now, even to (former) business associates prior to the initial bankruptcy event. This could include 'salary' to family members or to other parties who were not actually working in the business. Or this may take the form of flips of real or personal property for nominal or inadequate consideration – or even just for the amount of the mortgage on title.

And the costs of finding out whether these or other types of transfers at undervalue have occurred in the years prior to the initial bankruptcy event are relatively small; and this kind of forensic accounting is fairly easy to accomplish. And your client will be thrilled to discover that his or her customer's bankruptcy is not necessarily the end of the story! It may be just the beginning…..

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