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REFORM OF FRAUDULENT CONVEYANCES AND FRAUDULENT PREFERENCES LAW

PART 2: PREFERENTIAL PAYMENTS

FINAL REPORT OF THE WORKING GROUP

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FRAUDULENT CONVEYANCES AND FRAUDULENT PREFERENCES LAW

INTRODUCTION

[1] The introduction that appears in the final report of the working group on the first part of this project, "Part 1: Transactions at Undervalue and Fraudulent Transactions", is equally pertinent to this report and will not be repeated.[1] This report is the final report of the working group on Part 2, addressing preferential payments. Although this part of the project has previously been identified as "Preferential Transfers", the term "Preferential Payment" was adopted by the working group and is used in the title of this report since it better reflects the subject.

[2] As part of its work during 2010-11, the working group was prompted by input received from Conference delegates on the final report on Part 1 and by issues that became apparent in its work on preferential payments to advance a few largely technical revisions to the recommendations proposed in the Part 1 report. A supplementary report on Part 1 is being delivered to the Conference in conjunction with this report. The final report on Part 2 recommends that many of the recommendations in the final and supplementary reports on Part 1 be applied, with or without revision, to an action challenging a preferential payment. For the most part, recommendations so adopted are explained only in summary fashion and are not reproduced in this report. Readers may wish to refer to the identified paragraphs of the Part 1 reports for a full statement of those recommendations and the accompanying commentary. The final report on Part 1 is referred to hereafter as the "Part 1 Final Report" and the supplementary report is referred to as the "Supplementary Report on Part 1".

WORKING GROUP

[3] The working group met periodically by conference call during 2010-11. Professor Tamara M. Buckwold of the University of Alberta continued as chair. Others who continued as members of the working group were Thomas G. Anderson Q.C. of Anderson Consulting (Vancouver), Professor Anthony Duggan of the University of Toronto, Professor Élise Charpentier of the Faculté de droit, Université de Montréal and Tim Rattenbury, Office of the Attorney General of New Brunswick. Michael MacNaughton of Borden Ladner Gervais LLP (Toronto) was able to participate in some of the meetings of the working group. The chair offers sincere thanks to the working group members, all of whom are volunteers and most of whom have participated in this project since work began in the fall of 2008. They have dedicated an enormous amount of time to reviewing and commenting on countless pages of discussion papers as well as to the numerous meetings of the working group, and have contributed tremendous

expertise and insight to the formulation of our recommendations. Their suggestions and comments were invariably constructive and their collegiality and enthusiasm throughout have lightened the work of the chair and brought this complex and prolonged project to within sight of its conclusion.

RECOMMENDATIONS

[4] This report is organized under headings that generally parallel the headings used in the Part 1 Final Report. As in the Part 1 reports, recommendations are indicated in indented and bolded text with explanatory comment in ordinary text. The following general headings are often divided into subtopics:

A. Title and Structure of the Act
B. Preferential Payments: Underlying Policies of Reformed Law
C. Grounds for a Remedy: Definition of the Cause of Action
D. Scope of the Statute: Transactions Falling Subject to the Proposed Act
E. Standing to Seek a Remedy
F. Remedies
G. Limitation Period

A. Title and Structure of the Act

[5] Legislation enabling creditors to challenge transactions identified as transactions at undervalue or fraudulent transactions (part 1 of this project) and the preferential payment of creditors (part 2) should be incorporated in a single statute. Both types of proceeding guard against interference with the legal right of creditors to enforce their claims against the property of a debtor through the judgment enforcement system, though they are designed to achieve respectively different specific policies. The legislation should clearly signal the policy and functional differences between an action challenging a transaction at undervalue or fraudulent transaction and an action challenging a preferential payment. Although the definitions and certain other provisions of the proposed statute will apply to both types of proceeding, the grounds for relief will be defined differently and some provisions will apply exclusively to transactions at undervalue and fraudulent transactions while others will apply exclusively to preferential payments. The structure of the Act will be determined in the process of drafting, but a potential framework would organize provisions under the headings:

- Definitions
- Transactions at Undervalue and Fraudulent Transactions
- Preferential Payments
- Common Provisions

[6] The recommendation that follows confirms and elaborates on paragraphs [8] and [9] of the Part 1 Final Report. Although the recommendation contemplates a stand-alone statute, a province or territory may elect to incorporate the provisions of a uniform Act into a broader judgment enforcement statute.

> **The legislation governing transactions at undervalue and fraudulent transactions (Part 1 Final Report and Supplementary Report on Part 1) and preferential payments (Part 2 Final Report) should be located in a single statute called the *Reviewable Transactions Act*. The Act should be organized by heading and otherwise to indicate the distinction between the two types of proceeding, though some provisions will apply to both.**

B. Preferential Payments: Underlying Policies of Reformed Law

[7] The payment of debt is to be encouraged and the law ordinarily permits people to pay their creditors in whatever order and proportion they please. The underlying assumption is that creditors who are not paid voluntarily may recover by obtaining a judgment on their claim and enforcing it through appropriation of the debtor's assets under judgment enforcement law; everyone will eventually be paid in full. The assumption no longer holds when a debtor is insolvent because he or she does not have the financial means to satisfy the claims of all creditors. One of the fundamental policies of bankruptcy law is that the unsecured creditors of an insolvent debtor are entitled to share in the debtor's assets on a pro rata basis. That policy is implemented by the payment scheme imposed in proceedings taken under the federal *Bankruptcy and Insolvency Act* (the BIA), subject to the prior right of payment specifically granted to identified creditors such as unpaid employees and family support claimants. The BIA reinforces the pro rata principle through provisions designed to prevent some creditors from recovering disproportionately more than others under a voluntary payment made by an insolvent debtor shortly before bankruptcy proceedings are initiated. A pre-bankruptcy payment that has the effect of giving a creditor a preference over another creditor is void as against the trustee in bankruptcy under the circumstances defined in section 95. In effect, the favoured creditor is required to share the payment received with other creditors according to the BIA distribution

scheme. A similar approach is adopted in the bankruptcy law of the United States and Commonwealth and other countries.

[8] Outside of bankruptcy proceedings, the proposition that debtors may pay creditors as they please is qualified by creditors' relief legislation, which has been part of provincial and territorial law in most Canadian jurisdictions for over a century.[2] While the specifics vary among provinces and territories, the general effect of this legislation is that an unsecured creditor who takes judgment enforcement measures against the property of a debtor must share the proceeds pro rata with other judgment creditors and, in some jurisdictions, with unsecured creditors whose claims are validated by a certificate delivered to the sheriff or enforcement official. Payments made voluntarily to a judgment creditor are not affected.[3] The creditors' relief legislation enacted in the late 1800s was accompanied by fraudulent preferences legislation which, like the anti-preference provisions of the BIA, was designed to prevent avoidance of the creditor sharing scheme by the payment of some unsecured creditors at the expense of others. A version of that legislation remains in place in the provinces and territories today.

[9] While it has been suggested that there is no role for anti-preference law outside of bankruptcy, the consensus of the working group is that provincial legislation remains a necessary adjunct to creditors' relief law.[4] The creditor sharing philosophy implemented by that law could be easily defeated if a debtor's right to allocate payments to creditors is entirely unrestricted. However, the recommendations for reform of provincial preferences law should respect these principles:

(1) Preferences law should be limited in scope: The law should interfere with voluntary payments to creditors only when the paying debtor and benefitting creditor are likely to or should know that a payment will undermine the ability of other creditors to recover their claims under provincial judgment enforcement law.

(2) Provincial law should be consistent with the BIA: Provincial law should be designed to operate in a manner that is consistent with the preferences provisions of the BIA.

(3) Preferences law should be integrated with other law governing transactions that impede the right of creditors to recover through the judgment enforcement system: The provisions of the *Reviewable Transactions Act* governing preferential payments should be structurally integrated with those governing

transactions at undervalue and fraudulent transactions taking into account the different policies to be achieved.

C. Grounds for a Remedy: Definition of the Cause of Action

The cause of action

[10] A creditor who has standing to challenge a payment made by the debtor to another creditor should be granted relief on the grounds indicated. When combined with the 1 year limitation period during which a payment may be challenged (see heading G below), the effect of the rules proposed roughly parallels the effect of the BIA preferences provisions that apply to non-arm's length payments.

(1) An order for relief will be available where a debtor makes a payment to or in favour of a creditor who is not dealing at arm's length with the debtor if the payment has the effect of giving that creditor a preference over another creditor.

(2) For the purpose of subsection (1),

(a) a payment has the effect of giving the creditor a preference if the debtor

(i) is insolvent at the time of the payment,

(ii) becomes insolvent as a result of the payment, or

(iii) makes the payment in circumstances in which the debtor is demonstrably at risk of insolvency and the debtor does become insolvent within six months of the date of payment.

(b) Persons who are related to each other are presumed not to deal with each other at arm's length while so related but the presumption may be rebutted by proof that they are dealing at arm's length.

(c) 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.

(d) Persons are related to each other when they are related to each other for the purposes of the *Bankruptcy and Insolvency Act,* Canada.

(e) Persons are deemed to be dealing with each other at arm's length in respect of the following:

(i) a margin deposit made by a clearing member with a clearing house; or

(ii) a transfer, charge or payment made in connection with financial collateral and in accordance with the provisions of an eligible financial contract.

(3) In this section,

clearing house" means a body that acts as an intermediary for its clearing members in effecting securities transactions;

"clearing member" means a person engaged in the business of effecting securities transactions who uses a clearing house as intermediary;

"creditor" includes a surety or guarantor for the debt due to the creditor;

"margin deposit" means a payment, deposit or transfer to a clearing house under the rules of the clearing house to assure the performance of the obligations of a clearing member in connection with security transactions, including, without limiting the generality of the foregoing, transactions respecting futures, options or other derivatives or to fulfil any of those obligations.

"financial collateral" and "eligible financial contract" have the meaning ascribed by the *Bankruptcy and Insolvency Act,* Canada

[11] Under section 95(1) of the BIA, a payment by an insolvent person to a non-arm's length creditor that occurs during the 12 month period prior to bankruptcy is void if it has the effect of

giving the recipient creditor a preference over another creditor. The provisions recommended here similarly offer relief when an insolvent debtor makes a payment to a non-arm's length creditor. Superficially, they differ from the BIA in that preferential effect is inferred from the debtor's insolvency and need not be otherwise proven. A payment by a debtor who is insolvent or becomes insolvent shortly thereafter will almost invariably constitute a preference in fact. Since the state of insolvency means that the debtor is by definition unable to satisfy all creditors in full, the creditor who is paid voluntarily will receive a proportionately greater recovery than those creditors who are not. The working group considered at length the alternative of including in the cause of action a separate requirement of proof that the payment had the effect of preferring the recipient creditor. However, it became clear that it is difficult, if not impossible, to devise a meaningful test of what constitutes preferential effect outside the context of bankruptcy. The test included in some of the current provincial statutes is obscure and rarely if ever relied upon in litigation. The working group was satisfied that a test of preferential effect is not required; the payment of one of two or more creditors by an insolvent debtor in itself produces a preference in the vast majority of cases. In the result, the circumstances that constitute a voidable preference under the BIA are substantially the same as those that constitute a preferential payment under the proposed legislation, though the rules are formulated differently.

[12] Clauses (2)(b) through (e) and paragraph (3) advance harmonization with the BIA by adopting the BIA provisions that determine when the debtor and the creditor receiving a payment are not dealing at arm's length. This is accomplished in part by including rules that replicate parallel BIA provisions with minor changes in wording and in part by incorporating under clause (2)(d) the extensive BIA provisions that define related persons by reference and under paragraph (3) the BIA definitions of "financial collateral" and "eligible financial contract". The other definitions in paragraph (3) are drawn verbatim from section 95 of the BIA, where they apply for the purposes of that section, but are replicated in full to avoid incorporation by reference to a specific BIA section number, which may change over time. The BIA rules determining relationship apply to the BIA in its entirety so may be adopted by reference without identification of a particular section of the Act. Similarly, the terms "financial collateral" and "eligible financial contract" are defined in the BIA's general definitional provisions. The approach taken in the drafting of the *Reviewable Transactions Act* may vary in format but should achieve the results indicated by the recommendations.

[13] The definition of "creditor" in paragraph (3) recognizes that a payment to a person who has guaranteed a debt may constitute an indirect means of paying the creditor to whom the debt is owed; debtor pays guarantor, who is obliged under the guarantee to pay creditor.

[14] The recommendations of the working group allow only payments to non-arm's length creditors of an insolvent or nearly insolvent debtor to be recovered by other creditors. Payments to arm's length creditors are not vulnerable. This approach is supported by the general policies of limited interference with the payment of creditors and substantial consistency with the BIA, outlined above. Payments to arm's length creditors can rarely be challenged under the BIA; they are void only if made within the 3 month period prior to bankruptcy and the debtor intended to give the recipient creditor a preference over another creditor. Although a presumption of intention to prefer arises from the preferential effect of a payment, the presumption is readily rebutted (e.g. the payment is made in the "ordinary course", the debtor's dominant intention was to remain in business or the payment was elicited by a "diligent creditor" through ordinary collection measures). The creation of a provincial cause of action designed to maintain the desired consistency of approach with the BIA would require the imposition of a 3 month limitation period and retention of the intention to prefer test that is a primary factor in the dysfunctional state of existing law. Such an approach would serve only to create uncertainty without offering creditors any meaningful protection against disproportionate voluntary payments.

[15] The decision to exempt arm's length payments from challenge is inferentially supported by the approach taken in other countries and by existing law, all of which implement a policy of limited intervention. The preference rules that apply under the bankruptcy law of other jurisdictions protect arm's length payments by various means, whether by requiring proof of intention to prefer, exempting "ordinary course" payments or sheltering recipients who were unaware of the debtor's fragile financial circumstances. All are plagued by uncertainty and none have proven entirely satisfactory. Although payments to arm's length creditors can in theory be challenged as preferences under current provincial law, the substantial restrictions imposed and defences offered by the legislation mean that the theory rarely bears out in practice. Successful preference actions almost always involve payments to non-arm's length creditors and in practice arm's length creditors are rarely party to a calculated attempt to avoid the creditors' relief law that would otherwise limit their recovery to a proportionate share of the debtor's non-exempt assets. In short, the law generally does not permit interference with arms' length payments. Little is to be gained by attempting to devise rules that will separate legitimate from wrongful arms' length payments and whatever modest benefits might be achieved would be outweighed by the costs flowing from the uncertain outcomes produced by ambiguous rules.

Definition of insolvency

[16] The definition of insolvency recommended in the Part 1 Final Report is also appropriate for purposes of the cause of action relating to preferential payments.

> **The definition of insolvency recommended in paragraph [32] of the Part 1 Final Report also applies to the provisions of the Act governing preferential payments.**

D. Scope of the Statute: Transactions Falling Subject to the Proposed Act

General definition of "payment"

[17] The statute would grant relief to a creditor who can prove that the debtor has made a "payment" to another creditor in the circumstances defined by the cause of action. The term "payment" should be defined generally as follows:

> **(1) "Payment" means, subject to (2), a transaction under which a debtor directly or indirectly transfers, creates or confers a benefit on a creditor by way of satisfaction of or as security for the satisfaction of a claim.**

[18] The definition of "payment" implicitly incorporates the definition of "transaction" adopted in the Part 1 Final Report at paragraph [38], which is designed to capture all types of transaction under which a debtor directly or indirectly transfers to a third party value that would otherwise have been available to satisfy creditors' claims. However, the definition of "payment" creates a distinction between a preferential payment and a transaction at undervalue or fraudulent transaction. A "payment" subject to challenge as a preference is a transaction under which value is transferred by a debtor to a creditor in satisfaction of or as security for a claim. A transaction that is not a "payment" (i.e., not in satisfaction of or as security for a claim) may only be challenged under the Part 1 rules. The definitions of "creditor" and "claim" are discussed below in relation to standing.

Excluded transactions involving secured debt

[19] Paragraph (2) of the definition of "payment" would exclude transactions that could otherwise fall within the general definition but should not be subject to challenge as a preference.

(2) "Payment" does not include a transaction under which

(a) a debtor satisfies an obligation that is secured by a security interest in property of the debtor to the extent that the security interest has priority over the rights of unsecured creditors of the debtor,

(b) a person transfers, creates or confers an interest in property as security for new value advanced by the transferee, or

(c) a person gives a security interest in property as collateral in substitution for collateral of equivalent value given to secure the same obligation.

[20] *Clause (2)(a):* A payment of debt secured by a security interest in the debtor's property should not be subject to challenge as a preference if the security interest has priority over judgment creditors under the applicable rules of judgment enforcement law. The result of the payment is neutral as far as unsecured creditors are concerned to the extent that the payment eliminates the security interest. The newly unencumbered value of the debtor's property is available to unsecured creditors in substitution for the money or other property paid for release of the security. This will not be true when the security interest discharged by payment has priority over another security interest that in turn has priority over judgment creditors. However, reversal of the payment would require revival of the security interest discharged by payment and disrupt established priorities. The case should fall with the general rule. On the other hand, if the security interest is subordinate to a writ or judgment charge, unsecured creditors are entitled to recover from the debtor's property before the secured debt is satisfied. The secured creditor knew or should have known when the security interest was taken that satisfaction of the debt secured would be subordinate to the rights of unsecured creditors to the extent of their priority; unsecured creditors should be permitted to challenge a payment towards the secured debt as a preference.

[21] *Clause (2)(b):* Preference law is designed to deal with the preferential payment of existing unsecured debt, whether by an immediate transfer of value or by giving security for payment in response to a demand to pay or to otherwise defer payment to a later date. The provision of security for antecedent debt is equivalent to payment because enforcement of the security will satisfy the debt and, from the point of view of other creditors, the collateral is removed from the asset base available to satisfy their claims. Preference law is not intended to

prevent people from giving security to obtain new money or credit. Clause 2(b) ensures that unsecured creditors cannot recover collateral given to a secured creditor for new value.

[22] *Clause (2)(c):* A creditor who accepts a one form of collateral in substitution for another securing an existing debt should not be deprived of his or her security. Existing provincial legislation includes a provision to this effect.

Payments made by a transfer of exempt property

[23] The rationale for the revised recommendation that transfers of exempt property may be challenged as a transaction at undervalue or fraudulent transaction is explained in the Supplementary Report on Part 1. That rationale applies equally to the payment of a creditor through a transfer of exempt property.

> **The recommendations regarding transfers of exempt property advanced in the Supplementary Report on Part 1 at paragraphs [12] and [13] also apply to the provisions of the Act governing preferential payments.**

Disclaimer of interest and refusal of power of appointment

[24] The Part 1 Final Report at paragraph [51] provides that "[t]he statute should not explicitly address the disclaimer of an interest or the refusal to exercise a power of appointment." The same approach should be applied to preferential payments. If a debtor disclaims an already vested interest in satisfaction of a debt, the payment effected by the disclaimer can be challenged as a preference. If the debtor declines to accept an interest before it vests or to exercise a power of appointment in favour of him or herself, the debtor's choice cannot be challenged.

> **The recommendation regarding disclaimers of interest and refusal of a power of appointment in the Part 1 Final Report at paragraph [51] also applies to the provisions of the Act governing preferential payments.**

Payments effected by court order or operation of law may not be challenged as a preference

[25] The Part 1 Final Report recommends that a transfer of value effected by an order of the court or operation of law may be challenged as a fraudulent transaction when a legal proceeding is used intentionally or a rule of law is manipulated to defeat the creditors of the transferor. This

approach cannot be applied directly to payments to creditors because the preferential payments cause of action does not require an intention to prefer. As a matter of policy, the intentional use of legal proceedings to put one's assets beyond the reach of creditors is not the same as invocation of legal proceedings by a creditor to recover a debt, nor is satisfaction of a debt through the exercise of a legal right equivalent to satisfaction through a voluntary payment. Recovery of debt by unsecured creditors through legal measures that provide access to a debtor's property, such as judgment enforcement or distress for rent, is comparable in many respects to the enforcement of rights of realization by a secured creditor. The enforcing creditor is exercising a right granted by law, not extracting a preference. To the extent that the creditor obtains an advantage relative to other creditors, the advantage is conferred by the law rather than the debtor. Where procurement and enforcement of a judgment are the means used, the enforcing creditor will be required to share the proceeds with those who qualify under the creditors' relief rules. Although section 95 of BIA allows a "judicial proceeding taken or suffered by an insolvent person" to be challenged as a preference, the meaning and scope of the phrase is obscure and the small number of reported cases invoking that part of the provision indicates that legal proceedings are rarely used to confer a preference. The recommendation below avoids any argument that a transfer of value through the procurement or enforcement of a judgment or otherwise under a rule of law falls within the general definition of "payment" as an indirect transfer or conferral of a benefit.

(3) "Payment" does not include a transaction effected by the procurement or enforcement of a court order or by operation of law.

Payments associated with the breakdown of a spousal relationship

[26] Paragraphs [58] to [64] of the Part 1 Final Report discuss the special problems and policy considerations associated with transfers of value from a debtor to a spouse or former spouse under a separation agreement or court order for support or division of property. The same problems and policies come into play when a transfer is a payment to the recipient spouse as a creditor under a claim for support or property. Spouses are "related persons" under the BIA definitions adopted for purposes of the preferential payments cause of action. If the ordinary rules are applied, any transfer to a spouse as creditor could be challenged as a preference and the recipient spouse could resist the claim only by proving that the payment was in fact at arm's length. Whether separating or divorced spouses are at arm's length in a particular context will often be difficult to determine. Interference with the payment of legitimate spousal claims arising from family breakdown is inconsistent with the policies considered in the Part 1

recommendations and, where the claim involves support payments, with the preferred status generally conferred by law on maintenance debts. Maintenance debts must be paid from the proceeds of judgment enforcement measures before other creditors are paid. A payment to a spousal creditor under a separation agreement or court order for support or division of property should not be subject to challenge under the preference rules. However, such a payment may be challenged if it falls within the Part 1 rules that apply to transfers between spouses generally; that is, if the payment was made with the primary objective of hindering or defeating the creditors of the paying spouse, it does have that effect and the recipient spouse intended to assist in achieving that objective by entering into the transaction.

> **Where the parties to a transaction that is a "payment" are or were in a spousal relationship and the payment is effected by**
>
> **(a) a separation agreement, or**
>
> **(b) a court order for the division of property and financial resources or support arising from the breakdown of the spousal relationship,**
>
> **the provisions of the Act that apply to a payment to a creditor who is not at arm's length do not apply but the payment is a "transaction" and may be subject to challenge in accordance with the recommendations in paragraph [64] of the Part 1 Final Report.**

E. Standing to Seek a Remedy

Part 1 recommendations applied to preferential payments

[27] The recommendations in the Part 1 Final Report allow a transaction to be challenged by a "creditor," who is a person who holds a "claim." Those recommendations are equally appropriate in an action to challenge a preferential payment, subject to minor modifications.

> **The recommendations in the following paragraphs of the Part 1 Final Report apply to proceedings to challenge preferential payments, subject to the modifications indicated below: paragraphs [67] (definition of creditor) as modified, [71] (definition of claim) as modified, [73] (claim does not include a secured obligation,**

[74] (claim need not be established by judgment as a condition of standing) and [75] (suspension of proceedings when claim is not established by judgment).

[28] The recommendation in paragraph [67] of the Part 1 Final Report defines a creditor as a person who holds a claim at the date of the transaction in relation to which a remedy is sought and, where the cause of action relied upon requires proof that the transaction was intended to hinder creditors, includes a person who holds a claim that arose after the date of the transaction. The inclusion of post-transaction creditors in the definition is not appropriate in relation to anti-preference law, which is designed to prevent disruption of the sharing entitlements of creditors who hold claims at the time one of them receives a disproportionate payment, not to protect potential future creditors.

For purposes of an action challenging a preferential payment, the definition of "creditor" should be limited to a person who holds a claim at the date of the payment in relation to which a remedy is sought.

[29] The definition of "claim" in paragraph [71] of the Part 1 Final Report has the effect of including within the category of "creditor" a person who holds a conditional or contingent claim. A conditional claim is one associated with an obligation that presently exists but need not be performed until the condition occurs or is met; for example, a claim based on an existing debt payable at a future date or under prescribed conditions. A contingent claim is based on an obligation that can only be enforced if an identified event or state of affairs that may or may not occur (i.e. a contingency) does occur; for example a promise to pay money on another person's default or if a sporting team wins a game. It is not appropriate to give a person who holds a contingent claim standing to challenge a transaction as a preferential payment since, at the time of the payment, the holder of the claim has no right to share in the debtor's assets and may never acquire such a right. In contrast, the holder of a conditional claim has an existing claim the enforcement of which may be prejudiced by a preferential payment. We note also that, in relation to preferential payments, the definition of "creditor" not only determines standing to commence proceedings but also plays a role in the cause of action, which offers relief where a debtor makes a payment to or in favour of a "creditor."

For purposes of an action challenging a preferential payment, "claim" includes a right to enforce an obligation that is subject to a condition but not a claim based on a contingent obligation.

"Claim" does not include a secured obligation

[30] Paragraphs [72] and [73] of the Part 1 Final Report address the standing of a creditor whose claim against the debtor is secured by a security interest in the debtor's property. The recommendation advanced in paragraph [73] provides that a creditor is entitled to a remedy only to the extent that the creditor's claim is unsecured. The second part of the recommendation deals with the possibility that a creditor who has a security interest in property transferred away by the debtor may become effectively unsecured due to the operation of a priority rule that operates in favour of the transferee. In such a case the holder of the security interest is unsecured to the extent that the security interest is eliminated or subordinated and has standing as an unsecured creditor. The same rules should apply to a transfer of property that constitutes a preferential payment.

> **The recommendations in paragraph [73] of the Part 1 Final Report should also apply in an action challenging a preferential payment and, for that purpose, a reference to a "transaction" includes a "payment" and "transferee" includes a creditor receiving a payment.**

Claim need not be established by judgment as a condition of standing

[31] Paragraph [74] of the Part 1 Final Report advances the recommendation that a creditor may commence an action under the Act whether or not his or her claim against the debtor has been reduced to judgment. Paragraph [75] recognizes that while a creditor without a judgment has standing to commence an action, the creditor may only share in the money or property recovered if his or her claim is validated by a judgment or order of the court before the money or property is distributed. The Supplementary Report on Part 1 recommends a slightly restructured formulation of the provision proposed in paragraph [75]. These provisions collectively are equally appropriate in an action challenging a preferential payment.

> **The recommendations in paragraph [74] of the Part 1 Final Report and in paragraph [17] of the Supplementary Report on Part 1 also apply in an action challenging a preferential payment.**

F. Remedies

General principle governing the award of a remedy

[32] The Part 1 Final Report provides a general statement indicating the objective to be achieved by an order for relief granted by the court in an action challenging a transaction at undervalue or fraudulent transaction. The court is expected to tailor the terms of the order in accordance with the circumstances of the case, drawing on the accompanying list of specific forms of order. The objective of relief in relation to a preferential payment is different and should be separately stated. It is relatively straightforward: to set aside the payment so that the amount paid is shared proportionately with other creditors of the paying debtor who are qualified to share under provincial law. The relationship between the order granted and the sharing regime of creditors' relief law is indicated by the recommendation advanced below in paragraph [35]. This approach parallels the BIA's treatment of preferences. Action by the trustee in bankruptcy avoids the payment with the result that the amount paid is recovered for the benefit of the bankruptcy estate and paid out in accordance with the distribution scheme of the BIA. The principle guiding relief against a preferential payment may be stated as follows:

> **Where grounds for relief are established, the court shall make an order setting aside the payment.**

Forms of order

[33] A comprehensive list of specific types of order that may be made in an action challenging a transaction at undervalue or fraudulent transaction is provided in the Part 1 Final Report. All but those indicated in the paragraph that follows are appropriate in an action challenging a preferential payment. Clause (i) of the Part 1 forms of order is revised as recommended in paragraph [14] of the Supplementary Report on Part 1.

> **(1) In an action challenging a preferential payment, the court may make any of the forms of order identified in paragraph [77] of the Part 1 Final Report as revised by the Supplementary Report on Part 1 except those indicated in paragraph (2) and, for that purpose, a reference to a "transaction" includes a "payment" and "transferee" includes a creditor receiving a payment.**

[34] If applied to an action to set aside a preferential payment, clause (e) of the Part 1 Final report forms of order would allow a court to require a creditor receiving the payment through a transfer of property, a license, quota, right to use or right to payment to disgorge income earned through the use or exploitation of the asset received. This is not appropriate. The beneficiary of a transaction at undervalue or fraudulent transaction has no right at all to the property received as against the transferor's creditors, who should be allowed to recover both the property and the profits earned by the transferee through its use as provided in clause (e). In contrast, the preferentially paid creditor is entitled to be paid; the only illegality in receiving property in payment is in not sharing it. Therefore the recipient of a preferential payment should be required to restore the amount of the payment by return of the property or benefit transferred or its value, but should not be required to compensate other creditors for income earned through the use or exploitation of the property; the order contemplated in paragraph (e) should not be available. An order for relief may capture a natural increase in the value of the property, which could include interest generated by interest-earning property (e.g. a GIC) or the appreciated value of property transferred under a preferential payment. The court may order that the preferred creditor repay the value of the property received as payment or allow creditors to seize the property from the transferee, in either case recovering the appreciated value of the property or its value including value derived from its interest-earning capacity. Paragraph (j) of the forms of order deals with a case involving a transfer of value by means of a court order. Since such a transfer is not subject to challenge as a preferential payment, the form of order provided is not relevant in this context. The following recommendation precludes use of the paragraphs (e) and (j) forms of order to relieve against a preferential payment.

(2) Forms of order that shall not be made in an action challenging a preferential payment are those indicated in clauses (e) and (j) of paragraph [77].

Intersection of remedy with creditors' relief legislation

[35] The Part 1 Final Report includes recommendations to ensure that property recovered in an action challenging a transaction at undervalue or fraudulent transaction is shared among all creditors of the debtor who are entitled to participate in a distribution of the debtor's property under the creditor's relief legislation of the jurisdiction. Those recommendations are further elaborated through the revisions recommended in the Supplementary Report on Part 1 at paragraphs [15] and [16]. The recommendations apply equally to an action challenging a preferential payment.

The recommendations in paragraphs [15] and [16] of the Supplementary Report on Part 1 should also apply in proceedings to challenge a preferential payment.

Factors to be considered in the granting of an order (the "qualifying factors")

[36] The recommendations in this paragraph direct the court to take into account the factors identified in making an order for relief. They are explained in the paragraphs that follow.

(1) The court may adjust the terms of an order setting aside a payment, or make an order in favour of the creditor receiving the payment for recovery of an identified sum against the debtor, in recognition of expenditures and non-monetary investments made by the creditor that have increased the value of property received under the payment.

(2) Where the court orders that property transferred by the debtor under the payment or its proceeds be vested in the debtor, the court may grant the transferee a security interest in the property securing expenditures and non-monetary investments made by the transferee that have increased the value of property received under the transaction, to the extent of the expenditures or the value invested.

(3) A security interest granted under (2) has priority over the rights of all creditors of the debtor in relation to the property, including secured creditors.

(4) A security interest in personal property granted under (2)

(a) may be registered in the *Personal Property Registry*, and

(b) if the security interest is registered before the date of bankruptcy of the debtor, the security interest has the status of a security interest perfected under the *Personal Property Security Act* at the date of bankruptcy as against the trustee in bankruptcy.

(5) Where a payment discharges the obligation of a person other than the debtor under a guarantee or indemnity securing the obligation paid, the court may

refuse to grant an order setting aside the payment if the obligation under the guarantee or indemnity is not restored or revived as a result of the order.

[37] The qualifying factors that apply in an action to challenge a preferential payment are a subset of those that apply in an action to challenge a transaction at undervalue or fraudulent transaction (see Part 1 Final Report at paragraph [86]). Recommendation (1) above addresses a case in which a creditor who is paid by the transfer of an asset thereafter increases the value of the asset through the investment of money or effort. An order for relief should set aside the payment to the extent of the value of the unimproved asset but should allow the creditor to retain the increased value produced by the creditor's investment. For example, if the court orders that the asset revest in the debtor so that it can be seized in judgment enforcement proceedings or declares that the asset may be seized from the creditor, it should order that the debtor pay the amount of the increased value to the creditor. If the court instead orders the creditor to pay a sum of money representing the payment received, the sum should be the value of the asset less the increase in value produced by the creditor's investment. The court should not adjust an order to take into account increases in the value of property transferred to a creditor resulting from appreciation or the accrual of interest, since naturally occurring increases in the value of the property would have been available to the other creditors had it not been transferred.

[38] Recommendations (2) through (4) parallel those parts of the recommendations set out in the Supplementary Report on Part 1 at paragraph [20] that also deal with investments in property that have increased its value. Readers should consult the Supplementary Report for further explanation of the rationale and operation of the recommended provisions. The recommendations that apply to preferential payments do not include provision for an order restoring the value given by the creditor receiving the payment, since the objective of the action is not to restore the value of property transferred by the debtor to his or her creditors but rather to require the transferee creditor to share a payment made by the debtor in return for value already given by the creditor.[5] As noted in the Supplementary Report to Part 1, the complications associated with the application of recommendations (2) through (4) arise only if the relief granted by the court revests in the debtor the property transferred under the preferential payment. They may be avoided by an order for sale of the property with distribution of an appropriate share to the transferee creditor or by an order permitting the transferee to retain the property but requiring him or her to pay a sum equivalent to its unimproved value.

[39] Recommendation (5) deals with a case involving a preferential payment to a creditor who holds a third party guarantee or indemnity as security for the debt. The definition of "payment"

means that payment of a debt secured by an interest in the property of the debtor is not subject to challenge as a preference. This does not prevent creditors from challenging the payment of a debt secured by a third party guarantee or indemnity agreement. If the guarantee or the obligation to indemnify is discharged by the payment, an order setting aside the payment would leave the creditor with neither the money paid nor the security provided by the guarantee or indemnity. The legislation should prevent that result. The payment can be set aside only if the consequent revival of the original debt revives the obligation of the guarantor or indemnitor.

Relief not precluded by operation of statutory priority rules

[40] Paragraphs [87] and [88] of the Part 1 Final Report address the availability of relief when property transferred by a debtor is subject to a security interest or a writ or judgment charge that is subordinated or cut off by the transfer. If the transaction is a transaction at undervalue or fraudulent transaction, the fact that it invokes a priority rule in favour of the transferee does not preclude an order for relief. The same rule should apply to a transfer of property that constitutes a preferential payment.

> **The recommendations in paragraph [88] of the Part 1 Final report should also apply in an action to challenge a preferential payment and, for that purpose, a reference to a "transaction" includes a "payment" and "transferee" includes a creditor who receives a payment.**

[41] The Part 1 Final Report did not explicitly address the position of a secured creditor whose security interest is cut off or subordinated by a transaction if the order for relief revests the property in the debtor. Such an order is designed to allow judgment creditors, including the plaintiff in the reviewable transaction proceeding, to seize or attach the property in judgment enforcement proceedings. However, it may be argued that the secured party's security interest reattaches when the property revests in the debtor or that reversal of the transfer restores the priority ranking ascribed to the security interest before the transfer or both, depending on the effect of the priority rule in question. If the argument succeeds, the secured party's right to enforce the security interest may have priority over the enforcement rights of judgment creditors, defeating the objective of the order for relief; the entire benefit of the proceeding would accrue to the secured party. This would be unfair and would produce inconsistent outcomes depending on the form of the order granted by way of relief in the proceeding. If the secured party's security is lost under a priority rule, the secured party has standing to challenge the transaction and to participate in the remedy as an unsecured creditor. The security interest effectively disappears for purposes of the reviewable transaction action. The secured party cannot be allowed to rely

on the action to restore its security and effectively reverse the operation of the priority rule at the expense of both the transferee and other unsecured creditors. The secured party should be treated as an unsecured creditor for all purposes in relation to the reviewable transaction proceeding. The following recommendation should apply to any action under the *Reviewable Transactions Act*.[6]

> **Where property transferred under a transaction is subject to a security interest that is cut off or subordinated to the interest of the transferee as a result of the transfer, the holder of the security interest may not assert a claim to the property recovered under the order for relief on the basis of the security interest, regardless of the form of the order and, for that purpose, "transaction" includes a "payment" to a creditor and "transferee" includes a creditor receiving a payment.**

Subsequent transferees of property or a benefit

[42] The Part 1 Final Report includes recommendations (at paragraph [91]) that allow a remedy to be granted against a person who has not dealt directly with a debtor but has indirectly received property or a benefit that originated with the debtor (i.e., Debtor transfers property to A, who transfers it to B). The terms of the recommendations relate directly to the Part 1 causes of action so cannot be adapted to an action challenging a preferential payment. The appropriate rule should allow for recovery against a secondary transferee of property transferred under a preferential payment only if the original recipient and the secondary transferee are not dealing at arm's length; the secondary transferee is presumptively in a position to ascertain the provenance of the property and the risk of losing it to the creditors of the original transferor-debtor. The same approach should apply to subsequent transfers. The result of the recommendation that follows is that relief may be granted against a person other than the creditor who receives property under a preferential payment only if each transaction in the chain of transactions leading to the defendant was not at arm's length.

> **If grounds for relief against a creditor who receives a payment from a debtor are established, the court may make an order against a person who has received all or part of the benefit conferred under the payment**
>
> **(a) in a transaction with the creditor, if the person was not dealing at arm's length with the creditor, or**

(b) in a transaction with a transferee subsequent to the creditor, if the parties to each transaction under which the benefit of the payment was transferred were not dealing at arm's length.

Prejudgment orders

[43] The recommendation in paragraph [94] of the Part 1 Final Report provides for prejudgment orders designed to prevent a debtor from dealing with property that would otherwise be available to satisfy creditors' claims in a manner that would constitute a transaction at undervalue or fraudulent transaction or, if such a transaction has already occurred, to prevent further action on the part of the debtor or another person that would prejudice the right of a creditor challenging the transaction to obtain an effective remedy. The same provisions should apply in relation to a preferential payment.

The recommendation in paragraph [94] of the Part 1 Final Report should also apply in relation to a preferential payment.

G. Limitation Period

[44] The working group carefully considered the limitation period that is appropriate to the commencement of actions challenging transactions at undervalue/fraudulent transactions and preferential payments respectively. The recommendations in the Part 1 Final Report were reviewed and reconsidered fully following delivery of the report at the 2010 annual meeting of the ULCC (see further Supplementary Report on Part 1 at paragraphs [5] through [8]). The limitation period does not operate merely to induce appropriately prompt litigation of claims; it plays an important role in circumscribing the cause of action and thereby offers a necessary degree of protection to the finality of transactions. A 1 year limitation period was accordingly adopted for purposes of an action challenging a transaction at undervalue or fraudulent transaction, subject to extension where facts relating to the claim for relief are concealed. Application of the same limitation period to an action challenging a preferential payment is further justified by the primary guiding policies articulated above. In particular, provincial legislation governing preferential payments should be consistent with the BIA rules governing preferences to the extent reasonably possible. The BIA permits the trustee to challenge non-arm's length payments to creditors only if they are made within the period beginning 1 year before the initial bankruptcy event and ending on the date of bankruptcy. Under provincial legislation, a limitation period of 1 year following the payment subject to challenge is the closest possible equivalent.

The recommendations in paragraph [96] of the Part 1 Final Report should also apply to an action to challenge a preferential payment and, for that purpose, a reference to a "transaction" includes a "payment" and "transferee" includes a "creditor receiving a payment."

NEXT STEPS

[45] The recommendations of the working group accepted by the Conference will be translated into a *Uniform Reviewable Transactions Act* during 2011-12. The work will be performed by the chair of the working group in conjunction with the statutory drafter assigned to the project in consultation with the working group. The statute will be delivered to the Conference at the annual meeting of 2012.

MOTION

[46] The working group seeks a motion of the Conference that:

(a) The final report of the working group on Part 2: Preferential Payments is accepted;

(b) The working group is directed to draft a *Uniform Reviewable Transactions Act* for delivery to the Conference at the annual meeting of 2012.

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[1] The report was accepted by the Conference at its 2010 annual meeting in Halifax.

[2] For further history and explanation see Tamara M. Buckwold, Reform of Fraudulent Conveyances and Fraudulent Preferences Law (Transactions at Undervalue and Preferential Transfers) Part II: Preferential Transfers at paras. 2-6, a background paper delivered to the ULCC at the 2008 annual meeting.

[3] The Uniform Law Conference of Canada *Uniform Enforcement of Money Judgments Act* would create a limited exception to this rule. A judgment creditor who has delivered an enforcement instruction to the enforcement officer must remit any payment received towards the judgment to the officer for distribution under the statutory scheme. See s. 180(3). This approach has been implemented in Saskatchewan's new *Enforcement of Money Judgments Act*, S.S. 2010, c. E-9.22 (unproclaimed at date of writing).

[4] In the United States, England and other Commonwealth countries the creditor sharing principle operates only in bankruptcy. Creditors' relief legislation that governs outside of bankruptcy is unique to Canada.

[5] The operation of paragraphs (2) and (3) may be better understood by considering an example. Assume that Debtor transfers a boat to Creditor in payment of a debt. Creditor invests $20,000 in having the boat repaired and repainted. The grounds for relief are established and an order setting aside the payment revests the boat in Debtor, making it available to qualifying creditors under judgment enforcement law. The court grants a supplementary order against Debtor in favour of Creditor in recognition of the $20,000 invested in the boat and declares that Creditor holds a security interest in the boat securing the amount of the order. The boat is subject to a security interest held by Bank in all Debtor's present and after-acquired personal property. Transferee's security interest has priority over Bank.

[6] Assume that SP has security interest in personal property of Debtor. Debtor transfers the property subject to SP's security interest to Creditor in payment of a debt. Debtor is insolvent and is related to Creditor; the transaction is not at arm's length. The payment cuts off SP's security interest or subordinates it to the interest of Creditor under a PPSA priority rule. The combined effect of the recommendations advanced is that: (1) the payment is a preferential payment and may be challenged by unsecured creditors of Debtor; the fact that a PPSA rule gives Creditor priority over SP's security interest is not relevant, (2) SP is treated as an unsecured creditor to the extent of the value of the property transferred and, along with other unsecured creditors of Debtor, has standing to challenge the payment, (3) if relief is granted in an action under the *Reviewable Transactions Act*, SP is entitled to share in a distribution produced by judgment enforcement measures against the property under the creditors' relief rules of the jurisdiction but cannot claim it on the basis of the security interest (SP must obtain a judgment and take the other steps required or, in some jurisdictions, obtain a certificate in order to share under creditors' relief law).