UNIFORM LAW CONFERENCE OF CANADA
CIVIL LAW SECTION

REFORM OF FRAUDULENT CONVEYANCES AND FRAUDULENT PREFERENCES LAW (Transactions at Undervalue and Preferential Transfers)

Report on Quebec Civil Law

By Élise Charpentier
Faculté de droit, Université de Montréal
Montréal, Québec

REFORM OF FRAUDULENT CONVEYANCES AND FRAUDULENT PREFERENCES LAW IN CANADA
(Transactions at Undervalue and Preferential Transfers)

TABLE OF CONTENTS

INTRODUCTION

a. Purpose of Report

[1] This paper constitutes an ancillary report to those prepared by professor Buckwold. It presents Quebec perspective on what is generally called fraudulent conveyances and preferences in common law jurisdictions.

[2] The report does not offer recommendations. Rather, it is a working document designed to provide an overview of the law applicable in Quebec.

b. Terminology

[3] In Quebec, fraudulent juridical acts entered into by a debtor that are prejudicial to the creditor are not called fraudulent conveyances or preferences; there is no specific term used in reference to these juridical acts. However, the regime set forth in the Civil code is found under the heading "Paulian action".

c. Approach of the Report

[4] Since Quebec law provides for a unified regime for juridical acts similar to fraudulent conveyances and preferences, they will be discussed simultaneously in this report.

Quebec civil Law

[5] The codal regime respecting Paulian actions is set forth at articles 1631 to 1636 C.C.Q. By this action the creditor who suffers a prejudice asks the court to declare that the injurious juridical act entered into by his or her debtor in fraud of the creditor's rights may not be set up against that creditor; that is, it cannot be raised or is "inopposable" against him or her. The purpose of this action is to protect the creditors by ensuring that two fundamental rules are observed. First, the property of a debtor is charged with the performance of his or her obligations and forms the common pledge of creditors. Second, equality between ordinary creditors must be respected.

[6] The creditor who wishes to exercise a Paulian action must prove that he or she suffers prejudice as a result of the act, that the act was made by the debtor in fraud of his or her rights (art. 1631 C.C.Q.), and that his or her claim is certain at the time the action

is instituted and liquidated and payable at the time the judgment is rendered (art. 1634 C.C.Q.). The action must be brought within one year from the day on which the creditor had knowledge of the act that caused the harm (art. 1635 C.C.Q.).

[7] To facilitate comparisons, the following summary highlights notable features of the Quebec regime, using headings inspired by those adopted in relation to the Statute of Elizabeth in the report prepared by professor Buckwold.

a. Juridical Acts

[8] Paulian actions are directed at injurious juridical acts. Article 163 C.C.Q. states that the "creditor who suffer prejudice through a juridical act made by his debtor … may obtain a declaration that the act mat not be set up against him ". The civilian notion of juridical act is very broad and flexible. The *Private Law Dictionary* offers the following definition: "Manifestation of intention of one or more persons in a manner and form designed to produce effects in law."[1] To illustrate the flexibility of the notion we can simply note that it is broad enough to include onerous contacts (e.g. sales), gratuitous contracts (e.g. donations), payments, as well as a debtor's provision of services to a third party without compensation or for less than their true value, the assumption of an obligation, the transfer of funds to a pension plan exempt from seizure,[2] and the designation of new irrevocable beneficiaries for a life insurance policy or a registered retirement savings plan.[3]

[9] In the absence of a juridical act, the Paulian action cannot be used, for example, to sanction a debtor who refuses to act.[4]

[10] Although there is no specific legislative provision in the Civil Code pertaining to the matter, it is generally understood that juridical acts regarding rights which are exclusively connected to the person cannot be attacked by Paulian action, even if their effect is to diminish the patrimony. For example, an act affecting the status of the person,[5] such as marriage, divorce, or acknowledgement of paternity or maternity, cannot be the contested by Paulian action.[6]

[11] Finally, the Paulian action cannot serve to declare inopposable an act to which the creditor is party.

b. Requirement of Prejudice

[12] Article 1631 C.C.Q. imposes a clear requirement on the creditor who undertakes a Paulian action: to succeed in an action the creditor must prove that the act causes him or her prejudice. This condition is based on recognition of the freedom to which everyone is entitled in the management of his patrimony. Consequently, if the patrimony of the debtor contains sufficient assets for the creditor to execute his claim, the creditor cannot make use of the Paulian action even if certain acts were carried out by the debtor to reduce the value of his or her patrimony. At this stage, it is not necessary to prove that the prejudice is intentional. It is sufficient to demonstrate that the attacked act is itself prejudicial.[7]

[13] Therefore, while insolvency is not a condition of a Paulian action in Quebec civil law it frequently plays an important role in that it facilitates demonstration of the required prejudice. Article 1631 C.C.Q. offers the following examples of juridical acts which entail a prejudice to the creditor: "an act by which he (the debtor) renders or seeks to render himself insolvent, or by which, being insolvent, he grants preference to another creditor".

[14] The concept of insolvency as it is used here does not refer to a technical or specialized meaning, such as the definition found in the legislation on bankruptcy.[8] Rather, it is a factual situation assessed on a case by case basis and left to the appraisal of the court. Most often, the qualification rests on proof that the debtor is no longer capable of meeting his or her commitments, or that his or her debts are greater than his or her assets.

[15] Insolvency of the debtor is not, however, the only expression of a prejudice that the creditor might suffer. Adopting a liberal interpretation of this concept, the courts now regard as prejudicial to the interests of the creditor all acts which make it more difficult to seize the property of the debtor. This is notably the case, for example, when a debtor sells an immovable, even for its market price, in order to change the nature of the assets forming the common pledge of the creditors, cash being easiest to conceal from attempted seizure by the creditor.[9]

[16] Despite the broad interpretation given to the concept of prejudice it is generally admitted that a refusal of enrichment cannot be considered as an impoverishment, since the creditor may not require that his debtor improve his financial situation.[10] The simple fact that a debtor remains passive, does not execute his or her claims or refuses to enter

into a contract that would be advantageous to him or her, such as a sale at a very good price, cannot constitute the basis of a Paulian action.

[17] Finally, a preferential payment made to a creditor may be considered as an impoverishing act if its purpose is to defraud other creditors. When the debtor favors a creditor by paying a debt which has not come to term or which is extinguished, he or she causes a prejudice to his other creditors. However, in the absence of fraudulent intention, the payment to an ordinary creditor of a debt that has come to term may not be attacked through a Paulian action even if it does impoverish the debtor.[11]

c. Debtor's Intention

[18] The inopposability of a juridical act depends on proof that it was made with fraudulent intent. It is not enough to show that the debtor entered into an act that causes a prejudice to his or her creditor. Evidence of the fraudulent character of the act is essential. However this does not require the demonstration of malicious intention on the part of the debtor because such evidence is most often difficult to produce. Rather, it requires evidence that the debtor has acted in a manner designed to protect himself or herself against a forced execution or that he or she was conscious of the prejudice caused to his or her creditor.[12] This intention may be established by any means, including by presumption based on proven facts.

[19] Nevertheless, proof of the required intention remains far from easy. Therefore, the legislature provides certain presumptions of fraudulent intention. These legal presumptions vary depending on the nature of the act; whether it is an act by gratuitous title or by onerous title. A creditor cannot benefit from any presumption unless it can be proven that the debtor was insolvent or that by the attacked act or payment, the debtor sought to become or became insolvent. In the case of an act by gratuitous title, evidence of one of these essential facts is sufficient. In the case of an act by onerous title, it must also be proven that the third party contracting with the debtor was aware of the situation.

i. Presumption of fraud - acts by gratuitous title

[20] Article 1381 C.C.Q. defines the act by gratuitous title as one where "[...] one party obligates himself to the other for the benefit of the latter without obtaining any advantage in return." However, the Court of Appeal has held that in the determination of the nature of an act one must go beyond appearances and seek its substance and its effects, given the parties respective situations and circumstances.[13] Accordingly, an act concluded for "1$ and other considerations" may, in certain circumstances, be qualified as an act by onerous

title if these "other considerations" amount to a substantial advantage, such as the payment of building expenses.[14]

[21] In other circumstances, an apparently onerous act may be considered by gratuitous title even if an advantage was received, when this advantage was of substantially less value than what was provided by the debtor.[15] In such a case, the courts may declare that the act is "gratuitous in part" and only apply the presumption of 1366 C.C.Q. to that portion of the act.[16]

[22] In the context of an act by gratuitous title, the presumption of fraud of article 1633 C.C.Q. requires only evidence that the debtor was or became insolvent at the time the contract was formed or the payment was made. This evidence alone is enough to demonstrate a fraudulent intention conclusively.[17] Knowledge or ignorance of the debtor's intention on the part of the third party has absolutely no effect on the presumption, which operates even if the third party was acting in good faith (i.e. was unaware of the insolvency of the debtor).

ii. Presumption of fraud - acts by onerous title

[23] Article 1632 C.C.Q. provides that "an onerous contract or a payment made for the performance of such a contract is deemed to be made with fraudulent intent if the contracting party or the creditor knew the debtor to be insolvent or knew that the debtor, by the juridical act, was rendering himself or was seeking to render himself insolvent".

[24] The other contracting party is considered as having been aware of the situation when his or her ignorance is the result of willful blindness;[18] that is, when he or she could easily have learned of it by undertaking a reasonable inquiry on the basis of known indicators of insolvency.

[25] Despite the terminology used in article 1632 C.C.Q. and the rule of interpretation of article 2847 C.C.Q.,[19] the Court of Appeal has determined that the presumption of article 1632 C.C.Q. is a rebuttable presumption which may be overcome by evidence of good faith.[20] According to the Court, a third party who is aware of the insolvency of the debtor but wanted to "safeguard his legitimate interests in the ordinary course of business, by means of a regular market"[21] may be considered in good faith. Accordingly, nothing prohibits a seller from being paid by a buyer whom he knows to be insolvent.[22] Also, the third party can demonstrate his good faith by proving that the attacked act was

not for the purpose of defrauding the rights of another creditor but rather to try to help the debtor to re-establish his financial situation.[23]

d. Requirements relating to the claim

[26] Article 1634 C.C.Q. requires that the claim of the creditor be certain at the time the action is instituted, and that it be liquidated and payable at the time the judgment is rendered. Additionally, the claim of the creditor must precede the fraudulent act of the debtor. This requirement is generally justified by the idea that the creditor is entitled to satisfaction from the assets that formed the common pledge at the moment of commitment. Since the Paulian action aims to protect the creditor against the fraudulent impoverishment of his or her debtor, acts accomplished by the debtor previous to the relationship cannot cause prejudice to the creditor.

[27] However, article 1634 C.C.Q. has taken into account the possibility that a debtor may enter into a juridical act in order to defraud a future creditor. Therefore, it provides: "He (the creditor) may bring the claim only if it existed prior to the juridical act which is attacked, unless that act was made for the purpose of defrauding a later ranking creditor".

e. Time limit to institute a Paulian action

[28] Article 1635 provides a predetermined time limit of one year to institute a Paulian action. This time limit cannot be suspended or interrupted.

[29] Under this rule, if a bankruptcy trustee takes the action on behalf of the creditors the calculation of the time limit begins at the moment when the trustee is nominated. If a creditor takes the action, the calculation begins at the moment when he "became aware of the prejudice resulting from the attacked act". The latter also applies to a creditor who obtained permission to institute a Paulian action under article 38 of the *Bankruptcy and Insolvency Act*, since his remedy is personal and not for the mass of creditors.[24]

[30] Despite the terminology, this requirement must be understood to relate to awareness not simply of the act in question but of the fraudulent nature of the act.[25] Indeed, a creditor can know of an act and its effect on the patrimony of his debtor without necessarily knowing that it was concluded in fraud of his or her rights. The requirement of fraud being essential to the success of the Paulian action, it is not unreasonable to begin the limitation period for the extinction of the right when the creditor becomes aware of the fraud. However, the creditor cannot be negligent and the time limit will begin as soon as he or she is aware of a potentially fraudulent maneuver.[26]

f. Effects on third parties

[31] Article 1631 C.C.Q. settles a controversy that existed under the old Code. The Paulian action does not entail the nullity of the act but renders it inopposable to the challenging creditor as well as all those who intervened in the action to protect their rights.[27] For example, in the case of a sale, if the act were to be null the property would return into the patrimony and benefit all of the debtor's creditors. Here, this is not the case.[28] The third party remains owner of the property purchased but the creditor may seize the property as if it were still the property of the debtor.

[32] The third party who concluded the act or who received the payment from the debtor suffers the effects of the inopposability of the act and finds himself or herself deprived of the befits of the act or payment.

[33] If the third party has transmitted his or her rights to a sub-acquirer, the creditor may obtain a finding of inopposability of this new act on the sole condition that the sub-acquirer himself acted in bad faith or received the property by gratuitous title. Otherwise, the sub-acquirer is protected and the creditor may not obtain compensation from the first third party acquirer.[29]

CONCLUSION

[269] Transactions at undervalue and preferential transfers are subject to the same rules in Québec and this uniform treatment does not raise particular problems. The system produces fairly predictable and consistent outcomes and is not the object of any serious criticism.

---

[1] *Private Law Dictionary and bilingual lexicons - Obligations,* Cowansville, Les éditions Yvon Blais, 2003.

[2] *In re : Biron*, [1999] J.E 99-479 (C.A.).

[3] *Droit de la famille-07512*, [2007] J.Q. 2339 (C.S.); *Langlois c. Jean*, [2002] R.L. 273 (C.S.); *Leduc (Syndic de)*, J.E. 98-613 (C.S.).

[4] *Banque Royale du Canada c. Charbonneau*, J.E. 99-767 (C.S.).

[5] *Martineau* c. *Canada (Procureur général)*, (2003) R.J.Q. 2751 (C.A.).

[6] Regarding personal and family matters, the Civil Code does provide certain direct remedies for a creditor who suffers a prejudice, without having to otherwise show the intention to defraud. See, for example, modification of a marriage contract (art. 438 C.C.Q.), renunciations pertaining to partition of property in a matrimonial regime (art. 470 C.C.Q.) or to a succession (art. 652 C.C.Q.).

[7] *Peluso c. Réalisations Mont-Chatel inc.*, [1998] R.J.Q. 2245 (C.A.).

[8] *Banque nationale du Canada c. S.S.*, [2000] R.J.Q. 658; [2000] J.Q. no. 471 (C.A.), para 40.

[9] *Duchesne c. Demers*, [2004] R.J.Q. 2909 (C.A.).

[10] *Realstar Hotel Services Corp. C. 3099-1103 Québec inc.*, 2005 QCCA 555; Jean-Louis BAUDOUIN, Pierre-Gabriel JOBIN and Nathalie VÉZINA,, Les obligations, 6e éd., Cowansville, Yvon Blais, 2005, no. 759, p. 741; Didier LLUELLES and Benoît MOORE, *Droit des obligations*, Montréal, Thémis, 2006, no. 2855, p. 1693-1694.

[11] For example, see, *Banque nationale du Canada c. S.S.*, [2000] R.J.Q. 658 (C.A.).

[12] *Pétro-Canada c. Les Pétroles Astro inc.*, [2004] R.J.Q. 179 (C.S.).

[13] *Bergeron (Faillite de)*, [2002] R.D.I. 22 (C.A.).

[14] *Pétro-Canada c. Les Pétroles Astro inc.*, [2004] R.J.Q. 179 (C.S.).

[15] *9022-8818 Québec inc. (Faillite de)*, J.E. 2004-1471 (C.A.). The burden rests on the creditor to prove that the advantage was disproportionate (*Bergeron (Faillite de)*, [2002] R.D.I. 22 (C.A.); *Pétro-Canada c. Les Pétroles Astro inc.*, [2004] R.J.Q. 179 (C.S.)).

[16] *9022-8818 Québec inc. (Faillite de)*, J.E. 2004-1471 (C.A.).

[17] *Cloutier c. Lagacé*, J.E 2002-1789 (C.S.).

[18] *Duchesne c. Labbé*, [1973] C.A. 1002.

[19] Article 2847 para. 2 : "A presumption concerning presumed facts is simple and may be rebutted by proof to the contrary; a presumption concerning deemed facts is absolute and irrebuttable".

[20] *Banque nationale du Canada c. S.S.*, [2000] R.J.Q. 658 (C.A.).

[21] My translation.

[22] *Malka (Faillite de)*, [2004] R.J.Q. 2440 (C.A.).

[23] *Malka (Faillite de)*, [2004] R.J.Q. 2440 (C.A.).

[24] *Stone (Faillite de)*, [2007] R. J.Q. 832.

[25] *Stone (Faillite de)*, [2007] R.J.Q. 832; *Crépeault c. Anjou (Ville de)*, J.E. 85-233 (C.A.); *(Sous-ministre du Revenu) c. Elliott*, 2007 QCCS 4274.

[26] *Stone (Faillite de)*, R.J.Q. 832

[27] Article 1636 C.C.Q.

[28] Unless, of course, the action was taken by the bankruptcy trustee of the debtor for the benefit of all of his creditors. But the principles remain the same.

[29] *Peluso c. Réalisations Mont-Chatel inc.*, [1998] R.J.Q. 2245 (C.A.).