

# Advising the Insolvent Debtor: Legal and Ethical Issues



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# Webinar Objectives

- ❖ The current state of the law is examined in the context of certain hypothetical scenarios
- ❖ The role of the lawyer is examined in general and with reference to the ethics of representing the insolvent debtor in the scenarios
- ❖ Exposure of the lawyer to potential criminal, civil and administrative liability is discussed with reference to the scenarios

# Legislation

- ❖ *Statute of Elizabeth*
- ❖ *The Fraudulent Preferences Act*
- ❖ *Bankruptcy and Insolvency Act*
- ❖ *The Registered Plan (Retirement Income) Exemption Act,*
- ❖ *The Enforcement of Money Judgments Act*
- ❖ *The Saskatchewan Farm Security Act*
- ❖ *Criminal Code*

# Sask. Statutory Provisions

- *Statute of Elizabeth*
  - any conveyance made for purpose of defrauding creditors is void
  - can apply to creditors not in existence at the time of conveyance
- *Fraudulent Preferences Act*
  - insolvency requirement and prohibits both transfer intended to prefer & transfers effecting preference
  - certain transactions deemed preferential
  - no application to payment to secured creditor

# Bankruptcy & Insolvency Act

- S.95 preferences void as against trustee
  - transactions 3 mos. before bankruptcy if arm's length
  - transactions within 12 mos. if non-arms length
  - payment to secured creditors excluded
- S.96 transfers at undervalue
  - court declares void or party privy ordered to pay difference in value

# Exemptions

- S. 67(1)(b) of BIA accepts provincial exemptions in bankruptcy
- Sask. Has significant exemptions
- EMJA – house, car & more
- SFSA – home quarter, equipment & more
- RRSP's and RRIF exempt under provincial legislation & BIA

# Scenario #1: Dr. Jones

## ❖ Dr. Jones' Assets

- Medical prof corp. with RE of \$300,000
- Home owned with his wife value of \$700,000; \$400,000 owed to DEF Trust maturing Nov.1
- Non-registered investments of \$500,000
- RRSPs (\$400,000; \$80,000 unused contributions)
- Cottage transferred to himself and his wife in 2005 with value of \$400,000

# Scenario #1: Dr. Jones

## ❖ Financial Position of Dr. Jones

- Dr. Jones is 42 and makes \$250,000 per year
- Invested in venture in 2008 with a friend
- Provided guarantee to ABC Bank for \$7 million
- MPC pays Dr. Jones salary of \$100,000 per year
- MPC pays \$60,000 per year to Mrs. Jones
- Venture fails; ABC demands \$5 million Oct. 30
- Friend has few exigible assets



# Scenario #2

- July 30, 2012 Dr. Jones cashes in unregistered investments
- August 10, 2012 he contributes \$100,000 to his RRSP
- Left with \$400,000.00

# Scenario #2 Result

- Un-secured creditor pool reduced by transaction
- RPEA protects RRSP from “any enforcement process”
- Stat Elizabeth & FPA cover transfers or payments to third parties not transfer of funds from one account to another
- S. 95 and S.96 not applicable to this transfer of funds

# Scenario #3

- resolutions passed by MPC to declare dividends to Mrs. Jones
- all R E paid out
- MPC articles permits “sprinkling”
- this has been past practice

# Scenario #3 - Result

- s. 101 of BIA deals with dividends by insolvent corporation
- apply Statute of Elizabeth & FPA
- apply statutes in conjunction with “piercing the corporate veil”
- court should reverse this but not clear case
- what result if Dr. Jones arranges to pay out usual dividends of \$60,000?

# Poll Question:

In Scenario 3, what is the result if Dr. Jones simply winds up the MPC?

# Scenario #4

- October 12, 2012 Dr. Jones transfers his share of cottage to his wife
- Dr. Jones receives no payment
- reversed by FPA & Statute of Elizabeth
- s. 96 of BIA may be invoked to recover \$200,000.00 or reverse

# Scenario #5

- November 1, 2012 Dr. Jones pays \$300G to DEF Trust
- Mrs. Jones pays \$100G to DEF Trust
- DEF Trust discharges mortgage
- house is exempt from seizure
- payment to DEF Trust un-affected by legislation
- equity of Dr. Jones may be recoverable at some time in future save for his exemption of \$50,000

# Scenario #6

- November 1, 2012 Dr. Jones pays \$100G to XYZ firm
- retainer for the defence of ABC Bank claim & insolvency proceedings
- Mearns makes sense but the defence of ABC claim etc. may use up retainer



# Professional Responsibilities

## ❖ The Law Society of Saskatchewan's *Code of Professional Conduct*

- Dishonesty or fraud by client (2.02(7), p. 25)
- Dishonesty or fraud when the client is an organization (2.02(8), p. 26)

# What to Do

- On guard for unscrupulous client
  - the impact of the internet
  - knowledge possessed by the lawyer
  - instructions from 3<sup>rd</sup> parties
- reasonable inquiry
  - financial position
  - objectives of client
- consult with colleagues or mentors
- withdraw if concerns remain
- reputation

# Ethics

- science of morals – rules of conduct
- drawing the ethical line
- largely a “smell test”
- answers “neither black nor white but grey”
- conduct is not unlawful *per se*
- in the insolvency context timing of conduct is critical
- Threshold question is the impact on the un-secured creditor pool

# Scenario #7

- Dr. Jones is looking for your advice
- you review his assets and the guarantee of ABC Bank
- you develop a strategy to defend & delay ( at least 1year) the ABC Bank action
- you & Dr. Jones implement the action in scenarios #2, #3, #4, #5 & #6

# Ethics & Dr. Jones

- the ethical spectrum
- advice provided after action has been taken by Dr. Jones
- this strategy & steps taken by the lawyer have crossed the “ethical line”
- when in doubt consult
  - experienced lawyer
  - Law Society

# Poll Question:

In Scenario 2, is a favourable result legal and ethical on the basis that Dr. Jones could have made the contributions sooner?

# Potential Criminal Liability

- ❖ s. 392 is specific section dealing with disposal of property with intent to defraud creditors
- ❖ s. 380 generic fraud section
- ❖ lawyer may be liable as party, for counselling the offence or in conspiracy
- ❖ client tosses lawyer under the bus
- ❖ prosecution would be bad result in any event

# Potential Civil Liability

## ❖ Mraiche decision

- transfers for nominal consideration
- lawyer had no knowledge of plaintiff's claims or near insolvency of transferor

## ❖ tort of civil conspiracy

- lawful or unlawful but purpose is injury to plaintiff
- unlawful – conduct directed at Plaintiff – actual damages

## ❖ insurance risk



# Further Information/Resources:

- For additional reading see the following which are cited in my paper:

Ethics and Advising the (Nearly) Insolvent Client Stuart Brotman and R. Graham Phoenix (2009) Nat. Insol. Review Issue #4 p. 41.

The Ethics of Creditor Proofing Robert A. Klotz 2011 Pitblado Lectures Winnipeg, Manitoba, November 25, 2011.