 | By Peter Farkas

Problems even for the innocent

Fraudulent conveyance acts may not be in keeping with the needs of a complex business environment and too often favour creditors

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Most people do not pay attention to their provincial fraudulent conveyance acts.* Why should they? It sounds as if FCAs apply to criminals, not to commercial matters. But FCAs can affect people when they do not expect it — impacting aspects of tax planning and family law matters. FCAs could come into play especially if you are a business owner or have significant personal assets.

You may think if you are solvent you can plan your financial affairs as you see fit: if you want to transfer your house to a spouse (as many unincorporated professionals do) you can do so; if you want to gift assets to a children's trust you can do so — with the same reasoning applying.

Similarly, you may think a corporation can reorganize its affairs when there is no prejudice to its creditors at that point in time. But *Abakhan & Associates Inc. v. Braydon Investments Ltd.* (2008 BCSC 1547; affirmed 2009 BCCA 521) clearly demonstrates that assets innocently transferred away may ultimately be claimed by creditors years later; worse, in the case of Abakhan, by creditors who were not even creditors at the time of the transfer. Talk about unjust enrichment.

In the Abakhan case, William Botham was the directing mind of Botham Holdings Ltd. BHL had been incorporated years earlier and had accumulated substantial worth such that its equity in real estate was worth about $20 million at the time of the attacked transaction.

In 2004, BHL sold a real estate asset at a profit and paid a large amount of capital gains tax. In 2005, Botham was looking for an opportunity to invest the funds realized by the sale of the asset. A friend who had experience in the car-leasing business encouraged Botham to invest

in a new business. Together they formed JW Auto Group and acquired a portfolio of leased vehicles. The proposed investment would have the tax benefit of generating capital cost allowance deductions. This would enable BHL to obtain refunds of capital gains tax, which it had previously paid. But BHL had to become a general partner in the new business, and the new business had to be its major source of revenue. As a general partner of JW Auto Group, BHL would be responsible for any debts incurred by the partnership.

Botham was advised by legal and accounting professionals that he could both protect BHL's assets from creditors' claims and qualify for the tax benefits by transferring BHL's assets to a new corporation and then using BHL to invest as a general partner in JW Auto. Braydon, the new corporation, was duly incorporated in October 2005 and the valuable assets were transferred from BHL to Braydon. BHL received preferred shares as consideration.

The auto-leasing business failed and in 2007 both the partnership (of which BHL was the general partner) and BHL were assigned into bankruptcy.

The trustee of BHL attacked the transfer of the assets from BHL to Braydon as a fraudulent conveyance, invoking the British Columbia FCA. Section 1 of the BC FCA, at the time, stated: "if made to delay, hinder or de-fraud creditors and others of their just and lawful remedies

(a) a disposition of property, by writing or otherwise,
(b) a bond,
(c) a proceeding, or
(d) an order

is void and of no effect against a person ... whose rights and obligations by collusion, guile, malice or fraud are or might be disturbed, hindered, delayed or defrauded, despite a pretence or other matter to the contrary." (BC's FCA has since been amended to remove the words "by collusion, guile, malice or fraud.")

There were many arguments made by the trustee and Botham as to the application of the FCA in this case, but the two key issues the court had to determine were whether the act was applicable in the absence of lack of dishonest intent on Botham's or BHL's part and whether subsequent creditors could avail themselves of the FCA.

For starters, even the trustee agreed that Botham had no mala fides in structuring the transaction the way he did; while the issue of creditor proofing was discussed, the main impetus was tax planning.

In the end the court determined that in order to invoke the FCA, it is not necessary to demonstrate that a transferor had a dishonest or morally blameworthy intent. The fact that BHL's assets were conveyed away to shield them from creditors was enough. This is in fact consistent with the wording of other FCAs (such as Ontario's), which do not include the words "by collusion, guile, malice or fraud" or similar wording implying a requirement of bad faith.

The issue the court then had to decide was whether the transferred assets were put out of reach of BHL's creditors, particularly creditors who did not exist at the time of the transfer. The court ruled that even future creditors could attack the transfer. It based this conclusion applying the definition of who can invoke the FCA being "creditors and others." The court felt subsequent creditors fell into the "others" category. As a result, the Braydon transaction was declared void with the effect that Braydon's assets were turned over to the trustee of BHL for distribution to its creditors.

The creditors of the auto leasing business were not creditors of BHL when the assets were transferred out. BHL was solvent at the time; no creditors were pressing for payment although BHL did have ordinary course creditors. Tax planning was the main motivation for the ultimate corporate structure. Even the trustee acknowledged that there was no dishonest intent on the part of Botham.

More recently, BC's Court of Appeal ruled in the case of *Mawdsley v. Meshen* (2012 BCCA 91). Mr. Mawdsley was the common-law husband of a woman with considerable net worth, which she had acquired before their relationship. As part of estate planning, just before her death, she transferred the bulk of her assets to an inter vivos trust in favour of her children and brother-in-law. Her will reflected the same distribution of assets. Upon her death, Mawdsley challenged the transfer saying the settlement of the trust was void, contravening the FCA.

Professionals routinely convey away their residences to a spouse not exposed to litigation. Later a creditor can claim it was a fraudulent conveyance and attack the transfer

The court in this case referred to the Abakhan case by stating that Botham had admitted one purpose of transferring assets was to protect BHL's assets from creditors. But this was not the case in Mawdsley. The court dismissed Mawdsley's claim stating there had to be an intention to "delay, hinder or defraud creditors" for the FCA to apply. In other words, just the effect of transferring of property is not enough to invoke the FCA; there has to be intent to prejudice creditors.

The court also dealt with the concept of "others" invoking the FCA. Certainly, in a family-law context the court rejected that a noncreditor at the time of a transfer can invoke the FCA.

There effectively is no time limitation as to when the FCA can be invoked, as provincial limitation periods only start running when creditors are deemed to have discovered the conveyance. This could be many years after the transfer. (Ontario's FCA does have a 15-year absolute limitation but the transferor is still exposed for a seemingly inordinate amount of time.)

So consider where this can impact innocent, run-of-the-mill transactions — tax planning transactions and certainly creditor-proofing attempts. Professionals — lawyers, doctors, accountants — routinely convey away their residences to a spouse who is not as exposed to litigation. Years later a creditor can claim that it was a fraudulent conveyance and attack the transfer.

Another example: a bank asks a business owner to purchase key-person insurance. The policy is placed in the borrowing

entity. This makes the premiums tax deductible. Years later the company fails and the cash surrender value goes to the company's creditors. The policy could have been placed in a separate entity with the bank as the beneficiary such that if the bank debt is repaid from other assets the business owner gets the CSV. Of course the premiums would not be tax deductible. This is another example of the natural tension between tax planning and creditor proofing.

The FCA (as interpreted in Abakhan) certainly forces a decision to be made between optimum tax-planning strategies and creditor proofing.

If asset protection is the goal, assets should be put in the name of a new corporation (or a spouse, or trust) from the start of ownership, thus there is never a conveyance. Risky activities should be conducted in a clean new entity. If Botham had used a new company for the auto-leasing business, the real estate would not have been exposed to the auto-leasing business's creditors.

If tax or estate planning involve asset transfers, there should be no discussion about creditor proofing. Easier said than done.

There should be some modernization of FCAs. There should be a limitation period for when the FCAs can be invoked running from the time of the transaction, similar to the Bankruptcy and Insolvency Act where, for example, under Section 96, a nonarm's-length, undervalue transaction can only be attacked within five years of its occurrence. The important take-away is that creditors lose their ability to attack transactions at a defined point in time.

Another change might be to reintroduce (or legislate) the notion that the FCA is designed to prevent dishonest intent, not just intent. There should be an intent test, perhaps using the badges of fraud as a guide, factors such as the timing of the transfer, consideration received and so on. The origin of FCAs was the Statute of Elizabeth circa 1571 in the UK. It was enacted as a criminal remedy, not a civil one. The title does have the word "fraudulent" in it, yet it has successfully been argued, as in the Abakhan case, that this is not meant to infer that in modern times it means dishonest intent.

It would be good to have clarity that FCA can only be invoked by creditors existing at the time of the conveyance, not subsequent creditors. The theory is that creditors are making decisions as to whether to supply credit to a counterparty based on current financial data provided by the counterparty, not on unknown events that took place years ago.

FCAs are too broad and not in keeping with the needs of a modern society and complex business environment. They have been interpreted in a manner that heavily favours creditors. Corporations and individuals should be entitled to arrange their affairs as they wish at a time when they have no issue with their creditors. FCAs should be amended to reflect this reality.

*(*All common-law provinces have such acts; in Quebec, creditors' rights are encompassed in the Civil Code.)*

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