OCA addresses fraudulent transfers under Bankruptcy and Insolvency Act

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The recent decision in *Ernst & Young Inc. v. Aquino*, the Ontario Court of Appeal (OCA) analyzed the criteria for establishing voidable transfers at undervalue under section 96 of the *Bankruptcy and Insolvency Act* RSC 1985, c B-3 (BIA), with a particular focus on the application of "corporate attribution" in the context of insolvency. This case is expected to have a significant impact on the availability of section 96 challenges in insolvency, making section 96 challenges available in circumstances where the fraud was perpetrated against the debtor company.

Background

John Aquino was the directing mind of Bondfield Construction Company Limited (BCCL), a construction company that operated in and around Toronto, as well as its affiliate, Forma-Con Construction (CC), which performed concrete forming.

Beginning in 2015, BCCL and its affiliated entities (the Bondfiled Group) began to experience liquidity challenges. As a result, in 2018 BCCL's bonding company engaged Ernst & Young Inc. (EY) to review the Bondfield Group's financial situation. EY's review determined that the Bondfield Group was experiencing cash flow challenges, and as a result, certain of the Bondfield Group's creditors began calling their loans.

On April 3, 2019, BCCL entered restructuring proceedings under the Companies' Creditors Arrangement Act (CCAA), and EY was appointed as Monitor. Soon after being appointed, EY discovered that BCCL illegitimately transferred over $35,000,000 to non-arm's length parties under a false invoicing scheme dating back more than five years. Shortly after, FCC was petitioned into bankruptcy. KSV Restructuring Inc. was appointed as trustee in bankruptcy of FCC, and upon investigating FCC's financial records, discovered that FCC had participated in a similar false invoicing scheme, in an amount exceeding $11,000,000.

Initially, the respondents insisted they had provided adequate consideration for the amounts that had been transferred to them under the false invoicing scheme, however, eventually conceded that, they had provided no value in respect of the impugned transactions. Both the Monitor and the Trustee applied to have the transactions declared "transactions at undervalue", voidable under section 96 of the BIA[1], and to have the beneficiaries of the false invoicing scheme held jointly and severally liable for the amounts that had been illegitimately transferred out of BCCL and FCC as “privies” to the transfers at undervalue.

Transfers at under value under s. 96 of the BIA

Section 96(1) of the BIA empowers the court to declare void a transfer at undervalue, as well as to order that a party to the transfer or another person who is privy to the transfer must pay to the estate the deficiency in the value. In cases where the party was not dealing at arm’s length with the debtor, the test applied under section 96(1) is less rigorous, and transfers at undervalue can be declared void if the transaction took place within the five year period before the date of bankruptcy, and

a. the debtor was insolvent at the time of the transfer or was rendered insolvent by it; or
b. the debtor intended to defraud, defeat or delay a creditor.

In *Aquino*, the respondents argued that the impugned transactions could not be voided because certain conditions under section 96(1) had not been satisfied. They claimed that at the time they received payments under the false invoicing scheme, both BCCL and FCC were financially stable, and as a result, the debtor companies were not insolvent at the time of the impugned transfers, nor did the impugned transactions render the debtor companies insolvent. Further, the respondents asserted that section 96(1) requires that the ***debtor*** intend to defraud, defeat or delay a creditor. The respondents (brazenly) did not contest that they actively intended to defraud the debtors. However, they argued that those intentions could not be imputed onto the debtors.

Intent to defraud, defeat or delay a creditor

In the result, the OCA upheld the application judge’s findings that the transactions were at undervalue in contravention of section 96 of the BIA[1], and that the respondents were jointly and severally liable for the deficiency.

In particular, the application judge did not accept the respondents’ position that the debtor companies were financially stable at time the impugned transactions took place, and took a dim view of an expert accounting report tendered by the respondents to illustrate the debtors’ financial health in the years leading up to insolvency. It was also relevant to the application judge that the debtors’ financial statements, prepared by an independent third party during the period when the impugned transactions occurred, were the subject of litigation.

The application judge declined to make a determination on the true financial condition of the debtors at the time of the impugned transactions. She held that badges of fraud (which, in the matter before her, included unusual accounting practices, large value of the payments, secrecy, non-arm’s length status of the transactions, and unusual haste in completing the impugned transactions) create “a rebuttable presumption of the intention to defraud, defeat or delay creditors". As a result, she held that the evidentiary burden shifts to those defending the fraud to adduce evidence to show the absence of fraudulent intent. In the present case, the respondents failed to rebut the presumption of fraudulent intent. These findings were upheld on appeal.

Corporate attribution to impute intent to defeat the debtors ’ creditors

The Court of Appeal also rejected the respondents’ submissions that Mr. Aquino’s intent could not be attributable to the debtors. In upholding the application judge’s ruling, the Court of Appeal set out three guiding principles to be considered by a court when applying the doctrine of corporate attribution in the context of the BIA (paras 71-73):

1. the court should be sensitive to the context established by the field of law in which an imputation of intent to a corporation is sought to be made;
2. the court should recognize that the attribution exercise is grounded in public policy, and that the underlying question is "who should bear the responsibility for the impugned actions of the corporation's directing mind?”; and
3. the court retains the discretion to refrain from applying it where, in the circumstances of the case, it would not be in the public interest to do so.

In considering these principles, the Court of Appeal distinguished the application of the doctrine in a bankruptcy context from ordinary civil or criminal applications since, in a bankruptcy, the debtor company is only a “bundle of assets to be liquidated with the proceeds distributed to creditors.” The Court noted that an approach favouring interests of fraudsters over creditors should not be adopted, and framed the test for imputing the intent of a directing mind to a corporation in the bankruptcy context as:

> “who should bear responsibility for the fraudulent acts of a company's directing mind that are done within the scope of his or her authority - the fraudsters or the creditors?”

In the instant case, it was clear that the respondents’ position would absolve the participants’ in the false invoicing scheme from any accountability for the transfers at undervalue at the expense of innocent (arm’s length) creditors. As a result, the Court of Appeal upheld the application judge’s finding that the intention of the debtor can include the intention of individuals in control of the corporation, regardless of whether those individuals had any intent to defraud the corporation itself. Consequently, the respondents were held to be liable to the debtors’ estates for the amounts paid to them under the impugned transactions.

Key takeaway

This case was the first time a Canadian court has considered the doctrine of corporate attribution in the context of transfers at undervalue under the BIA. As such, it provides valuable guidance regarding directors’ liability, particularly in respect of closely held companies that are financially distressed. It shows that related-party transactions that fraudulently extract value from a corporation are very likely to be impeachable under Section 96. In particular, such improvident transactions will not be shielded from section 96 liability, merely because the debtor company was also harmed. The Courts in Aquino have taken a practical and commercially realistic approach to interpreting section 96.

For more information, please reach out to any of the key contacts below.

[1] The Monitor brought its application under CCAA s. 36.1, which incorporates BIA s. 96 by reference.

[2] Two of the respondents' liabilities were limited to less than $100,000 each, on the basis of limited involvement in the false invoicing scheme.

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