March 8, 2018

BIA Preference Payments: Evidence Rebutting the Presumption must be Objectively Reasonable

By: Jassmine Girgis

Case Commented On: *Gustafson (Re)*, 2018 ABQB 77 (CanLII)

Introduction

Legislation that governs fraudulent preferences applies if a debtor elects to pay only one or a few of his creditors and not the others, with the consequence of preferring certain creditors. These transfers are improper if they are made on the eve of the debtor's bankruptcy. Preferences are governed provincially, by the *Fraudulent Preferences Act*, RSA 2000, c F-24, and federally, under the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 (BIA). This case deals with the preference provisions in the BIA.

In this case, the bankrupt made three payments to creditors preceding his bankruptcy, thereby giving rise to a rebuttable presumption that he intended to prefer the creditors. The court found the presumption had not been rebutted and set aside the preference payments, bringing the money back into the bankrupt's estate for distribution by the trustee in bankruptcy.

The presumption to prefer can be rebutted by showing that the debtor's dominant intent in making the payments was to restructure the debtor's financial affairs, presumably to avoid bankruptcy. In this case, while that was the bankrupt's stated intention, the bankrupt's actions did not rebut the presumption to prefer, as they were not objectively reasonable.

Facts

Grant Gustafson, the bankrupt, made three credit card payments, to TD Canada Trust, CIBC and RBC, for a total of $70,000. Within three months after the payments, Mr. Gustafson made a Division I Proposal under the BIA; at that time, the Canada Revenue Agency was his only remaining creditor, for approximately $1.15M. In it, Mr. Gustafson proposed to pay the CRA $400,000, which is about 27.22% of the debt, after deduction of the Trustee's fees. The CRA rejected the proposal and the debtor was declared bankrupt.

Division I proposals allow an insolvent person to make a proposal to his creditors to avoid bankruptcy. Where the creditors refuse the proposal, the insolvent person is deemed to have made an assignment in bankruptcy (BIA, s 57).

The trustee in bankruptcy brought two applications before Registrar W.S. Schlosser, to set aside the payments to CIBC and to RBC. CIBC opposed the application but no one appeared on behalf of RBC; the facts are the same for both applications. CIBC based its opposition on the trustee's report, which had indicated that the payments to creditors coincided with the bankrupt's lifestyle changes, to make his life more simple and orderly, and that there had been no indicators of fraudulent transactions on the part of the bankrupt.

Decision

Registrar Schlosser treated the trustee's report as affidavit evidence in the proceedings. The report referred to the bankrupt's motive in making the payments; the Registrar categorized that evidence as affidavit evidence sworn on information and belief, consisting partly of hearsay. The report also opined that the payments were not fraudulent transfers; the Registrar found this to be opinion evidence, ruled it inadmissible and determined it was neither binding nor determinative of the issue before him.

The Registrar noted that for s 95 BIA to be met, the debtor needed to be insolvent at the time of payment, and that the payment needed to constitute "a *preference in fact*" (para 8). Here, the debtor had been insolvent at the time of the payments, and he had paid some creditors, but not others, within three months preceding the bankruptcy, thereby meeting the two elements. Once these two elements are met, the legislation presumes the payment was an illegal preference unless the presumption can be rebutted by evidence. According to the case law, that evidence must show, on the balance of probabilities, that the dominant intent was not to prefer (para 8). To avoid having the payment set aside, that intent must be objectively reasonable (para 9). Situations in which the payments stood included consolidating loans to obtain a tax refund, attempting to stay in business, and protecting a valuable asset (para 9).

The Registrar determined that the motive of the bankrupt, "the desire to simplify, and to set one's life in order", did not demonstrate a dominant intention not to prefer some creditors over others (para 21). The proposal to the CRA was about 4% worse without the money paid to CIBC and RBC, and the bankrupt's explanation was not good enough to justify those numbers.

The payments to CIBC and RBC were set aside, and the funds went to the trustee for the bankrupt's estate.

Analysis

The relevant preference provisions in the BIA, sections 95(1)(a) and (2), read:

> **95 (1)** A transfer of property made, a provision of services made, a charge on property made, a payment made, an obligation incurred or a judicial proceeding taken or suffered by an insolvent person
>
>> **(a)** in favour of a creditor who is dealing at arm's length with the insolvent person, or a person in trust for that creditor, with a view to giving that creditor a preference over another creditor is void as against — or, in Quebec, may not be set up against — the trustee if it is made, incurred, taken or suffered, as the case

> may be, during the period beginning on the day that is three months before the date of the initial bankruptcy event and ending on the date of the bankruptcy;
> …
>
> **(2)** If the transfer, charge, payment, obligation or judicial proceeding referred to in paragraph (1)(a) has the effect of giving the creditor a preference, it is, in the absence of evidence to the contrary, presumed to have been made, incurred, taken or suffered with a view to giving the creditor the preference — even if it was made, incurred, taken or suffered, as the case may be, under pressure — and evidence of pressure is not admissible to support the transaction.

An illegal preference payment does not require an intent to defraud. Rather, it is unjust because it causes some creditors to get paid while others do not, and to prefer creditors in this way undermines the distribution scheme in the BIA. As articulated in *Re Norris* (1996), 1996 ABCA 357 (CanLII) at para 16, "[i]t is called fraudulent because it prejudices other creditors who will receive proportionately less, or nothing at all, and upsets the fundamental scheme of the Act for equal sharing among creditors".

The BIA requires several elements to be met to establish a presumption of a preference. Upon these conditions being satisfied, the presumption can be rebutted. The conditions are as follows.

First, the debtor must be insolvent. Insolvent person is defined in s 2 of the BIA; it is a factual state which can generally be described as a debtor ceasing to pay his liabilities generally as they become due. The bankrupt's insolvency at the time of the payments was not in dispute in this case (para 7).

Second, the debtor must have transferred property, provided services, given a charge on property, made a payment, incurred an obligation or suffered judicial proceedings.

Third, the transaction must be in favour of a creditor. These are not in issue in these proceedings, as Mr. Gustafson transferred a total of $70,000 to his creditors, RBC, CIBC and TD Canada Trust.

Fourth, if the transaction was at arm's length, which it was in this case, it must have been made within three months before the date of the initial bankruptcy event and ending on the date of bankruptcy. The BIA does not define "arm's length", but it does define "related persons", and lists connections that deem persons to be related to each other (ss 4(1)-(3)). Persons who are not related are "deemed not to deal with each other at arm's length while so related" (s 4(5)) and it is a question of fact as to whether unrelated persons are dealing with each other at arm's length (s 4(4)). There has been reference to the *Income Tax Act*, RSC 1985, c 1 (5th Supp) on the definition of "arm's length" (see *Piikani Energy Corporation (Re)*, 2013 ABCA 293 (CanLII) referring to *McClarty v R*, 2008 SCC 26 (CanLII)). The date of the initial bankruptcy event, defined in s 2, is the earliest day on which an assignment, notice of intention, or application for a bankruptcy order, is filed or commenced, and the date of bankruptcy, also defined in s 2, is the date of granting the bankruptcy order against that person. Here, the transactions had been made within three months of the bankruptcy (para 8).

Fifth, the transaction must have given the creditor a "preference in fact" (*Re Van der Leik* (1970), 14 CBR (NS) 229 (Ont HCJ)). This is proven once it is shown the creditor's circumstances in the bankruptcy are enhanced as a result of the transaction (*Re Van der Liek* at para 8).

Once these elements are shown, a rebuttable presumption will arise: it will be presumed that the debtor intended to prefer that creditor over other creditors. The creditor can rebut the presumption with evidence that the dominant intent of the debtor was *not* to prefer. The dominant intent test has been traced back to Houlden J.'s statement in *Re Van der Liek* at para 9:

> When the trustee has proved these three essentials [timing of transaction, insolvent debtor, preference in fact], he need proceed no further and the onus is then on the creditor to satisfy the court, if he can, that there was no intent on the part of the debtor to give a preference. If the creditor can show on the balance of probabilities that the dominant intent of the debtor was not to prefer the creditor but was some other purpose, then the application will be dismissed, but if the creditor fails to meet the onus, then the trustee succeeds.

The dominant intent of the debtor is to be determined objectively, by considering the circumstances of the debtor, and not "the debtor's personal ruminations" (*St. Anne-Nackawic Pulp Co (Trustee of) v Logistec Stevedoring (Atlantic) Inc*., 2005 NBCA 55 (CanLII) at para 6).

Determining the nature of the requisite intent to rebut the presumption has generated much case law, and from that, several categories have been articulated (for general commentary, see Roderick J. Wood, *Bankruptcy & Insolvency Law*, *2nd ed*. (Canada: Irwin Law Inc., 2015) at 211-214). Case law shows that the presumption is typically rebutted if the preference payment occurs for one of the following reasons. First, if the preference payment is made in the ordinary course of business, it will not be set aside. This is a factual question and the context of the business relationship, the type of business and the industry standard can be considered (*Robitaille v American Biltrite (Canada),* [1985] 1 SCR 290, 1985 CanLII 67 (SCC); *Deloitte & Touche Inc. v White Veal Meat Packers Ltd*., 16 CBR (4th) 74, 2000 CanLII 21117 (MB QB); *St. Anne-Nackawic Pulp Co (Trustee of) v Logistec Stevedoring (Atlantic) Inc*. at para 8). In *Deloitte & Touche*, the presumption was not rebutted when a bankrupt, who was habitually late in making payments, made payments to two creditors in the three months preceding its bankruptcy. The bankrupt had been unable to pay its other creditors at the time the preference payments were made, and had been overdue in paying many of its creditors, thereby preventing it from being able to carry on business in the ordinary course. Conversely, in *Robitaille*, the presumption was rebutted because the late payment to the creditor was in the ordinary course of the business relationship between the debtor and creditor, and was also standard in the industry (para 5).

Second, if the preference payment is made as a requirement to stay in business, the presumption can be rebutted. Where the debtor's preference payment allowed the debtor to finish refurbishing vehicles that obtained a much higher sale price than they would have had they been sold unfinished, the court concluded that the debtor's dominant purpose was to stay in business and maximize recovery for its creditors, thereby rebutting the presumption (*Davis v Ducan Industries Ltd*., 19 A.C.W.S. (2d) 80, 45 C.B.R. (N.S.) 290). Where the debtor's preference payment, which was a return of merchandise to the creditor, simply reduced the debtor's debt, and allowed it to continue dealing with that creditor only on a C.O.D. basis , the presumption was not rebutted, as the judge found the creditor had not assisted the debtor to stay in business, but only to continue purchasing from that creditor (*Spectrum Interiors (Guelph) Ltd., Re*, 1979 CarswellOnt 182, 29 C.B.R. (N.S.) 218). Similarly, in *Leon Friedman & associés Inc. v Creations K.T.M. Inc*., 1983 CarswellQue 50, 51 C.B.R. (N.S.) 123, the debtor's return of the merchandise to the creditor was not in the ordinary course of business nor had it benefited the debtor or the other creditors, thereby failing to rebut the presumption.

Third, the provision specifically states that a creditor cannot rebut the presumption by showing it pressured the debtor to make a payment but case law shows that the presumption is rebutted when debtors pay aggressive creditors to ward them off (see Anthony Duggan; Thomas G. W. Telfer, Canadian Preference Law Reform, 42 Tex. Int'l L.J. 661 (2007); Roderick J. Wood, *Bankruptcy & Insolvency Law*, *2nd ed*. (Canada: Irwin Law Inc., 2015) at 213-14; Clayton Bangsund, But I Didn't Mean to: The Role of Intent in American and Canadian Anti-Preference Law, 50 Alta. L. Rev. 815 (2013)). This is historically known as the doctrine of pressure, and the doctrine and the courts' treatment of it are well explained in the articles referenced above. Pressure was not alleged in this case.

Finally, the presumption will be rebutted if the payment was made to the creditor pursuant to a pre-existing agreement that was concluded prior to the statutory review period. See *Gregory (Trustee of) v Steve Butler Construction Ltd*., 23 CBR (3d) 143, 1993 CanLII 890 (BC SC), where the property was transferred on the eve of bankruptcy, but it was done pursuant to an agreement that had been entered into when the debtor was solvent (see too *Re Blenkarn Planer Ltd., 14 DLR (2d) 719,* 1958 CanLII 254 (BC SC)). However, if the debtor was insolvent at the time of making the agreement, the presumption will not be rebutted. See *Reference Re Farrar*, 1964 CarswellOnt 41, 6 C.B.R. (N.S.) 235; *Re Street*, 1975 CarswellOnt 128, 21 C.B.R. (N.S.) 228; *Guttman v Toronto-Dominion Bank*, [1984] 2 W.W.R. 443, 23 A.C.W.S. (2d) 523; *Gregory (Trustee of) v Steve Butler Construction Ltd*.

In this case, the judge determined that the dominant intent of the debtor was to "simplify life, restructure debt and, presumably, to enhance what became a proposal to the CRA" (para 9). He found that intent was not sufficient to rebut the presumption, and he ordered the payments set aside. The first two categories for rebutting the presumption are inapplicable in this case, as the debtor was not a commercial enterprise. However, the bankrupt's reasons are not entirely without merit here, as the courts have found an individual's desire to free himself from financial pressures to be analogous to a business paying creditors in the ordinary course in order to maintain its operations (*Andrews (Trustee of) v Minister of National Revenue*, 2011 MBQB 50 (CanLII) at para 46).

An individual debtor's intention to simplify his life and restructure his debt can be sufficient to rebut the presumption, if it is objectively reasonable, and not "wishful thinking" (*Andrews* at para 47). In *Dubois-Vandale (Trustee of) v MBNA Canada Bank*, 2006 MBQB 258 (CanLII), Hanssen J. recognized that the intent of the debtor was to reorganize her affairs to avoid bankruptcy, but did not find her plan to be objectively reasonable. She had selectively paid her creditors, leaving her other creditors with minimal or no payment; her debts were significantly more than her assets; and her income was not high enough to service the size of the loan she would require to consolidate her debts (see paras 16-18). Similarly, in *Andrews*, the debtor made two payments to the CRA, the second at a time her accounts were more than $35,000 in deficit, and when she was between jobs. Her income the year prior, according to her T4, was less than half the amount she needed to cover her expenses. The debtor had paid the CRA from the sale proceeds of her house, had done so because she believed the CRA could garnish her wages, and she had not been contemplating making an assignment in bankruptcy at the time she made the payments. However, the court found that she was so far in debt at the time she made the payments that her intention to repay her other creditors, though honest, was not reasonable.

In this case, the bankrupt's stated intention was to simplify life and restructure debt, presumably, the court found, to make an enhanced proposal to the CRA. But the bankrupt paid all his credit card debt, then made a Division I Proposal to his only remaining creditor, the CRA. He owed the CRA approximately $1.5 million, but proposed to pay $400,000, which would have been a net recovery of 27.22% of the debt he owed, a proposal that was made 4% worse without the money he had paid his other creditors. The stated intention might have been sincere and honestly held, but it was not objectively reasonable. One cannot help thinking this might be the "wishful thinking" referred to in *Andrews*.

This post may be cited as: Jassmine Girgis "BIA Preference Payments: Evidence Rebutting the Presumption must be Objectively Reasonable" (8 March, 2018), online: ABlawg, http://ablawg.ca/wp-content/uploads/2018/03/Blog_JG_Gustafson.pdf