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Business

Chasing debtors and fraudsters: Avoiding pitfalls of potential bankruptcy, part one

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(March 22, 2023, 11:14 AM EDT) -- Debt collection can be a challenging exercise for a creditor, particularly where the debtor makes, or may make, an assignment in bankruptcy. Due to the application of the *Bankruptcy and Insolvency Act*, (Canada) (the BIA), bankrupt debtors receive protection from creditors' claims, with claims typically being extinguished upon a debtor's discharge from bankruptcy.

Debt collection can become even more complicated when a creditor discovers that their debtor is a fraudster. Yet, a silver lining lies between these two statements — a discharge from bankruptcy does not release the bankrupt from a debt or liability arising from fraud, false pretences, or fraudulent misrepresentation.

As such, creditors can protect against or minimize a bankruptcy's impact on their debt collection by pleading, where appropriate, in a way that will allow their claim to survive a bankrupt's discharge under s. 178 of the BIA. Given that the law in this area has been evolving recently, a number of considerations are outlined below when pursuing a claim in which fraud may be pleaded.

The basics: Collecting from bankrupt debtor and the issue of fraud

Creditors often experience difficulties in collecting from bankrupt debtors due to the application of s. 178(1) of the BIA: a discharge from a bankruptcy releases the debtor from all claims provable in bankruptcy. However, there are eight exceptions to that rule set out in s. 178(1).

Debts under these exceptions are not released on the bankrupt debtor's discharge, but rather are grounded in an overriding social policy that the quality of these claims outweighs the benefit of relieving the bankrupt of their debts (*Simone v. Daley*, 43 O.R. (3d) 511). Creditors who believe their claim should survive a bankrupt's discharge must prove, on a balance of probabilities, that their claim falls under one of these enumerated exceptions.

The two categories of exceptions that creditors most often rely on are those under sections 178(1)(d) and 178(1)(e) of the BIA:

(d) any debt or liability arising out of *fraud, embezzlement, misappropriation* or *defalcation while acting in a fiduciary capacity* or, in the Province of Quebec, as a trustee or administrator of the property of others;

(e) any debt or liability resulting from *obtaining property or services by*

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false pretences or fraudulent misrepresentation, other than a debt or liability that arises from an equity claim; [emphasis added]

Gathering intel: Understanding your debtor

Before initiating a claim against a debtor, whether based in fraud or not, a prudent course of action for a creditor is to conduct searches on the debtor. Searches serve two primary purposes. First, they can assist a creditor with understanding the prospect of enforcing or collecting on a judgment. Conducting searches on the debtor through such offices as the Land Registry Office (parcel register searches) may help to indicate what property the debtor holds in their name against which a judgment may be enforced. A creditor can also conduct searches to confirm what pre-existing liabilities a debtor has already incurred, such as *Personal Property Security Act* searches (to confirm the debtor's secured and unsecured creditors) or litigation searches (to confirm what litigation a debtor is already involved in). Similarly, BIA searches can confirm whether a debtor has filed for bankruptcy or a proposal in the past. Without assets, the value in commencing a claim and enforcing a judgment diminishes.

Second, searches can shed light on whether a debtor actually owns property they have purported to own (for example, in an application for financing from a creditor). This will assist creditors in deciding whether there are other claims that will survive a potential bankruptcy (such as one based in fraud, false pretences, or fraudulent misrepresentation) that can be pleaded against the debtor to strengthen the likelihood of success or increase the pressure on a fraudulent debtor. Searches confirm the veracity of the information provided or the representations made by a debtor to a creditor to obtain financing. Completing this due diligence affords creditors a wider berth of remedies and provides creditors with the option of including a claim in fraud when commencing an action.

To search or not to search

As a general rule, when the court characterizes debt under s. 178(1), it cannot consider extraneous evidence not grounded in the litigation process that produced the judgment debt. This prohibition seeks to avoid creditor attempts to "recast" their claim in order to bring it under the enumerated grounds of s. 178(1) of the BIA (*Lawyers' Professional Indemnity Company v. Rodriguez*, ONCA 2018 171 at para. 49).

An exception to this rule is where a judgment creditor had no prior knowledge of the conduct which engages s. 178(1) and where the creditor could not have discovered the conduct with reasonable diligence. In *Royal Bank of Canada v. Kim*, 2019 ONSC 798, Justice David Broad explained the rationale as follows:

> In my view, to bar a judgment creditor who had no reasonable means of discovering the fraudulent conduct prior to commencing action or obtaining judgment from continuing pursuit of the fraudulent bankrupt after discharge would have the effect of rewarding the bankrupt for successfully concealing his or her fraud from the creditor.

It would seem then, that a creditor cannot bury their head in the sand. If reasonable due diligence would have uncovered the false pretences or fraudulent misrepresentation, then a creditor will be penalized for not having conducted that reasonable due diligence prior to the bankruptcy. Though each one of the searches described above may factor into assessing whether reasonable due diligence was conducted, their applicability to a particular debtor-creditor scenario will depend on the specific case. Having said that, courts should not (and have not) held creditors accountable for knowing information that they could not have known.

Discovering that your debtor is a fraudster

When commencing a claim, creditors must also always be alive to the applicable limitation period for their claim. Under the *Limitations Act* (Ontario), a proceeding shall not be commenced after two years from when the claim was discovered.

According to the Supreme Court of Canada (*Grant Thornton LLP v. New Brunswick*, 2021 SCC 31) a claim is "discovered" when the plaintiff has knowledge, actual or constructive, of the material facts upon which a plausible inference of liability on the defendant's part can be drawn. The plaintiff's knowledge will be "constructive" when the evidence shows that the plaintiff ought to have discovered the material facts by exercising reasonable diligence. Similarly, a "plausible inference of liability" will be drawn where the plaintiff had all of the material facts necessary to determine that it had *prima facie* grounds for inferring the defendant's liability.

A bankruptcy will typically buy a creditor additional time to commence a claim. Under s. 69.3 of the BIA, on a debtor's bankruptcy, any actions that were commenced, or could have been commenced, are stayed. While an action is stayed, limitation periods associated with those claims are typically suspended until the stay is lifted or the trustee in bankruptcy is discharged (*Finmax Investments v. Grossman*, 2012 ONSC 2436 at para. 34). The parties are effectively taken outside the regular litigation process such that the limitation period becomes irrelevant (*si Spergel Inc. v. I.F. Propco Holdings (Ontario) 36 Ltd.,* 2013 ONCA 550 at para. 44). However, where a bankrupt is not discharged or a claim survives bankruptcy, the limitation period continues to run. Similarly, it continues to run against a creditor who seeks to recover a debt in proceedings unconnected to the bankruptcy. In such circumstances, a creditor should move more quickly against a bankrupt debtor.

Section 69.4 of the BIA provides the court with the ability to lift a stay of proceedings triggered by a bankruptcy. Courts have "a wide discretion" to lift a stay of proceedings based on the "particular facts of the particular case." (*Fiorito v. Wiggins*, 2017 ONCA 765 at para. 35.) The onus for establishing that the stay of proceedings should be lifted lies with the party seeking to lift the stay, but it is "undeniably low" and is granted if there are "sound reasons." (*Global Royalties Limited v. David Brook*, 2015 ONSC 6277 at para. 20; affirmed 2016 ONCA 50). If a creditor's claim against a debtor has a potential limitation period concern, they should consider moving to lift the stay quickly.

This is the first of a two-part series.

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