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Business

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

By **Scott R. Venton, Alexander Evangelista, Teodora Obradovic**

Scott R. Venton

Alexander Evangelista

(March 23, 2023, 1:52 PM EDT) -- As we discussed in the first article in this series, 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. This article continues the discussion of how 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 section 178 of the BIA.

Pleading and proving fraud against your debtor

A claim for fraud must be pleaded with precision. The pleading must state what the fraud is and how the fraud was effected. If it does not, a judgment obtained by a creditor against the bankrupt will not be sufficient to allow the creditor to proceed after the bankrupt's discharge (*Thunberg v. Zadworny*, 2012 ABQB 576 at para. 28).

If pursuing a claim in fraud under s. 178(1)(d), a creditor must demonstrate "embezzlement," "misappropriation" or "defalcation" by showing, in its pleadings or in the proceeding, that: (i) money taken by the debtor to create the debt belonged to someone other than the debtor; (ii) the taking involves a wrongful use of the money; and (iii) the debtor received the money as a fiduciary. Inadvertence, negligence, or incompetence will not meet this definition.

Demonstrating that the fraud occurred "while acting in a fiduciary capacity" requires a creditor to show that: (i) the money taken to create the debt belonged to someone other than the taker; (ii) the taking involved a wrongful use of money; and (iii) the taker received the money as a fiduciary. The words "while acting in a fiduciary capacity" apply to s. 178(1)(d) in its entirety. If a creditor's claim falls within s. 178(1)(d), its legal costs in obtaining judgment and the interest on that judgment may also fall within the section (*Goldstein v. Goldar*, 2018 ONSC 608 at para. 8).

If pursuing a claim in fraud under s. 178(1)(e), the debt or liability must have arisen from a "false pretence" or "fraudulent misrepresentation." The essential test for both is that the property or services were obtained by "deceit," either by a positive act or failure to disclose material facts. Although a fraudulent misrepresentation requires the creditor to have relied on a false statement made to it, false pretences may be found in cases where a false statement was made by the debtor to, and relied upon by, a third party, depriving the creditor of the property to which it was entitled (*Shaver-Kudell Manufacturing Inc v. Knight Manufacturing Inc.*, 2021 ONCA 925 at para. 35).

Teodora Obradovic

A "fraudulent misrepresentation," more granularly, also requires a creditor to prove that: (i) the debtor made a representation; (ii) the representation was false; (iii) the representation was made knowingly, without belief in, or with indifference to its truth; (iv) the representation was relied on by the plaintiff in making property available; and (v) damages resulted. Each element must be pleaded with sufficient particularity.

However, the test under s. 178(1)(e) will not be met solely because a debtor lied or because their misrepresentations were morally objectionable. Rather, there must be a causal connection between the debtor's wrongdoing and the creation of the debt or liability.

A judgment may also be characterized as debt that falls within the meaning of s. 178(1)(e), and survives a debtor's discharge from bankruptcy. To determine if a judgment debt falls within s. 178(1)(e), the court will look to: (i) the preamble and reasons for the judgment; and (ii) the materials filed, including the facts pleaded or supporting evidence. However, where a creditor obtained partial summary judgment, and a judgment has been obtained by "litigation in slices," it is important to look at the slice that was determined, not the other allegations that could have been determined or put before the judge (but were not).

Recently, the Ontario Court of Appeal in *M.O.S. MortgageOne Solutions Ltd. v. Heidary*, 2022 ONCA 561, confirmed that, to obtain a declaration under s. 178(1) of the BIA that a judgment survives a debtor's discharge from bankruptcy, it is unnecessary for the plaintiff to specifically refer to s. 178 in its pleadings underlying that judgment, nor is there any requirement that fraud be specifically pleaded or particularized. The judge's task in a bankruptcy is to determine the nature and substance of the debt by examining the pleadings, any reasons that might have been given, and the proceedings that were before the court that granted the judgment. To that end, the question is whether the pleadings as a whole suggest fraudulent or otherwise "unacceptable" conduct and whether the evidence, facts and findings in the underlying proceeding are sufficient to make the required finding of fraud or false pretences.

Having your debt survive bankruptcy … before bankruptcy

In light of the Ontario Court of Appeal's guidance in *Heidary* that it is not strictly necessary to plead s. 178 in your pleadings, it is worth considering whether a creditor can obtain a declaration that a debt should survive bankruptcy before that bankruptcy has occurred. Judges have delivered conflicting decisions on whether a creditor can seek such a declaration. In *Bank of Montreal v. Mathivannan*, 2021 ONSC 2538, Justice Marvin Kurz (relying on two prior decisions from Justice Sean Dunphy) rejected the idea of such a hypothetical declaration being applicable to a bankruptcy proceeding prior to that proceeding commencing.

In contrast, a number of decisions have come to the opposite conclusion as Justices Kurz and Dunphy. For example, in both *Sunwell Investments v. Cheung*, 2013 ONSC 483 and *University Plumbing v. Solstice Two Limited*, 2019 ONSC 4276, the presiding judge granted declarations that the debtor's debt would survive a future bankruptcy. In *784773 Ontario Limited v. Larkin,* 2021 ONSC 1608, Justice Vanessa Christie recently acknowledged the conflicting case law. The justice declined to rule on whether the debt fell within s. 178(1)(d), but granted a declaration that the debt arose out of fraud, embezzlement, misappropriation or defalcation that occurred while the debtors were acting in a fiduciary capacity.

Therefore, when deciding to seek a declaration under s. 178(1) before a debtor is bankrupt, creditors should review the unsettled law in this area. However, they should take some reassurance from the fact that the Ontario Court of Appeal does not strictly require it and, in a number of decisions, judges have nevertheless granted this relief. In seeking such a declaration, either way, creditors should ensure that full particulars supporting a s. 178(1)(d) or (e) claim are pleaded.

Recent case study

A recent example applying many of the principles outlined above is Justice Michael Penny's decision in *Business Development Bank of Canada v. Baig Insulation Inc. et al*, Court File No. CV-22-00676573-00CL. Justice Penny's decision arose from a default judgment that the BDC had obtained against Baig Insulation Inc. and its principal, Zahid Baig, September 2018. The defendants had defaulted on a loan granted by BDC to Baig Insulation, which was guaranteed by Baig. In his loan application submitted on Feb. 15, 2017, Baig provided a number of representations (which he affirmed were true) including that:

- Baig Insulation was an operating business which required a loan to be used as working capital and to purchase equipment;
- Baig owned real property worth approximately $700,000, subject to a mortgage in the amount of $450,000;
- Baig's total household income was approximately $85,000; and
- Baig had no unsecured personal debts.

BDC ultimately granted the loan to Baig Insulation on March 19, 2017. In the loan agreement, Baig guaranteed the loan and agreed that all information provided in the loan application remained accurate.

After the defendants defaulted on their payment obligations under the loan in early September 2018, BDC commenced an action for payment of the debt and obtained default judgment in September 2018. However, on Oct. 9, 2018, mere weeks later, Baig made an assignment in bankruptcy. In his statement of affairs, the picture of his assets and liabilities were very different than in the loan application:

- Baig Insulation had ceased operations on December 1, 2016, over two months before the defendants submitted the loan application;
- Baig did not own any real property, and had not disposed of any real property within the five preceding years;
- Baig owed a total of $734,198 in unsecured liabilities, excluding the loan to BDC; and
- Baig's annual income was approximately $24,000.

After obtaining an order lifting the stay of proceedings in Baig's bankruptcy, BDC commenced a new action against Baig and Baig Insulation, and moved for a declaration that the judgment debt was debt within the meaning of s. 178(1)(e) of the BIA.

Justice Penny highlighted the uncontradicted evidence that Baig misrepresented that he owned real property with equity worth approximately $250,000, which the BDC relied on in advancing the funds. Baig's only purported response to this evidence was his assertion that a friend had filled out the loan application form for him (in exchange for a 30 per cent fee) and, as such, the misrepresentations in the loan application were not his. Justice Penny was not persuaded by this submission, pointing to the lack of evidence of this and the fact that Baig acknowledged signing the loan agreement (which incorporated the representations in the loan application).

By failing to ensure the representations were correct, Justice Penny ruled that "Mr. Baig knowingly and consciously put his head in the sand and declined to make inquiries because he did not care to know, or was reckless about, the contents of his application to BDC for the loan." In such circumstances, BDC's motion was granted.

Concluding remarks

Ontario and Canadian debtor-creditor law has left many pitfalls that creditors must learn to sidestep when collecting on their debt. Even before commencing a claim, a creditor should learn what they can about their debtor to understand the prospect of successful enforcement and collection. Although the scheme under the BIA and corresponding case law provides debtors with a number of protections against creditors, a carefully crafted litigation strategy can assist a creditor in maximizing their chances of recovery.

Creditors should complete their due diligence to avoid situations where they fail to make allegations regarding facts they ought to have known about the veracity of a debtor's representations, had they completed basic searches. It may impact a creditor's ability to properly frame the pleadings, and it may impact their ability to characterize a resulting judgment as one which belongs under s. 178 later if a bankruptcy arises.

To that end, if creditors have reason to believe that there is fraud or misrepresentation, given that the law as it stands at the time of the writing of this article, they should say so in their pleadings (even if they don't specifically refer to s. 178(1) of the BIA). Creditors can choose which claims to pursue as the litigation progresses, but if the debtor tries to avoid a judgment by going into bankruptcy, then the creditor has pleadings which support a claim that survives a discharge.

Similarly, even where a debtor files for bankruptcy before a claim is commenced, a creditor should keep their eye on the limitation period clock to ensure that they do not run out of time to commence a claim. In addition, if creditors complete due diligence before commencing a claim against a debtor, and discover something which may hint at fraud, creditors will have to make the decision to pursue the debtor before a limitation period expires.

This is the second of a two-part series. Read the first article: Chasing debtors and fraudsters: Avoiding pitfalls of potential bankruptcy, part one.

Scott R. Venton is a partner in the litigation group at Fogler, Rubinoff LLP. His practice focuses on corporate and commercial, gaming, bankruptcy and insolvency, restructuring, regulatory and insurance litigation. Alexander Evangelista is an associate in the litigation and dispute resolution group at the firm. He maintains a broad commercial litigation practice, including experience with shareholder and partnership disputes and construction, bankruptcy and insolvency, real property, debtor-creditor and judicial review proceedings. Teodora Obradovic is a lawyer with the litigation group at the firm. She is developing a broad practice in commercial and civil litigation, with a focus on contractual disputes, debtor and creditor matters, and bankruptcy and insolvency issues.

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