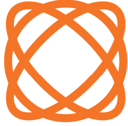

LAPOINTE ROSENSTEIN
MARCHAND MELANÇON
L.L.P. Attorneys

Newsletter

Bankruptcy, Insolvency and Restructuring

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M[tre] Jean-Claude Jr. Lemay

Bankruptcy as an escape from legal proceedings

Quebec businesses are the most affected by bankruptcy in Canada, with Quebec recording the highest number of corporate bankruptcies in 2015 with 1,684[1]. As such, it is not unusual that a business' bankruptcy can lead to its entrepreneur's personal bankruptcy[2], the latter acting as a personal guarantee for the former or otherwise being solidarily liable of its debts.

Entrepreneurs facing bankruptcy are, as a general rule, entitled to expect a fresh start. Indeed, in this regard, the Supreme Court recently reaffirmed Parliament's goal of giving the bankrupt the opportunity to financially rehabilitate themselves[3] while highlighting the close link between this objective and the release of debts at the end of the tunnel, as provided for in section 178(2) of the *Bankruptcy and Insolvency Act*[4] (hereinafter the "**BIA**").

With its back against the wall and bailiffs at the door, an entrepreneur might be tempted to make the hasty decision to file an assignment of property based on certain considerations, legitimate or otherwise. In any event, this decision, taken without first establishing which debts will or will not be discharged at the end of the process, can prove to be risky.

The idea of declaring bankruptcy may cross the mind of an entrepreneur personally facing a major legal proceeding. However, such a measure may result in the bankrupt not being released of such debt, as will be seen from the recent jurisprudence in such matters as *Charette (Syndic de)*[5] and *Gravel* v. *Deschambault*[6]. However, we will first analyse the rules and main exceptions relating to the discharge of a bankrupt's debts.

What debts are included in a bankruptcy?

The BIA consolidates a bankrupt's debts that may be discharged as "provable claims"[7]. This expression implies that there must be a debt, commitment or obligation owed to a creditor that arose before the debtor became bankrupt. It must also be possible to attribute a monetary value to that debt, commitment or obligation[8].

In the event of legal proceedings, it may be difficult to determine whether or not the debt was incurred before the debtor became bankrupt. While it is easy to identify amounts owed under a normal contract for a company, such as a line of credit[9] or a service contract[10], this rule may apply to more specific cases whereby the amount of the debt had not necessarily been brought to the attention of the debtor before the bankruptcy. This is especially the case in lawsuits.

In such a situation, according to the Court of Appeal in *Axa Assurances inc.* v. *Immeuble Saratoga inc.*[11], one must be able to prove that: (1) all the elements on which the claim is based were present before the date of the bankruptcy; (2) the claim has a high degree of certainty and probability; and (3) the alleged fault and damages arising from it occurred prior to the date of the bankruptcy, even if the claim is litigious[12].

The facts of this case are as follows. In 1983, Immeuble Saratoga inc. sold a property to Villiard, who resold it to D'Orazio in July 1985. In 1988, Villiard was released from a bankruptcy filed in 1987. More than 10 years after the release of Villiard's bankruptcy, the building was hit by a fire which was shown to be caused by a construction defect in the fireplace. D'Orazio received compensation and Axa, his insurer, sued Villiard and Immeuble Saratoga inc. under the vendor's quality guarantee.

Despite Villiard's bankruptcy, the Court of Appeal found that the claim was not provable, and therefore was not released. It ruled it was impossible for D'Orazio, at the time, to make a claim since he was unaware of the presence of the defect[13]. The first manifestation of the defect marks the starting point for determining whether a related claim can be considered a provable claim and thus part of the bankruptcy[14].

However, although a debt can technically be released, one of the exceptions set out in section 178(1) of the BIA

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which prevents the discharge of certain debts may apply. Let's see what this is all about.

A few exceptions to the discharge of debts

Section 178(1) of the BIA provides for several situations where, despite the provable nature of a claim at the time of bankruptcy, the claim will not be released for specific reasons. There is no explicit reference to the case where a company goes bankrupt due to legal proceedings.

It should be noted that, in current case law, it is generally expected that the discharge of the bankrupt extinguishes the debts and that exceptional cases are to be interpreted restrictively[15].

As such, section 178(1)a.1) provides that only civil files involving bodily injury or death resulting therefrom shall not be subject to a release. Subsections 178(1)b) and c) also provide the same for alimony or alimentary pension.

In the case of fraud, section 178(1)d) provides a rule that applies strictly to the administrator of the property of others or to trustees. Also, under section 178(1)e), obligations contracted under false representations are not discharged - for example, a loan of money contracted on the basis of false statements[16]. In this case, it is necessary to demonstrate that it was based on these representations that the obligation was contracted[17].

Theoretically, and insofar as the conditions of the *Axa Assurances inc.* v. *Immeuble Saratoga inc.*[18] judgment are satisfied with respect to the characterization of a provable claim, a bankrupt shall be discharged from a legal action preceding the bankruptcy. Situations in which a bankrupt is not released do not, theoretically, appear to involve any kind of lawsuits that precede bankruptcy. Nevertheless, recent case law clarifies the nature of lawsuits that survive the discharge of the bankrupt.

Avoiding lawsuits in light of recent jurisprudence

Two decisions merit our attention in light of the above.

In *Charette (Syndic de)*[19], a motion for discharge was filed by the bankrupt and contested by the former spouse of the bankrupt. She launched a $200,000 lawsuit for unjust enrichment upon the ending of their common-law relationship.

The transfer of the man's property occurred on the day prior to the filing of a motion for a default judgment to be pleaded against him in connection with this unjust enrichment claim, in a context where the woman held 79% of the man's total bankruptcy claims.

The Court used these facts as grounds to conclude that the man would not be discharged from this debt since one cannot go bankrupt for the sole purpose of avoiding the consequences of a lawsuit and the resulting judgment. In other words, such a maneuver hinders the release of debts to which a bankrupt is normally entitled to. This was a case where the man attempted to evade justice, which prompted the trustee to not release him, without however linking his reasons to a specific paragraph of section 178(1) of the BIA[20].

In *Gravel* v. *Deschambault*[21], in the context of a proposal, the common-law partners had signed an agreement governing the consequences of their separation, including a transfer of ownership of the common residence to the man in return for two successive installments totaling $70,000. However, between the two installments, the first one having taken place on the date of signature of the agreement, the man went bankrupt, whereas it was he himself who decided to split the payment in two installments.

The Court used the concept of fraud in section 178(1)e) of the BIA to argue that, by deliberately concealing his financial difficulties to his partner, by "forgetting" to note the debt owed to her in his consumer proposal and knowingly planning two successive payments in executing the agreement, the man made false pretenses and was unforthcoming. This hindered the application of section 178(1)e) of the BIA, thus preventing him from being released of this debt[22].

Conclusion

As we have seen, although debts incurred prior to bankruptcy are in principle debts that will be cleared by bankruptcy, even when we are dealing with a lawsuit initiated prior to the date of bankruptcy, this is not an infallible principle. The courts have recently been inclined to refuse to consider a bankrupt as being discharged from an obligation arising from a legal action on the ground that he had become bankrupt for the specific purpose of escaping this obligation.

Without suggesting unqualified application, and although the general rule remains the release of provable claims, it would be prudent, in light of the consequences referred to in this article, to think twice in the event one is tempted to resort to bankruptcy for the sole purpose of avoiding lawsuits.

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1. Office of the Superintendent of Bankruptcy Canada, Insolvency Statistics in Canada, Table 3: Insolvencies filed by businesses [online] https://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br03541.html (Page consulted on December 13, 2016).
2. *Génier (Syndic de),* 2016 QCCS 5079, par. 3; *Roy (Syndic de),* 2015 QCCS 1771, par. 6; *Roy (Syndic de)*, 2013 QCCS 4764, par. 5; *Munkittrick (Syndic de)*, 2013 QCCS 2510, par. 4.
3. *407 ETR Concession Co.* v. *Canada (Superintendent of Bankruptcy)*, [2015] 3 R.C.S. 397, 2015 CSC 52, par. 28.
4. L.R.C. c. B-3.
5. 2016 QCCS 4822.
6. 2015 QCCS 1474 (Motion to dismiss the appeal granted by 2015 QCCA 1146).
7. BIA, *supra* note 4, sec. 121(1), 178(2).
8. *Alberta (Attorney General)* v. *Moloney*, [2015] 3 R.C.S. 327, 2015 CSC 51, par. 55.

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9. *Plourde (Syndic de)*, 2012 QCCS 1567, par. 15.
10. *Société de protection des forêts contre le feu* v. *Desruisseaux*, 2003 CanLII 47933, par. 25 (C.A.).
11. 2007 QCCA 1807 (Partial out-of-court settlement for respondent Villiard (C.A.), 2008-06-26, 500-09-017043-068).
12. *Ibid*, par. 18.
13. *Ibid*, par. 19.
14. *In re Théroux*, J.E. 2005-1063, par. 30-32 (C.S.).
15. *Génier (Syndic de)*, *supra* note 2, par. 19.
16. See *Malakouti* v. *Ayazi*, 2011 QCCS 2791.
17. *Charbonneau (Syndic de),* 2010 QCCS 1728, par. 24.
18. *Supra* note 11.
19. *Supra* note 5.
20. *Ibid*, par. 91.
21. *Supra* note 6.
22. *Ibid*, par. 51-52.

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For more information, please contact:

Jean-Claude Jr. Lemay
514 925-6351
jean-claude.lemay@lrmm.com