Advising the Trustee: The Lawyer's Role in the Case of Fraud

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INTRODUCTION

You are at your desk. An email flashes across your screen. One of the bankruptcy trustees you have recently begun acting for asks you to call. You do. The trustee tells you that it thinks it has uncovered a fraud in one of its files. The trustee says that this has never happened before. What should the trustee do?

You realize that this is a first for you too. You have never actually had to deal with fraud in a bankruptcy file before. What do you tell the trustee? Your advice will be important to the management of the estate, and it could even be crucial. It could result in one or more investigations, reports to various authorities, calling in the RCMP, criminal proceedings, the commencement of civil proceedings. Or it could result in the trustee doing nothing at all. What do you do? And what do you advise the trustee?

This paper will address these questions and others. As with most things in law, the responses you provide will depend upon many things. Is the bankrupt a corporation or an individual? What kind of fraud or fraudulent activity has been discovered? Does it involve real property, personal property, or cash? How much money is involved? Does the trustee know where the money is now? What is the likelihood of being able to recover all or part of that money? Does the estate have sufficient funds to be able to conduct an investigation and any appropriate additional steps? Is the bankrupt being cooperative? Are there other persons you can identify as being involved with the fraud? How did the trustee learn about the fraud in the first place? All of these are important questions and the answers will be critical in your being able to properly advise the trustee.

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And there is more. Fraud is not just your basic legal issue or dispute. It involves moral and ethical issues. It may trigger additional responsibilities on your part, as the lawyer, and on the part of the trustee. Both you and the trustee are governed by regulatory bodies. You likely both belong to professional associations, and are bound by professional obligations under your respective codes of conduct. Both of you must be aware of those professional obligations.

You as the lawyer must also recognize that you are being retained to provide legal advice, with respect to legal obligations, and not advice with respect to moral and ethical issues, or professional codes of conduct. The trustee is also a professional, who must be able and willing to exercise its professional judgment in these areas. You are simply advising the trustee with respect to its obligations, not telling it what to do. The trustee must be prepared to make its own decisions, but it likely will be relying upon your advice and recommendations.

We have broken this paper down into several parts. First, we examine the general framework in which the bankruptcy and insolvency lawyer and the trustee operate - the *BIA*, the trustee's role, and the trustee's obligations and duties under the legal and professional regimes.

Part two deals with situations in which the trustee may learn or actually does learn about fraudulent conduct, and how to be alert to such situations.

Part three looks at unlawful and fraudulent conduct, and other bankruptcy offences. We also examine transfers at undervalue and fraudulent transfers, so that you know what these transactions are and what you can do when you do learn about them.

Part four addresses what the trustee should do if it learns that a fraud has indeed been committed. What action should the trustee take? We consider whether the trustee is obliged to take positive steps to deal with the matter, or whether it can decide to do nothing at all.

Let us begin.

THE BIA AND TRUSTEES

The *Bankruptcy and Insolvency Act* ("*BIA*") is one of a number of statutes that deal with insolvent debtors.[1] As federal legislation, the *BIA* applies across Canada, and the Act's provisions, along with the General Rules thereunder, provide a comprehensive regime that addresses both the restructuring of debts of insolvent persons pursuant to a proposal, and the liquidation of the estates of insolvent persons in the case of a bankruptcy. In both cases, the *BIA* provides for the imposition of a licenced trustee into the proceedings to ensure that the insolvent debtor or the bankrupt is complying with their statutory obligations.[2]

This paper will confine itself to the situation where the trustee performs its duties and obligations in the context of a bankruptcy, rather than a proposal. The trustee's duties and obligations in a proposal under the *BIA* are very different from those in a bankruptcy. While we will only address the bankruptcy context, the trustee certainly has a role to play if it discovers, or is informed of, a fraud in the course of a proposal under the *BIA* as well, and it may well be that you, as a lawyer, are called upon to provide advice in such a situation.

The purposes of the *BIA* are said to be fourfold: (1) to permit an honest but unfortunate debtor to obtain a discharge from debts, subject to reasonable conditions, so as to allow the debtor to restart their finances; (2) to provide the orderly and fair distribution of property of a bankrupt among unsecured creditors; (3) to allow for an investigation to be made into the affairs of a bankrupt, as appropriate and where necessary; and (4) to permit the setting aside of preferences, transfers at undervalue and other fraudulent transactions.[3]

Trustees are licenced under the *BIA* and are required to comply with a prescribed Code of Ethics under the General Rules.[4] Licences are issued by the Superintendent in Bankruptcy and failure to adhere to the prescribed standards and the Code of Ethics could result in the trustee's licence being suspended or cancelled.[5] It is important for the lawyer acting for the trustee to be aware that the trustee is subject to regulation and to always advise the trustee to act in a manner that will ensure that it will be permitted to maintain its licence.

Trustees are also officers of the court, and as such, they have a duty to make full and frank disclosure of all material matters to the court.[6] Trustees must present their findings in a dispassionate and non-adversarial manner, so as to permit the court to decide the particular matter on its merits.[7] It is because the trustee is an officer of the court, sometimes referred to as the "eyes and ears of the court", that the court will usually show deference to the trustee's opinions, reports, and decisions.[8] It is therefore critical to the proper functioning of the entire bankruptcy system that trustees act in a manner that is beyond reproach and maintain an impeccable reputation. Anything less could cause immense harm and disruption, not only to the entire bankruptcy system, but more importantly, to the various stakeholders and users of the system.

However, trustees also act, and indeed, it is their duty, to try to maximize realizations in an estate, so as to be able to obtain a reasonable dividend for the unsecured creditors. Subject to the rights of secured creditors, the bankrupt's assets devolve upon, and vest in, the trustee upon bankruptcy.[9] It is the trustee's job to realize upon the assets, so as to be able to distribute the funds in a way that maximizes the return for the unsecured creditors.[10]

The trustee also fulfills other functions within the bankruptcy process: preparing initial bankruptcy documentation, including the statement of affairs and list of creditors; holding a first meeting of creditors; reporting to creditors; collecting and finalizing the claims against the bankrupt; preparing a report and recommendation to the court with respect to the bankrupt's discharge; and reporting any breaches of the bankrupt's obligations under the *BIA* or other law to the Official Receiver.[11]

The trustee is usually the main point of access to, and interaction with, the bankruptcy system, for most creditors and insolvent persons. The trustee must therefore be aware of its various roles and work to ensure that it acts always in a manner that is consistent with its duties and obligations.

LEARNING ABOUT FRAUD AND FRAUDULENT CONDUCT

A trustee may learn about, or come across evidence of, a fraud in many different ways or from many different sources. Trustees need to be alert to this fact and be prepared to act where circumstances warrant. Debtors may divulge information indicating or alluding to the fact that they were involved in fraudulent conduct, or fraudulent activity, in an initial meeting with the trustee, or thereafter during the bankruptcy process.

It is not uncommon for a debtor to advise the trustee, for example, of their having transferred certain property to their spouse or their children in the past, which transfer may have been at undervalue, or having made a recent payment to a related creditor, but not others, prior to the bankruptcy, so as to constitute a preference.[12] In such cases, the trustee cannot simply ignore the information or give the bankrupt a "pass" or "one strike".[13] The trustee has a responsibility to act upon that information. Any other conduct on the part of the trustee could be seen as a breach of the trustee's obligations owed to the estate's creditors.[14]

The trustee should also be alert throughout its administration of the estate to any additional communications with the debtor that flag potentially problematic, pre-bankruptcy conduct.[15] In particular, certain comments or actions of the debtor may provide valuable evidence of the bankrupt's involvement in fraudulent or other improper conduct. Examples include the debtor making inconsistent statements during the bankruptcy in regards to certain debts or transfers, refusing to answer questions about certain debts or transfers, or even explaining a transaction without realizing that it constituted fraudulent conduct.[16]

A trustee may also be contacted by a creditor or other aggrieved party who wishes to inform the trustee of certain facts or circumstances that the trustee might not otherwise be aware of. Creditors often contact trustees following the initial bankruptcy event and once they have had a chance to review the bankrupt's Statement of Affairs. They may have special knowledge of the debtor's financial affairs or they may notice a discrepancy in the debtor's listed assets.[17] The trustee ought to note each of these matters down and seek additional information for possible future investigation or other action by the trustee.

The trustee may also learn of fraudulent conduct on the part of the debtor as disclosed in the proofs of claim submitted by creditors and which must be reviewed by the trustee.[18] As noted, creditors are often eager themselves to share with the trustee information that may lead to a finding or conclusion on the part of the trustee that the debtor was involved in fraudulent activity. This could be anything from the hiding of assets to specific fraudulent transactions.

BANKRUPTCY OFFENCES, PREFERENCES AND TUV'S

Trustees may seek legal advice with respect to other matters, and in particular, offences under the *BIA*. Part VIII of the *BIA* creates a series of offences to penalize wrongdoing by those involved in the bankruptcy process.[19] These offences include fraud and fraudulent conduct. These offences can be either criminal or quasi-criminal in nature, and as such, can be dealt with in the criminal courts.[20] However, the fact that the offences are listed in the *BIA* does not mean that the individual cannot or will not be prosecuted for the same offence under the *Criminal Code* or that civil remedies for recovery of any funds are not applicable.[21] Indeed, bankrupts can be subject to prosecution under the *Criminal Code*, and still be held liable civilly as well.[22]

Section 198(1) of the *BIA* lists seven strict liability offences, including fraudulent disposition of the bankrupt's property before or after the date of the initial bankruptcy event, and making a false entry or knowingly making a material omission in a statement of accounting.[23] The trustee must consider, in the course of its administration of the estate, whether it ought to take steps where it obtains information in relation to one or more bankruptcy offences.

Some examples of fraudulent conduct that have been held to be bankruptcy offences under section 198(1) include:

- a fraudulent preference under section 95 of the *BIA*;[24]
- failure to disclose the receipt of payments from the Workers' Compensation Board;[25]
- failure to disclose a bank draft for $158,000 received within one year prior to making an assignment in bankruptcy;[26] and,

- intentional falsification of financial statements and the value of the shareholder equity in a company's financial statements, fraudulent disposition of assets after becoming insolvent, and fraudulently transferred significant assets from the bankrupt company to its controlling and directing mind for his own personal use.[27]

In addition to the bankruptcy offences, the *BIA* also identifies two types of reviewable transactions: preferences and transfers at undervalue.[28] Sections 95 and 96 create a framework that permits parties to challenge these transactions that would otherwise reduce the value of the insolvent debtor's estate and thus, the amount of money available for distribution to the creditors.[29]

Pursuant to s. 95 of the *BIA*, where an insolvent person transfers property, makes a payment, takes a charge on a property, or incurs an obligation, in favor of a creditor, with a view to giving that creditor "a preference over another creditor", the said transaction is void as against the trustee, if made within three months of the initial bankruptcy event, where the creditor is dealing at arm's length, and within 12 months, if the creditor is not dealing at arm's length.[30] Further, if the transaction had the effect of giving the creditor a preference, it will be presumed to have been given for such purpose, though the presumption is rebuttable.[31] Note that, until such time as the particular transaction is set aside as a preference, the transaction remains valid.[32]

A transfer at undervalue ("TUV") is defined in s. 2 of the *BIA* as a disposition of property for which "no consideration is received by the debtor", or for which the consideration received is "conspicuously less than the fair market value" of the property. Pursuant to s. 96 of the *BIA*, a court may declare the TUV void as against the trustee, or order that any party to the transfer pay the difference between what was paid and what the property was actually worth to the trustee, where the parties were dealing at arm's length, and the transfer took place within one year of the date of bankruptcy, and the debtor was insolvent at the time of the transfer, or rendered insolvent by it, and the intention in effecting the transfer was to defraud, defeat or delay a creditor.[33] If the parties were not dealing at arm's length, then the transaction may be

declared void, or the court may order payment of the difference in value, if the transaction occurred within one year of the date of bankruptcy, regardless of intent, or within the five previous years, if the debtor was insolvent at the time of the transfer, or the debtor can be shown to have intended to defraud, defeat or delay creditors.[34]

The case law is replete with examples of situations where bankrupts have willingly transferred their assets and property to non-arm's length persons and failed to disclose it on the Statement of Affairs. In the case of *Re Rehman*, the bankrupt transferred his interest in a property to his children.[35] The evidence showed that his children had either contributed no money towards the transfer of the property or an amount far less than the actual value of the property.[36] The court concluded that the bankrupt's transfer of the property was done with the intent to defraud creditors, and declared the transfer void as against the trustee.[37]

WHAT TO DO WHEN THE TRUSTEE CONTACTS YOU

Once the trustee discovers fraudulent conduct on the part of the bankrupt, or uncovers what appears to be a preference or a transfer at undervalue, the trustee may well contact you as legal counsel and seek your advice. The trustee will enquire what it ought to be doing now that it has this information. Is it obliged to act and to take certain steps? If so, how? You as the lawyer will have to respond.

The *BIA* and its accompanying regulations and the case law thereunder should be the starting point for any lawyer retained to advise a trustee. The statute sets out a comprehensive regime with detailed rules that should always guide a trustee and anyone advising the trustee.[38] The case law provides additional context, information and guidance by providing specific examples of situations where the courts have dealt with similar, if not identical, issues and matters.

In addition, the legal practitioner should refer the trustee to the *Bankruptcy and Insolvency General Rules* ("*Rules*"), and in particular, the Code of Ethics for Trustees.[39] The Code of Ethics directs trustees to be impartial, and to provide "full and accurate information" to any interested party.[40] The *Rules* also state that trustees cannot assist or encourage any person to act in an illegal or dishonest manner in respect of the bankruptcy process.[41]

Mandatory Actions

Report to the OSB

In certain prescribed instances, the trustee must take positive steps to address the conduct in question. For example, where a trustee becomes aware that a bankrupt is not abiding by the law, the trustee must report the matter to the Office of the Superintendent in Bankruptcy ("OSB").[42] Reporting the matter to the OSB will result in the creation of a file by that government agency. That file will then be sent to either one of the OSB's investigation units, or to the RCMP.[43] The OSB will investigate and examine the bankrupt's assets, along with any impugned transactions, as well as the causes of the bankruptcy.[44]

This may well be very helpful to the trustee in its own administration of the file. The trustee will be able to rely upon any investigations by and findings of the OSB, while at the same time, saving the estate the cost of having to undertake any such investigations on its own. This does not mean that the trustee ought not to perform its' own investigations if the circumstances warrant. After all, the OSB investigation may not provide the trustee with the kind of information that the trustee may wish to have at its disposal. Indeed, practically speaking, the OSB investigations are not relied on by trustees very often and such investigations don't usually yield a lot of useful information for the trustee.

Analyze Any Preferential Payments

A trustee is also required to analyze any preferential payments made by the bankrupt.[45] This is axiomatic and ought not to be at all controversial. Preferential payments, as we saw earlier, are not permitted, and if discovered by the trustee, will need to be analyzed by the trustee to determine the number and amounts of such payments, for later determination as to what, if anything, the trustee ought to do about such payments.

Prepare a Report for the Discharge Hearing

In addition, if the trustee believes that the bankrupt has committed an offence under the *BIA*, the trustee must note it, and prepare and submit a report which addresses the bankrupt's

conduct, for use at the bankrupt's discharge hearing.[46] The report to be prepared by the trustee for the discharge hearing and referenced above must be exhaustive and honest.[47] It must also be accompanied by a resolution of the inspectors declaring whether or not they approve or disapprove of the report.[48]

The report itself is designed to assist the court in deciding whether or not to grant the bankrupt a discharge of his or her debts and on what terms. The court will use the report as evidence of the statements contained therein.[49] The report ought to include information with respect to such matters as the affairs of the bankrupt, the causes of the bankruptcy, and the conduct of the bankrupt, including any breaches by the bankrupt of any laws and any additional obligations pursuant to the *BIA*.[50] The report must also describe and draw conclusions from any review the trustee performed in regards to potential preferences, fraudulent conveyances or transactions at undervalue.[51] If the bankrupt has failed to comply with any applicable legislation or court order, the report must also clearly state this to be the case.[52]

If the bankrupt has been involved in any fraudulent conduct, the trustee must not only include this information in the report, but it must also draw the court's attention to it. In the case of *Re Kultgen*, the trustee was found to have breached its duties imposed by the *Act* and the *Rules* when it simply raised the bankrupt's questionable conduct in the trustee's report, without having gone further into the matter and without having drawing the court's attention to it.[53] In that case, the court found that the trustee had failed to meet its obligations when it merely accepted the bankrupt's written explanation for its fraudulent conduct; the trustee would have learned that the bankrupt's explanation was untrue by simply reviewing the bankrupt's statement of income and expenses.[54]

Court reports are critical pieces of information to the court, and as noted above, the court will be relying upon its own court officer. The duties imposed on the trustee - particularly the mandated preparation of the report where the trustee learns of unlawful conduct on the part of the bankrupt - are important and the trustee must not treat them as mere perfunctory activities.

Discretionary Options

While the trustee is obliged to take certain steps in regard to and in response to unlawful conduct by the bankrupt, the trustee will also be faced with deciding whether additional steps are warranted. What should the trustee do? Should it perform an investigation and / or commence legal proceedings to reverse the transaction of purchase and sale or recover the transferred funds? These additional steps may not be mandatory, but they may well mean the difference between recovery for the creditors and no recovery.

Funding Issues

While it may be that your first response is that the trustee will need to review the evidence to determine whether to proceed and how far, the practical answer to many of these questions will depend, at least initially, on whether the trustee has any funds in the estate. If the bankruptcy is a "no asset bankruptcy", then the trustee, like it or not, will have very few options when it comes to trying to recover additional funds. Similarly, if the estate has very limited funds, or the assets referenced are not liquid assets, then the trustee will again find itself in a position where it will likely be difficult to engage outsiders to investigate the matter further, or pursue legal avenues to recover the property or the funds in question.

Even in cases where there are funds in the estate, such that the trustee can consider its options - including consulting or retaining outside legal counsel - more fully, the trustee must then consider whether taking such steps will enhance recoveries for the unsecured creditors of the estate. This will involve a careful analysis of several matters, including the issue in dispute, the information or other evidence at the disposal of the trustee, the amount in question, and the costs of proceeding and ultimately hopefully realizing the funds for the estate. The trustee must present the facts to the estate inspectors and, in most cases, seek their approval, by way of a resolution, authorizing the trustee to pursue the particular course of action, at least up to a point.

If the trustee discovers, following its analysis of the situation, that it is unlikely that the additional steps to be taken will increase the chance of additional recoveries for the unsecured

creditors, then the trustee ought to candidly advise the inspectors of that as well. In other words, even if there has been unlawful or even fraudulent conduct, it may not be worth spending the estate's scarce resources to pursue these claims, however distasteful it may seem to let the matter go, or let the bankrupt "get away with it".

If there are no funds in the estate to fund a legal action, the trustee may have other options. It can ask one or more of the creditors to fund the litigation. The funding creditors would be entitled to recover their funding costs out of the proceeds of settlement or any judgment.[55] If that does not result in the trustee being able to move forward with the litigation, the trustee could also offer the cause of action to the creditors via a s.38 proceeding.[56]

In many cases though, there will be resources available to the trustee to consider whether to take additional steps on behalf of the estate to recover property that has been removed from it. It then becomes a matter of how the trustee ought to exercise its discretion to spend the estate's funds.

We will now examine a number of options available to a trustee where it wishes to pursue the bankrupt's unlawful or fraudulent conduct.

Investigation

The first thing a trustee ought to do when it learns of a fraud or a reviewable transaction is performing an initial investigation of the matter. This review does not need to be extensive or involve multiple professionals. However, the trustee must at least take certain basic steps to ensure that it is complying with its own professional obligations to try to maximize recoveries for the estate. Initially, this will likely involve a minimal review of whatever information or evidence is presented to the trustee, be it in documentary or other form, so that the trustee can determine, at least at the beginning, whether additional action is warranted.

Even if there are no assets in the estate, the trustee could send a letter to the purported recipients of any property fraudulently transferred or of any preferential payments received requesting the return of such property or funds. It may be that such a letter is successful and

results in the recovery of some property or funds, or a scenario where the trustee could negotiate some recovery for the estate. However, it if does not, the trustee's investigation and steps may simply end there, as there would be no additional available funds with which to pursue the recipients of the property or payments. While that may be an unfortunate result for the creditors, the trustee is by no means obliged to take steps or perform costly actions when there are no funds available to finance such steps.

Examinations

The *BIA* also permits the trustee, with the approval of an ordinary resolution passed by the creditors or a resolution of a majority of the inspectors, to conduct an examination of the bankrupt, as well as others.[57] This includes agents, directors, officers, or employees of the bankrupt.[58] Such examinations are part of the investigatory process that can assist the trustee in determining whether it may be worthwhile for the trustee to commence legal proceedings on behalf of the estate.[59] The examinations are conducted under oath and their scope is "quite wide", covering the bankrupt's business, property, causes of the bankruptcy and any dispositions of property. A transcript of the examination is prepared and produced and can be used on any subsequent application to the court.[60]

Commencing legal proceedings

Once the trustee has conducted its investigation, it may then wish to consider whether to institute legal proceedings against the bankrupt and other persons to recover property that properly belongs to the estate. It is important to note that the trustee cannot pursue the claims of or on behalf of individual creditors, but can only pursue claims that are advanced on behalf of all creditors, such as fraudulent preference claims and constructive trust claims.[61]

If the trustee decides to undertake litigation relating to the property of the bankrupt during the bankruptcy process, the trustee will require authorization from the estate inspectors.[62] If the trustee fails to obtain the approval of the inspectors, the trustee will be personally liable for any costs of the proceeding.[63] It is thus imperative to advise the trustee of its obligation to obtain the authorization of the inspectors, prior to commencing any legal proceedings, to ensure that

the trustee is not left in the position where it will be obliged to pay legal costs to the other side, as well as any additional disbursements and costs for any professionals retained by the trustee, out of its own funds, and without recourse to the estate.

As noted above, if the trustee is considering commencing legal proceedings in respect of the property of the bankrupt, it ought to consider a number of factors. First, it must always keep in mind that its primary duty and function is to seek to maximize the value of the estate for the unsecured creditors. Thus, the only reason to commence litigation would be to pursue an avenue that, in the trustee's considered view, would likely increase the value of the estate. The trustee should ensure that it has analyzed the matter carefully and properly documented the pros and cons of commencing legal proceedings. This will assist and protect the trustee should things not go well in the litigation and the costs of the proceeding outweigh the actual realizations. The trustee should also inform the inspectors, when seeking their approval to commence litigation, of the trustee's analysis so as to be able to justify its choices and recommendations to move forward with the litigation.

Second, the trustee should recognize and consider that litigation can be a lengthy and costly process. We have already noted that the trustee should prepare an analysis prior to embarking on litigation that examines the pro's and con's, or the costs and benefits, of proceeding. Of course, those costs include the direct, out-of-pocket costs that the trustee will incur when it retains litigation counsel. However, the trustee will also spend additional time with litigation counsel, informing and instructing counsel, preparing documentation for counsel, perhaps attending with counsel at examinations or court attendances, and generally participating in the litigation process. The trustee may also report back to the inspectors at various stages to inform them as to the state of the litigation, and perhaps to obtain their ongoing approval. The trustee, as any professional would, will charge the estate for its time. That time and those charges will, of course, be in addition to counsel's time. Can the matter stand two sets of professional fees?

Third, litigation can be and usually is a lengthy process. Defendants often do what they can to slow down the process and delay any judgment, no matter how inevitable. The additional time

will impact the estate as it will then take longer to conclude the estate than would otherwise be the case. This can add to the frustration of the creditors and other players in the system.

Fourth, even if the trustee is successful in obtaining judgment, there may be other problems. The defendant may appeal the judgment, delaying the matter further and increasing the costs. The judgment may simply result in a declaration that requires the trustee to pursue the matter further, or commence additional legal proceedings. For example, in the case of a reviewable transaction, or a fraud, the transaction may be voided with the result that the property or the funds are to be returned to the bankrupt's estate.[64] However, the funds may need to be traced before they can be recovered. In some cases, additional legal proceedings may need to be commenced to secure the funds from the ultimate transferee.

And of course, the trustee must always ensure that it checks in advance and conducts the necessary and appropriate searches prior to undertaking any legal proceedings to determine if there are any secured creditors who might stand to gain from any actions taken by the trustee, given that anything the trustee recovers is still subject to the rights of the secured creditors.

However, if the trustee conducts a proper analysis and determines that it is worthwhile proceeding with litigation, the hope is that the result will be recoveries to the estate for the benefit of all of the unsecured creditors.

Thus, there are a number of matters that any trustee must consider before making the decision to pursue litigation on behalf of the estate. Experienced counsel will go through all of these matters with the trustee to ensure that the trustee will be protected, should things not go according to plan, but also to ensure that the trustee properly and thoroughly analyzes the situation before counsel commences the proceeding.

Oppose the Bankrupt's Discharge

Another option for the trustee when dealing with an individual bankrupt who appears to have been engaged in unlawful or fraudulent conduct is to oppose the bankrupt's discharge. The *BIA* provides that a bankrupt may be discharged from their debts, subject to certain exceptions, at

the conclusion of the bankruptcy process.[65] However, the bankrupt is not entitled to be discharged from their debts and a court may refuse a bankrupt's discharge, or grant a conditional discharge (on terms).[66]

In reality, trustees rarely file an opposition to a bankrupt's discharge. This is so for a number of reasons. First, as is the case with litigation, there is the additional time and expense involved. Opposing a bankrupt's discharge will, in most cases, lengthen the bankruptcy process, due to the additional work and preparation that must go into opposing a bankrupt's discharge.[67]

Second, in many cases, it is not clear that the trustee's opposition will result in any additional recoveries to the estate. Thus, prior to opposing the bankrupt's discharge, the trustee ought to investigate and try to determine whether the opposition to discharge will truly increase the value of the bankrupt's estate, and lead to any real gains for the unsecured creditors. If it does not, then the trustee's actions will not have made any real financial difference to the estate.

Further, the trustee's opposition to the bankrupt's discharge may lead the court to grant the bankrupt a conditional or suspended discharge. The court's order may impose additional terms and conditions upon the bankrupt that require the trustee to continue investigating and administering the estate.[68] In those situations, the bankruptcy process will be prolonged, which may, for some unsecured creditors, impose additional burdens.[69] Most creditors simply want the matter to be completed and the estate wrapped up as quickly and efficiently as possible. Further, once again, it is not clear in those circumstances that any recoveries will be real net recoveries to the estate, once the additional time spent by the trustee, and possible legal counsel for the trustee, is taken into account.

Finally, opposing a bankrupt's discharge requires the trustee to take additional administrative steps, including notification requirements, and address the bankrupt's conduct in greater detail and depth in the trustee's report filed in opposition to the discharge itself.[70] This is particularly true if the basis for the trustee's opposition to the bankrupt's discharge is as a result of alleged unlawful or fraudulent conduct. In that regard, the report must precisely set out the grounds for why the trustee recommends that the court refuse the discharge, and recommend possible

conditions that ought to be applied to the bankrupt in order for him or her to obtain a discharge. [71]

On the substantive side, the case law notes that, even though a court can grant or refuse a discharge, whether the trustee can prove one of the facts listed in s. 173(1) of the *BIA*, where there was no proof of the facts listed, the bankrupt's conduct would have to be "extreme" for the court to refuse the discharge.[72] By way of example, the court did refuse a discharge in the case where the bankrupt did not cooperate with the trustee, was evasive and untruthful in response to the trustee's enquiries, and disposed of assets.[73]

In the case of fraud, courts have held that in order for the bankruptcy court to refuse a discharge, pursuant to section 173(1)(k) of the *BIA*, on the basis that the bankrupt was guilty of fraud or fraudulent breach of trust, there must be an existing judgment in civil court or a conviction in criminal court in respect of those matters.[74] Simply alleging fraud or fraudulent breach of trust, or even providing the bankruptcy court with evidence of the alleged conduct, is not sufficient. The court will not enter into an enquiry at the discharge hearing to determine if the bankrupt is guilty of fraud.

On the other hand, in appropriate cases, it may well make sense for the trustee to seek a conditional discharge, as it may result in the recovery by the estate of substantial funds for distribution to the creditors. By way of example, in the case of *Re Hardtke,* the trustee opposed the bankrupt's discharge, and was supported in its opposition by the OSB and the Canada Revenue Agency ("CRA").[75] When the individual filed for bankruptcy, he listed $1,365,000 in debts owed to the CRA, and assets of a mere $15,500. The debtor claimed that the amount owed to the CRA was due to the fact that his tax advisor had been found guilty of tax evasion and fraud, which affected the bankrupt's 1994-1999 tax years.[76] Following the OSB's examinations of the bankrupt, it became clear that the bankrupt had transferred properties to his wife at under value, under reported his income, falsified expenses, and failed to disclose a cottage and an RRSP.[77] The court held that the bankrupt misled the trustee with respect to various matters and created a "sham" in separating his office and transferring his assets to his wife at undervalue.[78]

The Court ordered a discharge conditional upon payment by the bankrupt to the estate of $75,000, in minimum monthly instalments of $1,000, and it also ordered that the bankrupt cooperate with the trustee who would continue to investigate the bankrupt's assets, and provide evidence to the trustee with respect to multiple transactions that were raised before the court.[79]

In that case, the trustee's opposition to the bankrupt's discharge was justified, as it resulted in additional recoveries to the unsecured creditors, at minimal cost and expense to the estate. Further, the bankrupt was a practising chiropractor and thus had the capacity to pay the additional funds into the estate.

CONCLUSION

Acting for a trustee in bankruptcy can be an interesting and rewarding experience, particularly where the mandate may involve fraud or other unlawful conduct. However, it is a mandate like any other, in the sense that the legal practitioner should only accept the mandate and agree to act where the practitioner has the requisite level of knowledge and experience. Bankruptcy and insolvency law is, on its own, a complex, sub-area of legal practice; adding fraud or other unlawful conduct to the mix only increases the need for seasoned, expert counsel.

ENDNOTES

[1] *Bankruptcy and Insolvency Act*, R.S.C 1985, c. B-3, as amended ["*BIA*"]. Another statute that address the situation of an insolvent debtor is the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended. However, that statute addresses restructuring of corporate debtors, who remain in possession of their assets. A monitor is appointed by the court to oversee the restructuring process, and there is no trustee involved. For simplicity sake and since we are dealing with the situation where the lawyer is called upon to advise a trustee, we will confine our approach to and focus our comments on the *BIA* and its provisions.

[2] Licensed Insolvency Trustee is the new term that replaced "Trustee in Bankruptcy" or, in French "Syndic de faillite." The change was effective April 1, 2016. Bankruptcy Canada, *Licensed Insolvency Trustees, a New Name for Trustees* (2017), online: Bankruptcy Canada, <https://bankruptcycanada.com/insolvency-blog/licensed-insolvency-trustees-a-new-name-for-trustees/≥.

[3] L. W. Houlden, Morawetz, and Janis Pearl Sarra, *Bankruptcy and Insolvency Law of Canada*, 4th ed, loose-leaf (Toronto: Thomson Carswell, 2009) ("*Looseleaf BIA*").

[4] *Bankruptcy and Insolvency General Rules*, C.R.C., c. 368 ["*Rules*"] at ss.34-53, Code of Ethics for Trustees.

[5] *BIA*, *supra* note 1 at s. 13.2(5).

[6] Frank Bennett, *Bennett on Bankruptcy*, 15th ed, (Toronto: CCH Canadian Limited, 2013) ("*Bennett on Bankruptcy*") provides a very helpful summary of a trustee's duties, cited in *Re White,* (2009) 98 OR (3d) 291 (SCJ), pp. 75-76; also see L. W. Houlden, Geoffrey B. Morawetz, and Janis Pearl Sarra, *The Annotated Bankruptcy and Insolvency Act* (Toronto: Thomson Carswell, 2017) ("*Annotated BIA*") at 858.

[7] *Residential Warranty Co. of Canada Inc., Re,* 2006 ABQB 236 at para 28, upheld on appeal with no discussion in this regard, in 2006 ABCA 293 at para 28; *Annotated BIA, supra*, note 6, at 55.

[8] *Bennett on Bankruptcy*, citing *Re White*, *supra* note 6.

[9] *BIA*, *supra* note 1 at s. 71.

[10] *Ibid* at s. 30.

[11] *Bennett on Bankruptcy*, *supra*, note 6; Office of the Superintendent of Bankruptcy Canada, "Bankruptcy and Insolvency at a Glance" (December 2, 2015), online: The Government of Canada <https://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/h_br01545.html≥.

[12] *BIA, supra* note 1 as ss. 95-96.

[13] Anna Jane Samis Lund, *Discretionary Decision-Making By Trustees in Canada's Personal Bankruptcy System* (Law Dissertation, The University of British Columbia, 2015) [unpublished] ("*Lund Dissertation*") at 145.

[14] *Ibid* at 145.

[15] *Ibid* at 147-148.

[16] *Ibid* at 144-145.

[17] *Ibid* at 155

[18] *Ibid*.

[19] *BIA*, *supra* note 1 at Part VIII.

[20] *Annotated BIA*, supra, note 6 at 1040.

[21] The *Criminal Code,* RSC 1985, c C-46 and the details of the criminal offences are beyond the scope of this paper.

[22] Looseleaf BIA at 13-1.

[23] *R v Rosen* (2011), 85 CBR (5th) 143 (BC Prov Ct); Annotated BIA, supra, noted 6 at 1041; *BIA*, *supra* note 1 at ss. 198(1)(a) and 198(1)(c) .

[24] *BIA*, *supra* note 1 at s. 95; *Re BC Boat Sales Ltd* (1962), 35 DLR (2d) 557 (BC CA).

[25] *R v Yaremkevich*, 2002 ABPC 174, finding the bankrupt guilty of an offence under s. 198(1)(d) of the *BIA*, *supra* note 1.

[26] *R v Farrell*, 2010 ONCJ 391 at paras 29-30.

[27] *R v Eid*, 2016 ONSC 3221 at paras 316-318 and 330-331.

[28] *BIA*, *supra* note 1 at s. 95-96.

[29] *Annotated BIA*, supra, note 6, at 574.

[30] *BIA*, *supra,* note 1 at s. 95(1)(a)-(b).

[31] *Ibid* at s. 95(2).

[32] *Annotated BIA, supra,* note 6, at 579.

[33]*BIA*, *supra,* note 1 at s. 96.

[34]*Ibid*.

[35] 2015 ONSC 188.

[36] *Ibid* at paras 45-47.

[37] *Ibid* at paras 50-51 and 55.

[38] See for e.g. *BIA*, *supra* note 1 at ss. 13-41.

[39] *Rules*, *supra* note 5 at ss. 34-53.

[40] *Ibid* at s. 39.

[41] *Looseleaf BIA*, supra, note 3, at 2-8.

[42] Office of the Superintendent of Bankruptcy Canada, "You Owe Money - Offences under the *Bankruptcy and Insolvency Act* (BIA) and the *Criminal Code*" (December 2, 2015), online: The Government of Canada <https://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/h_br01545.html≥

[43] *Ibid*.

[44] Office of the Superintendent of Bankruptcy, *supra* note 42.

[45] *BIA*, *supra,* note 1 at ss. 95-96.

[46] *Ibid*.

[47] Canadian Association of Insolvency and Restructuring Professionals, *Standards of Professional Practice*, 15.3(e).

[48] *BIA*, *supra* note 1, at s. 170(1).

[49] *Ibid* at s. 170.

[50] *Ibid* at s. 170(1).

[51] Canadian Association of Insolvency and Restructuring Professionals, *Standards of Professional Practice*, 15.3(e).

[52] *Ibid*.

[53] *Re Kultgen*, 2001 ABQB 189 at para 12. The trustee filed a letter from a creditor along with its report alleging potential fraudulent behaviour and the bankrupt's written response without commenting on either the letter or the trustee's views of the matter, including whether the evidence filed and the response were credible. The court was left in the unenviable position of having to decide the matter without any guidance or recommendation from its officer / trustee.

[54] *Ibid* at paras 8-10.

[55] *Lund Dissertation, supra*, note 13, at 150-151.

[56] *BIA*, *supra* note 1 at s. 38.

[57] *Ibid* at s. 163(1).

[58] *Ibid* at s. 163(1).

[59] *Annotated BIA, supra*, note 6 at 819.

[60] *Annotated BIA, supra*, note 6 at 826.

[61] 2015 ABCA 137 at para 23.

[62] *BIA*, *supra* note 1 at s. 30(1)(d).

[63] *Looseleaf BIA, supra*, note 3

[64] *BIA*, *supra* note 1 at ss. 95-96.

[65] *Ibid* at ss. 178(1)-(2).

[66] *Ibid* at s. 172.

[67] *Lund Dissertation, supra*, note 13, at 202.

[68] See for e.g. *Re Hardtke,* 2012 ONSC 4662 ["*Re Hardtke*"].

[69] *Lund Dissertation, supra*, note 13, at 202.

[70] *BIA*, *supra* note 1 at s. 170.

[71] *Re O'Hara* (1977), 23 CBR (NS) 222 (Ont HC); Annotated BIA, supra, note * at 863.

[72] *Annotated BIA, supra*, note 6, at 869.

[73] Mancini (Trustee of) v Mancini (1987), 63 CBR (NS) 254 (Ont SC) cited by Geoffrey B. Morawetz, and Janis Pearl Sarra, *The Annotated Bankruptcy and Insolvency Act* (Toronto: Thomson Carswell, 2017) at 869.

[74] *Annotated BIA, supra*, note 6 at 904.

[75] *Re Hardtke, supra* note 68 at para 1.

[76] *Ibid* at paras 4-7.

[77] *Ibid* at paras 122-125.

[78] *Ibid* at para 128.

[79] *Ibid* at paras 131-133.