

CREDITORS ISSUES

PROTECTING YOUR BUSINESS AND PERSONAL ASSETS

Mark C. Stacey and Aaron L. Sherriff

In order to better protect your business and personal assets you need to understand how the commercial litigation process really works. Armed with an appreciation of how the system actually operates you can develop strategies to make your assets unavailable (or less available) to your creditors.

1. So You've Been Sued – Now What?

Liabilities usually arise from legal claims for uninsured professional negligence or because of unpaid debts to creditors. In either case the claimant – referred to in our Supreme Court as a plaintiff – will likely pursue collection through legal action.

Whenever served with court papers which initiate a legal claim, it is advisable to immediately seek legal advice. Determinations about how to defend a legal action are often fact driven. There can be serious consequences if you do not respond properly and in a timely fashion. For example, if you are served with a writ of summons and fail to file an appearance within 7 days of being served, a plaintiff can apply (without further notice to you) for a default judgment. If a default judgment is obtained it can be difficult and costly to set aside in order to re-open the litigation. The court may require that the full amount of the debt be posted as security in order to set aside the default judgment.

Prior to the trial of an action, a creditor also has the right to apply to court to seize assets or garnish funds into court until a judgment order is obtained.

The most common means of such prejudgment execution orders are:

- (a) Mareva injunctions – order by a court which restrains a defendant from disposing of assets pending the outcome of the action between the parties. In order to obtain such extraordinary relief, a plaintiff must establish that it has a strong case; irreparable harm will result if the order is not granted; and that the balance of convenience favours the plaintiff. See: *Aetna Financial Services Limited v. Fiegelman*, [1985] 2 WWR 97 (SCC); *Mooney v. Orr* 1994, 98 BCLR (2d) 318 (SC), etc.

- (b) Prejudgment Garnishment. Section 3 of the Court Order Enforcement Act permits a plaintiff to apply for an order that debts due from another person (or entity) to the defendant, be instead paid into court pending judgment or settlement. The claim must be a liquidated amount for a sum certain and not be subject to any adjustments or set-offs. This form of garnishment can be utilized to attach funds held in bank accounts. However, prejudgment garnishment cannot attach wages from an employer.

Both Mareva injunctions and prejudgment garnishing orders may be obtained without notice to the defendant debtor. However, a defendant may subsequently apply to set them aside. Nevertheless you should understand that these powerful remedies are available to a creditor prior to trial.

2. What Can a Judgment Holder Do To You?

In order to directly collect on a contested claim a plaintiff must obtain an order for judgment. This can be obtained in a trial, the hearing of a petition or by way of some other type of order. Usually a judgment will only be obtained upon notice to the debtor as part of an ongoing legal action.

Once a creditor obtains a judgment however it has a wide array of procedural remedies available to collect the judgment if the defendant is unwilling or unable to pay the amount ordered.

Such remedies include:

(a) Post Judgment Garnishment:

- wages (usually a maximum of 30% of the net income due within 7 days of service of the garnishment order) (See: c. 3 of *Court Order Enforcement Act*);
- funds held by financial institutions including chequing accounts, savings accounts and term deposits (see: *Bel Fran Investments Ltd. v. Pantuity Holding* [1975] 6 WWR 374 (BCSC));
- shareholders loans due and payable (see: *R. v. Big White Developments Ltd.* [1984] BCD Civ. 1724-05 (SC));
- demand loans between businesses (see: *Roe v. Mr. Build (Can) Ltd.*, [1988] BCWLD No. 845 (Co. Ct.);
- pensions and annuities (dependent on their nature) (see: *Bank of Montreal v. Freedman* (1984), 58 BCLR 289 (SC);
- builders lien trust funds (subject to claims by the trust beneficiaries) (see: *A & M Painting v. Byers* (1981), 28 BCLR 43 (CA).

- (b) Execution against Real Property – ss. 80-113 of the *Court Order Enforcement Act* allows a judgment creditor to register its judgment against property and compel the sale of the judgment debtor's interest in the property;

- (c) Execution against Personal Property – Personal property of the judgment debtor such as motor vehicles and household furnishings are exigible under s. 55 of the *Court Order Enforcement Act*. There is also a procedure for seizing and selling company shares provided for by ss. 64-69 of that Act.

Further, statutory creditors such as CRA (for employee remittances and GST), provincial sales tax and WCB have a significant array of collection remedies. As the liabilities of incorporated businesses for statutory creditors can be assessed against directors and officers, it is advisable that all efforts be made to keep such accounts current even if it means that statutory creditors are paid before a businesses' ordinary trade accounts.

3. Your Creditors Can't Necessarily Get Everything You Have

Judgment creditors cannot usually obtain (or execute against) any more interest in an asset than a debtor has.

In addition, certain assets held by debtors are not exigible by judgment creditors and cannot be seized, including the following:

- (a) Jointly owned assets (i.e. bank accounts) are not subject to garnishment unless all joint parties are defendants (*238344 BC Ltd. v. Petriquin* (1984), 57 BCLR 224 (CA));
- (b) The *Court Order Enforcement Exemption Regulation*, allows a debtor (on the debtor's application) for exemption from execution against the following:
 - \$4,000 for household furnishings and appliances;
 - \$5,000 for a motor vehicle;
 - \$10,000 for tools and other personal property of the debtor that are used by the debtor to earn income from the debtor's occupation;
 - \$12,000 of equity in a principal residence located in Greater Vancouver or Victoria and \$9,000 in equity for a principal residence in the remainder of British Columbia.
- (c) Funds assigned as security are not subject to garnishment, so long as the security instrument is valid and in place before the garnishment (*Tyrer Enterprises Ltd. v. Lytton Lumber Ltd.* [1992] BCWLD No. 2452 (CA)).
- (d) S. 54(2) of the Insurance Act provides: "Where a designation in favour of a spouse, child, grandchild or parent of a person whose life is insured, or any of them, is in effect, the insurance money and the right and interests of the insured in it and in the contract are

exempt from execution or seizure.” The provision has been held to include RRSP’s that provide an option to convert into an annuity (Sykes (Re), [1998] BCJ No. 102 (CA)).

Be mindful that the courts are increasingly inclined to pierce the corporate veil to allow creditors to sue principals of corporations where the individual behind the company was the beneficiary of a transfer of property for which they did not provide reasonable value in exchange. This is commonly referred to as a transfer at non-arms-length or less than fair market value.

Generally speaking, any transfers or sale of property which are not made for “good and valuable consideration” or which are made for the purpose of defeating the claims of a creditor, can be challenged on application by a creditor. Such actions are referred to as *Fraudulent Conveyance* or *Fraudulent Preference* claims and are directed at setting aside or reversing the “fraudulent” transfer.

4. Strategies To Make Your Assets Unavailable To Your Creditors

In terms of strategies to protect your business and personal assets, little can be done to protect your current assets from your current creditors. However it is possible to protect your current assets from your future creditors, as well as the assets you will acquire in the future from your current and future creditors.

Incorporated companies are considered to be persons in law. Therefore if a judgment debtor is an incorporated company, a creditor is usually limited to executing a judgment against the assets owned by that company. There is also no legal requirement that an operating company must hold a minimum level of assets.

Using a multiple level (parent–subsidiary) corporate structure can allow for assets to be accumulated in a holding company and the use of those assets (such as equipment or patents) can then be leased back to a subsidiary operating company.

So long as an operating subsidiary is solvent, it can distribute profits or declare dividends to its parent company, shareholders or principals leaving minimal residual assets in the operating company.

A personal guarantee allows a creditor to step beyond an incorporated business and seek recovery of its debt directly from the guarantor. It may not always be possible to avoid providing personal guarantees for certain types of commercial transactions such as bank loans and commercial leases. But wherever possible owners of an incorporated business should avoid entering into personal guarantees.

Professionals can also be personally sued for allegedly negligent work, so you should also consider whether your personal assets are at risk by virtue of your professional activities. Asset protection planning should also extend to your personal assets, not simply to your business alone.

Where possible you should creditor proof your personal assets by employing strategies such as:

- (a) Ensuring as much as possible that your professional activities are insured. Additionally you should understand the limits of and/or exclusions in such insurance;
- (b) Place key assets such as matrimonial homes and investment accounts in the name of a spouse, or at least in joint names;
- (c) Ensure that personal investments are not exigible by investing in segregated funds and using annuity convertible RSPs;
- (d) Using legal structures such as discretionary trusts to protect ownership of assets and the allocation of income.
- (e) Operating your business and personal affairs out of lines of credit, not leaving substantial funds on deposit at a bank;
- (f) Utilizing multiple companies to separate business risk from the accumulation of profits and assets; and
- (g) Advancing a shareholders loan to your company and taking back a General Security Agreement, thereby placing you in the position of a secured creditor vis-à-vis your business.

Keep in mind however that any strategy to re-organize your assets must take into account possible income tax consequences triggered by the transfer, sale or deemed disposition of assets which have capital gains, fair market valuation issues and/or recaptured depreciation.

5. Conclusion

In conclusion, it is not recommended that you try to restructure your assets to avoid obligations to your current creditors. Little can be done to protect you once legal action has been initiated naming you and/or your business as a defendant.

However, understanding the remedies available to judgment creditors provides valuable insight into how your business and personal holdings could be restructured. The strategies you employ now will impact the vulnerability of your assets to creditors who may claim against your incorporated businesses and/or you personally in the future.

The purpose of this paper is to generally inform you about how the commercial litigation process actually works and to identify strategies you can use to protect your assets. Many of the topics referred to above are more complex than the simplified description provided. In considering how to better protect your business and personal affairs, you should obtain legal advice to ensure that the strategies you employ are suitable for your particular circumstances.