# KEEPING CURRENT

June 22, 2022

## Sale of commercial units by nearly-insolvent debtor not a fraudulent conveyance

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Creditors of an insolvent or nearly insolvent debtor may be understandably frustrated if the debtor sells its few remaining assets, leaving the unsecured creditors without any means to satisfy a judgment. However, provided there are *bona fide* reasons for the sale and the buyer has no knowledge of any fraudulent intent on the part of the seller, the creditor may be left without recourse to challenge the transaction.

In *Vestacon Limited v. Huszti Investments (Canada) Ltd.*, 2022 ONSC 2104 (CanLII), the court addressed the issues arising in such circumstances. Here, the plaintiff Vestacon Limited ("Vestacon"), sought to attack the sale of three commercial building units by the defendant, Huszti Investments (Canada) Ltd o/a Eyewatch ("Huzsti"), which Vestacon had constructed without getting paid.

At the time of the purchase of the units by Huszti, a private mortgage lender, Benson Custodian Corporation ("Benson"), brokered and administered a first mortgage loan to Huszti by two of Benson's clients. Huszti obtained a vendor takeback mortgage from the seller, which was registered in second position. Benson also financed a construction mortgage loan, which was registered in third position.

Vestacon was hired by Huszti for construction of the units. The units were substantially complete and ready for occupancy in June 2017. Vestacon delivered a number of invoices to Huszti totalling $449,819.31.

Vestacon and Huszti had discussions about the outstanding invoices at least as early as the summer of 2017 and Huszti made numerous promises to pay. Huszti proposed a payment schedule by way of post-dated cheques to satisfy the outstanding amounts. Vestacon accepted the proposal on October 25, 2017.

Vestacon apparently trusted Huszti's assurances that it would pay the outstanding invoices and did not take any steps to register a construction lien or otherwise safeguard its interests.

Not only was Huszti not paying

Continued on page 2

Vestacon's invoices, but it was also not paying its lenders. Huszti defaulted on the mortgages on September 1, 2017. On October 11, 2017, the first mortgagees issued a notice of power of sale.

Benson was understandably concerned about these developments. In addition to concern for the first mortgagees, who were its clients, Benson was worried that if the units sold under power of sale, the proceeds would not be sufficient for Benson to recover the funds advanced under the construction mortgage loan registered in third position.

To avoid a power of sale, Benson negotiated to purchase the units from Huszti. It did so through a numbered company which directed that title to the units be taken by the defendant, 2603553 Ontario Inc. ("260 Ontario"). 260 Ontario was incorporated as a single-purpose company for the sole purpose of holding the units. The principal of 260 Ontario was also an officer and director of Benson.

Vestacon subsequently commenced litigation against Huszti and 260 Ontario. In addition to suing Huszti for the unpaid construction work, Vestacon claimed that Huszti transferred the units to 260 Ontario by way of a fraudulent conveyance in which 260 Ontario had knowingly participated.

Vestacon's claim was based on the Ontario *Fraudulent Conveyances Act*, which provides that a conveyance of property "made with intent to defeat, hinder, delay or defraud creditors" of their "just and lawful actions, suits, debts, accounts, damages, penalties or forfeitures" is void as against such persons. The statute provides that a transaction is not void if it was made "upon good consideration" (*i.e.* value) and in good faith to a person without notice of the transferor's intention to defeat, hinder, delay or defraud creditors.

In the case at hand, this meant that to void the transfer of the units, the intention of the transferor (Huszti) was relevant and Vestacon had to prove that 260 Ontario had knowledge of Huszti's intention to defeat, hinder, delay or defraud Vestacon of its claim.

In order to assess a transferee's knowledge of a transferor's intent, the courts will look to whether there are "badges of fraud" present in the transaction. In *Bank of Montreal v. Bibi*, 2020 ONSC 2949, at para. 23, the court outlined the traditional badges of fraud as follows:

(i) the transferor has few remaining assets after the transfer;

(ii) the transfer was made to a non-arm's length person;

(iii) there were actual or potential liabilities facing the transferor, he was insolvent, or he was about to enter upon a risky undertaking;

(iv) the consideration for the transaction was grossly inadequate;

(v) the transferor remained in possession or occupation of the property for his own use after the transfer;

(vi) the deed of transfer contained a self-serving and unusual provision;

(vii) the transfer was effected with unusual haste; and

(viii) the transaction was made in the face of an outstanding judgment against the debtor.

In an Endorsement granting summary judgment to 260 Ontario dismissing Vestacon's action against it, the Ontario Superior Court of Justice

reviewed each of the badges of fraud and found that Vestacon's evidence did not come anywhere near establishing a fraudulent intent on the part of Huszti, and was even weaker in attempting to establish that 260 Ontario had knowledge of Huszti's fraudulent intent.

In that regard, there was no evidence to support a conclusion that there was anything other than a normal, arm's-length commercial relationship between Benson and Huszti. As well, there was no evidence showing that 260 Ontario ought to have been suspicious about the transaction. 260 Ontario paid good value for the units (93% of the appraised value) and the deal was done privately, without incurring real estate commissions, and in the face of a notice of sale issued by the first mortgagees. The negotiations that led to the conveyance took place over several months.

Vestacon argued that the sale was self-serving since the initial Agreement of Purchase and Sale (APS) provided that Huszti would remain in possession of the units. However, this did not occur. Rather, 260 Ontario leased the units to unrelated tenants.

Vestacon also argued that at the time of the transaction, Huszti had accumulated significant debts and liabilities and was facing insolvency and that the transfer of the units effectively dispossessed Huszti of its last remaining asset that could have been used to pay its outstanding debts.

The court accepted that Huszti was likely insolvent or nearly so at the time of the conveyance. However, the first mortgagees had issued a notice of sale and if Huszti did not realize on its only assets (the units), the first mortgagees were going to proceed to sell them. While imminent insolvency and dispossessing oneself of one's last asset are recognized badges of fraud, the motion judge's view was that they create a stronger suspicion of fraud when the conveyance at issue is of an unencumbered asset. In this case, Huszti's last remaining assets–the units– were encumbered by three separate mortgages and after paying out the mortgagees and discharging the arrears of property taxes, Huszti was left with only about $80,000.

Selling the asset and paying out creditors is not indicative of a fraudulent intention on the part of Huszti Investments, and certainly does not suggest that 260 knew or should have known that Huszti Investments was conveying the units to it for good consideration to defeat creditors. In effect, Huszti did use its last remaining asset to pay its creditors. It just paid out its secured creditors, which it was required to do. Vestacon, by failing to avail itself of its construction lien rights or taking other security, ranked below the creditors that were paid out on closing.

260 Ontario therefore established that there was no genuine issue requiring a trial and the claim against it was dismissed.

Unfortunately for Vestcon, even though Huszti was near insolvency, the sale of the units to 260 Ontario was found to have been a legitimate business transaction on the part of 260 Ontario, both to shore up the relationship between Benson and the first mortgagees (its clients) and to protect its own equity as third mortgagee. The sale was commercially reasonable. The proceeds went, as they had to, to pay out the secured creditors which did not include Vestacon since it failed to secure its claim by way of a construction lien.

## Contact us

If you have a litigation matter and are in need of legal advice, please do not hesitate to contact James Cook, at 416.865.6628 or jcook@grllp.com.