

## DEFENDING A DEBTOR IN A COLLECTION LAWSUIT

### INTRODUCTION

The purpose of this paper is to discuss a number of strategies that counsel can utilize when defending a "debtor" in a collection lawsuit. The focus of our paper is on the "debtor" who has creditors pressing for payment, and where a judgment against the "debtor" could result in the "debtor" being exposed to bankruptcy or other insolvency-based remedies.

While our focus is on defending the debtor, settlement should always be the overall objective and negotiations towards settlement should be attempted at the appropriate time.

Defending a debtor presents its own ethical challenges. Counsel should be familiar with the *Rules of Professional Conduct* and the common law principles which have been developed over time. Whether defending the lawsuit for the debtor or attempting to broker a settlement with creditors, there are important considerations that counsel must keep in mind. It is counsel's duty to resolutely and honourably<sup>1</sup> represent the client - the debtor - while at the same time ensuring that counsel acts with integrity<sup>2</sup> and in good faith with both other counsel and the court. While fearlessly raising every issue and advancing every argument on behalf of her client<sup>3</sup>, counsel should ensure that she maintains her credibility so that it remains intact when she attempts to broker a settlement or represents the next client. These ethical considerations will be discussed throughout the paper as they arise.

### STEPS BEFORE DEMAND IS MADE

Often the debtor will know that a creditor is in a position to make demand, although formal notice has yet to be given. If counsel for the debtor is involved before demand is made, there is a possibility that the dispute, or some of the issues can be resolved without the need for litigation.

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<sup>1</sup> Rules of Professional Conduct, Rule 10

<sup>2</sup> Rules of Professional Conduct, Rule 1

<sup>3</sup> Rules of Professional Conduct, Rule 10, commentary 2

If the creditor has yet to make a demand, then likely the creditor has also not invested a great deal of time and money in attempting to collect. By meeting with the creditor and their counsel early, counsel for the debtor may be able to frame the issues and present a creative resolution that the creditor will find acceptable.

An early meeting with the creditor will also allow you to learn the personality of the creditor (and its counsel) and to assess whether the creditor is likely to be aggressive or open to compromise. It also allows you to assess the strength of the creditor's position and, hopefully, to determine the strength of the debtor's position. Notwithstanding that most meetings such as these are on a without prejudice basis, meeting and assessing the individuals involved in the decision making process can be very helpful.

## **METHODS FOR OBTAINING INFORMATION BEFORE LITIGATION**

As in any action, the more information that counsel is able to obtain about their client and the opponents case, before the litigation begins, the better.

There are a variety of ways to gather information:

- Begin by speaking to the debtor and determining who the "players" are: who the debtor has been dealing with; who are the witnesses to these dealings; who will be helpful to the debtor; who will be detrimental to the debtor;
- Interview any witnesses, if possible, and obtain witness statements;
- Obtain all documentation in the debtor's possession. This is probably the best source of information at this stage. Ensure that the debtor is providing all of his files, both information that is helpful and information that is detrimental, preferably in chronological order, with an index;

- If settlement meetings are conducted, ask the creditor to see the documentation that the creditor is referring to and, if possible, obtain copies of these documents. If documentation is provided, confirm whether these documents are being provided on a without prejudice basis only or whether the debtor may use these documents in subsequent proceedings;
- Either before or after demand has been made, ask the creditor to see the debtor's file. This is especially helpful when dealing with financial institutions. If allowed to review the file, obtain copies of relevant documentation. If not allowed to review the file, take advantage of that conduct.

Once the information is gathered, a chronology of events and documents should be completed. This is essential when dealing with a large number of transactions. Not only will a comprehensive chronology assist in drafting pleadings and conducting discoveries, it can also be an effective and intimidating tool in negotiations if counsel for the debtor is well versed in the facts.

### **THE PRE-EMPTIVE STRIKE - WHEN SHOULD THE DEBTOR TAKE THE OFFENSIVE**

There are times when the debtor will come to counsel before the creditor has commenced an action. This can be very advantageous for the debtor as there are certain instances where the best defence is a good pre-emptive offense. Instead of waiting for the creditor to commence an action, the debtor can take a pre-emptive strike by commencing an action (or where appropriate an application) against the creditor. The goal of this strategy is twofold. First, it places the debtor in a position to control both the process and to frame the issues in the action. It is often better to be the plaintiff rather than the defendant. Second, it places the debtor, psychologically, in the best negotiating position. This is especially where the creditor is uncertain about taking aggressive legal action, or where the creditor does not have the resources to litigate. Consider, when making a pre-emptive strike, the strategy of serving an Offer to Settle with the Statement of Claim (or Application Record). This can promote quick and immediate settlement discussions. There is no

downside, as even if the Offer to Settle is ignored, the debtor/Plaintiff's cost position is protected under Rule 49 of the *Rules of Civil Procedure*.

In order to make a pre-emptive strike, it is essential that counsel first obtain all documentation and information in the debtor's possession. Independent investigation, if possible, should also be completed. Again, chronologies, especially if there are numerous transactions, can be very helpful and will frame the factual basis for the claim.

Once the preparatory work has been completed, an action or application can be commenced by the debtor prior to action by the creditor. The relief that may be requested includes:

- a declaration of rights. For example;
  - for a contract for supply of goods: that ABC Company has breached the contract, or that XYZ Company is not indebted to ABC Company;
  - for a promissory note: that the promissory note is void and unenforceable; or,
  - for a guarantee: that there has been a material variation of the agreement between the creditor and the primary debtor without the consent of the guarantor such that the guarantor is thereby released from any obligations<sup>4</sup>;
- an action for damages for any of the following:
  - breach of contract or established practice or conduct<sup>5</sup>;

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<sup>4</sup> *Toronto-Dominion Bank v. Gallucci* [1999] O.J. No. 1188 (O.C.A.) reversing [1998] O.J. No. 881 and *Manulife Bank of Canada v. Conlin* [1996] 3 S.C.R. 415 (S.C.C.)

<sup>5</sup> *Royal Bank of Canada v. Chongsim Investments Ltd. et al.*(1997) 32 O.R. (3d) 565 (O.G.D.)

- negligence;
- trespass<sup>6</sup>;
- conversion<sup>7</sup>;
- failure to give reasonable notice or make reasonable demand<sup>8</sup>, including failure to give proper notice of a notice of sale under mortgage or notice of intention to enforce security under the *Bankruptcy and Insolvency Act*;
- recklessness or bad faith;
- fraudulent misrepresentation or negligent misrepresentation<sup>9</sup>;
- breach of fiduciary duty;
- failure to act in good faith where such an obligation exists<sup>10</sup>;
- intentional interference with contractual relations;
- inducing breach of contract;
- conspiracy;<sup>11</sup>

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<sup>6</sup> *Murano v. Bank of Montreal* (1998) 41 O.R. (3d) 222 (O.C.A.), affirming (1995) 20 B.L.R. (2d) 61 (O.G.D.); *Ronald Elwyn Lister Ltd. et al v. Dunlop Canadian Limited* (1982) 41 C.B.R. (N.S.) 272 (S.C.C.)

<sup>7</sup> *Murano v. Bank of Montreal* (1998) 41 O.R. (3d) 222 (O.C.A.), affirming (1995) 20 B.L.R. (2d) 61 (O.G.D.); *Ronald Elwyn Lister Ltd. v. Dunlop Canada Limited*, supra

<sup>8</sup> *Murano v. Bank of Montreal* (1998) 41 O.R. (3d) 222 (O.C.A.), affirming (1995) 20 B.L.R. (2d) 61 (O.G.D.), *Kavcar Investments Ltd. et al. v. Aetna Financial Services Ltd. et al.* (1989) 70 O.R. (2d) 225 (O.C.A.), *Mister Broadloom Corp. (1968) Ltd. v. Bank of Montreal et al.* (1983) 44 O.R. (2d) 368 (O.C.A.) leave to appeal refused 55 N.R. 160 (S.C.C.)

<sup>9</sup> See *The Queen v. Cognos* [1993] 1 S.C.R. 87 (S.C.C.) for the elements of negligent misrepresentation. See also *Hedley Byrne & Co. v. Heller & Partners Ltd.* [1964] A.C. 465 (H.L.)

<sup>10</sup> *Royal Bank of Canada v. Chongsim Investments Ltd.*, supra. See *Gateway Realty Ltd. v. Arton Holdings Ltd.* (1992) 112 N.S.R. (2d) 180 (N.S.C.A.), affirming [1991] N.S.J. No. 362 for duty to act in good faith. See also the *Bankruptcy and Insolvency Act*, s.247

<sup>11</sup> *Claiborne Industries Ltd. v. National Bank of Canada* (1986) 55 O.R. (2d) 289 (O.C.A.)

- improvident sale or improvident conduct;<sup>12</sup>;
- mismanagement by either a privately appointed receiver manager or a court appointed receiver manager<sup>13</sup>;
- injunctive or other interlocutory relief such as interim preservation of property<sup>14</sup> or interim recovery of assets or a court appointed receiver manager<sup>15</sup>;
- a certificate of pending litigation if property is involved<sup>16</sup>. Note the restrictions on obtaining a certificate of pending litigation with regard to security against land unless it is claimed that the validity of the security itself is in question<sup>17</sup>;
- rescission;
- specific performance;
- rectification of an agreement<sup>18</sup>;
- an accounting<sup>19</sup>; and,
- fraud.<sup>20</sup>

A recent and good example of an effective and successful pre-emptive strike is *Murano et al v. Bank of Montreal*<sup>21</sup>. In that case, the creditor, the Bank of Montreal,

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<sup>12</sup> *Sterne v. Victoria & Grey Trust Co.*, (1984) 49 O.R. (2d) 6 (H.C.J.), *Canada Trustco Mortgage Co. v. Windsor Painting Contractors Ltd.* (1991) 22 R.P.R. (2d) 222 (O.G.D.)

<sup>13</sup> *Sterne v. Victoria & Grey Trust Co.*, supra, *Canada Trustco Mortgage Co. v. Windsor Painting Contractors Ltd.*, supra

<sup>14</sup> Rule 45 of the *Rules of Civil Procedure*

<sup>15</sup> Section 101 of the *Courts of Justice Act*, R.S.O. 1990, c.C.43, Rule 41 of the *Rules of Civil Procedure*

<sup>16</sup> Section 103 of the *Courts of Justice Act*, R.S.O. 1990, c.C.43

<sup>17</sup> *Hirji et al v. Khimani et al* (1978) 19 O.R. (2d) 750 (H.C.J.), *Camlachie Building Consultants Inc. v. Fieldstone* [1978] O.J. No. 728 (O.C.A.), *Lawrence Avenue Group Limited et al v. Innocan Realty Inc. et al* (1999) 44 O.R. (3d) 155 (O.G.D.)

<sup>18</sup> *Peter Pan Drive-In Ltd. v. Flambro Realty Ltd.* (1978) 22 O.R. (2d) 291 affirmed 26 O.R. (2d) 746 (O.C.A.), *H.F. Clarke Limited v. Thermidaire Corporation Limited* [1976] 1 S.C.R. 319 (S.C.C.)

<sup>19</sup> *Cordoba Developments Incorporated et al. v. Montreal Trust Company et al.* (1981) 20 C.P.C. 96 (H.C.J.)

appointed a receiver and manager of the plaintiffs' (who were the "debtors" of the Bank of Montreal) four video stores after only providing the plaintiffs with two hours notice before taking possession. In or about the same time, the Bank of Montreal also disclosed information about the plaintiffs to creditors, lenders, business associates and suppliers of the plaintiffs. As a result of that disclosure, other major creditors demanded payment. The plaintiffs successfully sued for trespass, conversion and damages. They were also awarded solicitor and client costs. This case is an excellent example of the "debtor" taking the offence against a creditor who has breached its obligations and acted improperly.

## TYPES OF DEFENCES

### a. *Generally*

Once the creditor has commenced an action against the debtor, the goal is to prepare a defence (and perhaps counterclaim) against the creditor's claim. This requires a complete understanding of both the strengths and weaknesses of the debtor's case. It is necessary to fashion a defence that is supportable on the facts and documentation, as well as strong enough to, ideally, promote settlement between the debtor and creditor, and of course successfully defend a judgment.

In preparing the defence, the following should be considered:

- has the creditor sued the correct party?
- has the creditor commenced the action prematurely<sup>22</sup>, for example: before certain condition precedents have been fulfilled: see also the effect of Rule 14.01(4) and Rule 25.06(3) of the *Rules of Civil Procedure*.
- has the creditor commenced the action before default has occurred, before invoices have been rendered, or before payment is due on any invoice.

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<sup>20</sup> See "Ethical Considerations" for discussion respecting allegations of fraud.

<sup>21</sup> *Murano v. Bank of Montreal* (1995) 20 B.L.R. (2d) 61 (O.G.D.), affirmed (1998) 41 O.R. (3d) 222 (O.C.A.)

<sup>22</sup> *Stornelli v. Dell Construction Co. Ltd.* [1966] 20 O.R. 413, *Township of Oro v. Kneeshaw* (1979) 24 O.R. (2d) 690

- is there an enforceable contract?
- has there been a breach of contract such as late delivery, delivery of the wrong goods, poor quality, the wrong quantity or negligence?
- is the debtor entitled to an accounting<sup>23</sup>, for example see section 22 of the *Mortgages Act*, R.S.O. 1990, c.M40;
- the defence of equitable set-off to avoid a judgment<sup>24</sup>. This can also be in conjunction with a counterclaim;
- the defence of misrepresentation such as innocent, negligent or fraudulent misrepresentation and the effect, depending on whether the contract is executory or not, whether the debtor is entitled to rescission, or damages, and the effect of any exculpatory clause<sup>25</sup>;
- the defence of misrepresentation by omission if it created a misleading impression, even innocently, which induced the debtor to obligate himself;
- the defence of misrepresentation of present intention<sup>26</sup>;
- the defence of suspension of the agreement; this is related to the condition precedent defence of equitable estoppel<sup>27</sup>;
- the defence of fraudulent<sup>28</sup> misrepresentation in circumstances where the "villain" is silent and creates a misleading impression<sup>29</sup>;

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<sup>23</sup> *Cardoba Developments Incorporated et al v. Montreal Trust Company et al* (1981) 20 C.P.C. 96 (H.C.J.), *Karteri v. Sugarman* (1999) 22 R.P.R. (3d) 38

<sup>24</sup> *Telford v. Holt* (1987) 21 C.P.C. (2d) 1 (S.C.C.), *Best Buy Carpets Ltd. v. 281856 B.C. Ltd. et al* [1987] 1 L.R. 1-2197

<sup>25</sup> *Bank of Nova Scotia v. Zackheim* (1983) 44 O.R. (2d) 244 (O.C.A.) reversing 42 O.R. (2d) 592; *CIBC v. Larsen* [1983] 5 W.W.R. 179 (B.C.C.A.); *Bauer v. Bank of Montreal* [1980] 2 S.C.R. 102 (S.C.C.)

<sup>26</sup> *International Casualty Co. v. Thomson* (1913) 48 S.C.R. 167

<sup>27</sup> *Hawrish v. Bank of Montreal* [1969] 2 D.L.R. (3d) 600

- the defence of breach of fiduciary duty may be available if there is a fiduciary relationship between the debtor and the creditor<sup>30</sup>. Also consider whether the debtor is entitled to rescission or damages because of a breach of fiduciary duty<sup>31</sup>;
- if there is no fiduciary relationship, consider whether there is an obligation on the creditor to act in good faith and fairly towards the debtor<sup>32</sup>;
- the defence of a collateral contract, or breach of warranty and the limitations of those in light of the numerous exceptions to the Parole Evidence Rule<sup>33</sup>;
- the defence of rectification as a corollary or an exception to the Parole Evidence Rule<sup>34</sup>;
- the defence of *non est factum*<sup>35</sup>;
- the defence of the failure of a creditor, especially a lending institution in appropriate circumstances, to ensure that independent legal advice was provided<sup>36</sup>;
- unconscionability<sup>37</sup>;
- the *Unconscionable Transaction Relief Act*, R.S.O. 1990, c. U.2;

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<sup>28</sup> Note caution respecting allegations of fraud found herein

<sup>29</sup> *Burrows et al v. Burke et al* (1984) 49 O.R. (2d) 76, reversing (1982) 36 O.R. (2d) 737

<sup>30</sup> See *International Corona Resources Ltd. v. LAC Minerals Ltd.* [1989] 2 S.C.R. 574 (S.C.C.) for elements for fiduciary duty

<sup>31</sup> *London Loan & Savings Co. v. Brickenden* [1934] 3 D.L.R. 465 (P.C.); *Commerce Capital Trust Co. v. Berk et al* (1989) 68 O.R. (2d) 257 (O.C.A.); *Raso v. Dionigi et al* (1993) 12 O.R. (3d) 580 (O.C.A.)

<sup>32</sup> *Royal Bank of Canada v. Chongsim Investments Ltd.* (1997) 32 O.R. (3d) 565 (O.G.D.)

<sup>33</sup> *Bauer v. Bank of Montreal* [1980] 2 S.C.R. 102 (S.C.C.)

<sup>34</sup> *Peter Pan Drive-In Ltd. v. Flambro Realty Ltd.* (1978) 22 O.R. (2d) 291, affirmed 26 O.R. (2d) 746 (O.C.A.); *H.F. Clarke Limited v. Thermidaire Corporation Limited* [1976] 1 S.C.R. 319 (S.C.C.)

<sup>35</sup> *Marvco Colour Research Ltd. v. Harris* (1982) 26 R.P.R. 48 (S.C.C.); *Citibank Canada v. Cameron* (1991) 7 O.R. (3d) 777 (O.G.D.), affirming 40 O.R. (3d) 526

<sup>36</sup> *Bank of Montreal v. Featherstone* (1989) 68 O.R. (2d) 541 (C.A.); *Citibank Canada v. Cameron*, *Supra*

<sup>37</sup> *Lloyd's Bank v. Bundy* [1974] 3 All E.R. 757; *McKenzie v. Bank of Montreal* (1976) 12 O.R. (2d) 719, *Bertolo v. Bank of Montreal* (1986) 57 O.R. (2d) 577 (O.C.A.)

- the *Business Practices Act*, R.S.O. 1990, c. B.18, section 2;
- the *Consumer Protection Act*, R.S.O. 1990, c. C.31;
- the *Sale of Goods Act*, R.S.O. 1990, c. S.1, section 7, 14, 15 and 51;
- the *Bills of Exchange Act*, R.S.C. 1985, B-4, section 188-192;
- the *Statute of Frauds*, R.S.O. 1990, c. S.19;
- the defence of illegality;
- the defence of *laches*<sup>38</sup>;
- the defence of estoppel<sup>39</sup>, remembering that *res judicata* and estoppel must be specifically pleaded;

**b. The advantage of set-off**

Special mention must be made of the defence of legal and/or equitable set-off. Set-off can be used with or without a counterclaim.

If counterclaiming, it is always advisable to plead set-off in the statement of defence, if available, remembering the requirements of each of legal and equitable set-off. When set-off is used in conjunction with a counterclaim, it can make it more difficult for a creditor to obtain summary judgment as both the defence of set-off and the counterclaim must be disposed of in a summary manner.

The more difficult decision is whether to use legal and/or equitable set-off without a counterclaim. Equitable set-off may be available where the debtor has a claim against the creditor, but that claim has been barred by a limitation period, such that the debtor is not able to issue a counterclaim. For example, the limitation period on a mortgage is ten years. If the creditor waits ten years to launch the claim on the mortgage, any counterclaim that the debtor may have based on negligence would be barred by a six-year

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<sup>38</sup> *Institut National des Appellations d'Origine des Vins et Eaux-de-Vie et al v. Andres Wines Ltd. et al.* (1987) 60 O.R. (2d) 316 (O.H.C.J.)

<sup>39</sup> *Henderson v. Henderson* (1843) 3 Hare 100, 67 E.R. 313; *Angle v. Minister of National Revenue* [1975] 2 S.C.R. 248 (S.C.C.)

limitation period. However, equitable set-off may still be available<sup>40</sup>. Of course, this defence may still be met with a reply of *laches*.

The effect of the defence of set-off is that the creditor cannot obtain the full judgment against the debtor (subject to the amount of the set-off).

### **THE USE OF COUNTERCLAIMS, CROSS-CLAIMS AND THIRD PARTY CLAIMS**

If the creditor has commenced an action before the debtor has an opportunity to make a pre-emptive strike, but the debtor still has a claim, for example one of the claims referred to above, then a counterclaim should be seriously considered.

A counterclaim is also useful, for, even if the creditor obtains judgment on its claim, the court will often stay that judgment pending final determination of the counterclaim.

Counterclaims are available where the counterclaim is somehow related to the main action. There are instances where the court has struck a counterclaim where it is unrelated to the main action and it would be inconvenient to have the two heard together.<sup>41</sup>

Where there is more than one defendant and the debtor has a claim against the other defendant, for example against a joint guarantor or as a joint tortfeasor, a cross-claim should be made. The circumstances where a crossclaim is available are set out in Rule 28.01 of the *Rules of Civil Procedure*. (A good example of the advantage of a counterclaim and a crossclaim within the counterclaim is found in the precedents attached and may allow defences to be raised that are not otherwise available. An example of this is where the creditor only sues the guarantor. The guarantor counterclaims against the creditor for declaratory relief, adding the debtor. The debtor may then crossclaim against the creditor, for example for damages, or a reduction of the debt, which cause of action or defence may not be available to the guarantor under the terms of the guarantee.

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<sup>40</sup> *459017 Ontario Limited v. Braithwaite* (2000) Unreported decision of E. MacDonald J.

<sup>41</sup> *Bosa v. Citarella* (1982) 39 O.R. (2d) 700 (Div. Ct.), *Long v. Long* [1943] O.W.N. 78 (Master)

Similarly, if there is a third party whom the creditor has not included in the action, that person should be added in a counterclaim or by way of a third party claim. The circumstances where a third party claim is available are set out in Rule 29.01 of the *Rules of Civil Procedure*. From the debtor's perspective, if there is a third party who should be joined, that may assist in reaching a settlement.

## ETHICAL CONSIDERATIONS

While counsel has a duty to her client, including the debtor, to fearlessly put forward every available defence<sup>42</sup>, counsel cannot put forward a defence that she knows is unsupported by the facts. Likewise, counsel cannot put forward a defence that counsel knows the debtor will be untruthful about if he ever gives evidence under oath.

There are similarities to representing the debtor and representing a client charged with a criminal offence. There are times when counsel must be careful not to ask too many questions or to caution the debtor that while all statements made are subject to solicitor and client privilege,<sup>43</sup> the statements may impede counsel's ability to represent the client and may not be privileged if they disclose a fraud. However, if the debtor does advise that a crime may have been committed, then counsel will have a positive obligation to disclose that information. Certain disclosure can also limit the defence that counsel puts forward, can limit the type of settlement or resolution that can be obtained for the debtor, and the information that may be discussed in a settlement meeting.

Counsel must also be careful not to become drawn into the debtor's enthusiasm for his case, especially allegations of fraud, bad faith or dishonesty, or to become drawn in with a debtor's desperation to deal with his problems. Regard should be had to Rule 6 and the commentary to 6 of the Rules of Professional Conduct:

"When advising the client the lawyer must never knowingly assist in or encourage any dishonesty, fraud, crime or illegal conduct, or instruct the client on how to violate the law and avoid punishment. **The lawyer should be on guard against becoming the tool or dupe of an unscrupulous client or persons associated with such a client.**" [Emphasis added]

<sup>42</sup> Rule 10, commentary 2 of the *Rules of Professional Conduct*

<sup>43</sup> Rule 4 of the *Rules of Professional Conduct* and the principle of solicitor-client privilege

Rule 10, commentary 2 is also of key importance, as it cautions against abuse of process and discusses situations where counsel must be cautious. It states:

"2. The lawyer has a duty to the client to raise fearlessly every issue, advance every argument, and ask every question, however distasteful, which the lawyer thinks will help the client's case and to endeavour to obtain for the client the benefit of every remedy and defence authorized by law. The lawyer must discharge this duty by fair and honourable means, without illegality and in a manner consistent with the lawyer's duty to treat the tribunal with candour, fairness, courtesy and respect.

The lawyer must not, for example:

- (a) abuse the process of the tribunal by instituting or persecuting proceedings which, although legal in themselves, are clearly motivated by malice on the part of the client and are brought solely for the purpose of injuring the other party;
- (b) knowingly assist or permit the client to do anything which the lawyer considers to be dishonest or dishonourable;
- (c) knowingly attempt to deceive a tribunal or influence the course of justice by offering false evidence, misstating facts or law, presenting or relying upon a false or deceptive affidavit, suppressing what ought to be disclosed, or otherwise assisting in any fraud, crime or illegal conduct;
- (d) knowingly misstate the contents of a document, the testimony of a witness, the substance of an argument or the provisions of a statute or like authority;
- (e) knowingly assert something for which there is no reasonable basis in evidence, or the admissibility of which must first be established;
- (f) deliberately refrain from informing the tribunal of any pertinent authority which the lawyer considers to be directly on point and which has not been mentioned by an opponent;
- (g) dissuade a material witness from giving evidence, or advise such a witness to be absent;
- (h) knowingly permit a witness to be presented in a false or misleading way, or to impersonate another;
- (i) needlessly abuse, hector, or harass a witness;
- (j) needlessly inconvenience a witness.

A caution before making allegations of fraud. Clearly, allegations of fraud, bad faith or dishonesty are serious and must be carefully considered before being brought forward. The debtor must be fully informed of the consequences of making these allegations if they

cannot be substantiated, including the potential that solicitor-client costs may be awarded against the debtor<sup>44</sup>. In these circumstances, counsel should also protect herself by ensuring that she has obtained written statements and detailed notes from the debtor, and if possible, witness statements prior to making allegations of fraud, bad faith or dishonesty. Counsel should be sure that even if the case may not ultimately succeed, there is an arguable case to be presented. Remember as well that Rule 25.06(8) requires full particulars of fraud, misrepresentation, breach of trust, malice or intent, so that counsel must have some reasonable basis for these allegations before commencing the claim.

As well, counsel should always be aware of the cost consequences of Rule 57.07 of the *Rules of Civil Procedure*. Counsel that crosses the line, whether it be procedurally<sup>45</sup> or in the substantive<sup>46</sup> defence put forward for the debtor, may find herself faced with costs against her personally. The court can, on its own initiative, order a hearing to determine whether such costs should be ordered.<sup>47</sup> The courts are not quick to award costs against a solicitor personally<sup>48</sup>, and while counsel must be afforded an opportunity to fully respond to all allegations<sup>49</sup>, it can be a costly experience, both financially and to counsel's reputation. It is also important to remember that if an award of costs is made against the solicitor, the order can include a term that the client is not to indemnify the solicitor for the costs.

A word of caution: threatening costs against another solicitor personally should only be used when the circumstances truly warrant such a sanction. Often this threat is thrown out loosely. By doing so, it only lessens the impact that taking that step will have when it is really needed. In other words "don't cry wolf".

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<sup>44</sup> 131843 *Canada Inc. v. Double "R" (Toronto) Ltd.* (1992) 7 C.P.C. 93d 15 (O.G.D.)

<sup>45</sup> *Chernick v. Spodek* (1997) 37 O.R. (3d) 422, *Bridlepath Progressive Real Estate Inc. v. Unique Homes Corp.* (1992) 12 C.P.C. (3d) 109

<sup>46</sup> *Re Bisyk* (No. 2) O.R. (2d) 281 (C.A.), Rule 4 of the *Rules of Professional Conduct*, commentary 11

<sup>47</sup> Rule 57.07 of the *Rules of Civil Procedure*

<sup>48</sup> *Young v. Young* [1993] 4 S.C.R. 3 (S.C.C.)

<sup>49</sup> Rule 57.07(2) of the *Rules of Civil Procedure*

Anyone who has ever acted for a debtor in all likelihood has been confronted by the exclamation by counsel's new client that all the debtor needs is "a few months". Optimism is usually the foundation of such a request.

It is advisable to ensure that the debtor immediately understands that delay for the sake of delay is improper, contrary to the *Rules of Professional Conduct* and potentially an abuse of process. If the debtor has legitimate rights that can properly be maintained before the court, and if the effect of pursuing those rights results in some "delay", then that is not contrary to the *Rules of Professional Conduct* or an abuse of process.

Part of the advice to the debtor should also include the fact that Rule 57 does exist, and besides having a professional responsibility there is also the financial risk that a lawyer takes in attempting to pursue a matter that is frivolous and vexatious and only for the purpose of delay. It is advisable to do a confirming letter, or at the very least a memo to file, in order to protect against the "renegade client".

Obviously, the stronger the defence the more likely the debtor will obtain the time necessary for business recovery.

Counsel should also advise that the present system encourages matters to proceed expeditiously. Case Management helps control the process. However, the Masters office as presently organized has an unfortunate built in delay, as the scheduling of Master's motions is now by appointment, with unfortunate lead time required to make arrangements for motions.

## **PROCEDURAL CONSIDERATIONS**

### ***a. Interlocutory Relief***

Whether you have moved for interlocutory relief or are responding to it, the following are important considerations:

- whether moving or responding, an interlocutory motion provides the opportunity to cross-examine and obtain production of documents and files;
- if an order has been obtained without notice, for instance, a certificate of pending litigation or a mareva injunction, you can take advantage of Rule 39.01(6) of the *Rules of Civil Procedure*, by bringing a motion to set aside the order based on failure to make full disclosure;
- take advantage of the opportunity to negotiate with opposing counsel;
- be cognizant of the appeal procedures and the effect of an appeal on whether proceedings are stayed. See Rules 61, 62 and 63 of the *Rules of Civil Procedure*. When advising a client about the effect of an appeal, remember that interlocutory matters require leave and the test for leave to appeal is not easily satisfied<sup>50</sup>. As well, there is seldom a stay of an interlocutory decision;
- consider carefully whether to bring an interlocutory injunction. To begin with, it is important to caution the debtor that such motions are costly and risky. As well, injunctions are not often granted, especially in the circumstances that face debtors. For example, the circumstances where the court will grant an interlocutory injunction to restrain the exercise of a Notice of Sale under Mortgage or stop the sale of a property are rare as it is extremely difficult to demonstrate that irreparable harm that cannot be compensated for in damages will be suffered by the debtor, if the property is sold. Finally, the injunction will not succeed if the undertaking as to damages provided by the debtor has no substance due to the debtor's financial situation.

As a closing comment, do not underestimate the importance of interlocutory relief, as litigation is often resolved at the interlocutory stage. This may be the best opportunity to

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<sup>50</sup> Rule 62.02(4) of the *Rules of Civil Procedure*

attempt settlement, especially if the interlocutory proceedings have been costly to the creditor and/or the debtor has been successful on any interlocutory motions.

**b. *The Motion for Summary Judgment***

In most cases, the major hurdle that the debtor must overcome is fending off a motion for summary judgment. At least one good defence is essential. However, proper planning can at least give the debtor a fair opportunity of raising a triable issue and avoiding summary judgment. On behalf of the debtor, it is advisable for the solicitor to not only prepare the pleading but also the affidavit of documents. There is nothing preventing the service of the affidavit of documents with the Statement of Claim or the Statement of Defence, although it is advisable to wait until the pleadings are completed, and issues defined, to ensure all relevant documents are available and produced. But if the affidavit of documents is complete and ready to be served, then as soon as pleadings are closed, counsel may serve the affidavit of documents and an appointment for discovery. This should allow the debtor to have an examination for discovery and review of all the creditor's documents prior to any motion for summary judgment. If there is a defence, either one that is apparent from the debtor's information and documents or one that arises from the creditor's productions, counsel will have a much better chance of successfully raising the defence.

If counsel succeeds in overcoming the threshold test and avoiding summary judgment<sup>51</sup>, some negotiating leverage may be gained. The creditor is then faced with the prospect of the proceedings taking substantially longer, before a trial and any possible judgment is obtained.

**c. *Mediation***

In Toronto, 1 in 10 actions is selected for mandatory mediation, Counsel must be prepared to deal with mandatory mediation, even in creditor-debtor actions.

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<sup>51</sup> *Guarantee Co. of North America v. Gordon Capital Corp. et al* (1999) 178 D.L.R. (4<sup>th</sup> 1 (S.C.C.) rev'g. (1998) 38 O.R. (3d) 563, rev'g. (1997) 32 O.R. (3d) 428 (O.C.A.)

Parties are often required to attend mandatory mediation before discovery has been commenced. This can work to the detriment of the debtor as discovery often gives the debtor the opportunity to obtain information to support his claim. This is especially true where the creditor is a financial institution and much of the documentary support for the debtor's defence (or counterclaim) is found in the creditor's files. For instance: where the debtor alleges that the Bank did not obtain consent to the renewal or extension of a guarantee, there will often be a note in the file of the Bank that no one contacted the guarantor or that there is no evidence that the Bank attempted to obtain the consent of the guarantor to a material change. If the debtor goes to mediation without that evidence, then he will have difficulty supporting his case at the mediation.

Under Rule 24.1.09(3), it is permissible to postpone the mediation session for up to 60 days if all parties consent to an extension of time for completion of the mediation, and this can allow for completion of discoveries. However, if this extension is obtained, discoveries have to be completed in a timely fashion in order to stay onside of the time requirements of Rule 24.1.09(1). The court also, if certain pre-conditions are met, may extend the time for the mediation session<sup>52</sup>.

Mandatory mediation does raise another concern. At this early stage, the debtor may be disadvantaged by disclosing his entire case before discovery and without the protection that the information will not later be used against him. However, on the flip side, for mediation to be effective, disclosure should be made. A compromise can only be reached, in all likelihood, by counsel for the debtor disclosing information that is of concern, to the mediator only, and not to counsel for the creditor.

Many believe that creditor-debtor actions do not easily lend themselves to mediation. However, since mediation promotes creative solutions, if the debtor can present to the creditor some incentive to settle or some solution that does not necessarily involve immediate payment, then it can be successful.

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<sup>52</sup> Rule 24.1.09(2) of the *Rules of Civil Procedure*

While the *Rules of Professional Conduct* govern various ethical obligations during litigation and state that counsel should "advise and encourage" settlement<sup>53</sup>, those rules do not specifically address negotiations or the dispute resolution processes. For a complete discussion of these issues, see "*Managing Mediation: Playing by the Rules, The Ethics of Misrepresentation in Informal Dispute Resolution*" by Fredrick H. Zemans<sup>54</sup>.

## THE TRIAL

It is seldom that this type of action reaches a full trial. The reasons are twofold: first, in Toronto only a small percentage of actions filed ever go to trial; second, many creditor-debtor actions are disposed of prior to trial either through motions for summary judgment or settlement. However, and especially in light of the recent jurisprudence respecting summary judgment motions, more creditor-debtor actions may reach trial.

It is not unusual for the debtor to ask his counsel on the eve of trial to attempt to obtain an adjournment. This is easier said than done. If there is a genuine reason for asking for an adjournment and it can be supported, then an adjournment should be requested. However, if the request for an adjournment is simply to delay the trial in order to obtain more time for the debtor, then counsel must scrutinize the request carefully. The *Rules of Professional Conduct* clearly provide that counsel must be honest with the court. More and more the court will challenge the reasons for an adjournment. If the reasons cannot be supported, then not only will counsel have misled the court and lost the chance for an adjournment, but her credibility will be tarnished. Again, do not cry "wolf". It is easy to become carried away with the debtor's enthusiasm and momentum, however, this is only one client, and counsel must ensure that she does not lose her credibility with the court with the result that the next client is prejudiced by that loss of credibility. As well, there is always Rule 57 to contend with.

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<sup>53</sup> Rule 10 of the *Rules of Professional Conduct*, commentary 6

<sup>54</sup> Zemans, Frederick H., *Managing Mediation: Playing by the Rules, The Ethics of Misrepresentation in Informal Dispute Resolution*, given at the Canadian Bar Association - Ontario, May 2, 1997

## APPEALS

If a judgment is issued against the debtor, if it is for more than \$25,000.00<sup>55</sup>, there is an automatic right of appeal to the Court of Appeal<sup>56</sup>. As well, if the judgment is for money alone, then it will be stayed pending the determination of the appeal<sup>57</sup>. Remember that while there is a stay, the judgment creditor can still register a Writ of Seizure and Sale<sup>58</sup>.

Presently, the Court of Appeal can hear an appeal from a successful motion for summary judgment within six to nine months. The debtor should be aware that while launching an appeal may afford him some additional time, the appeal will still be heard quite quickly and an appeal is costly. Obviously, appeals from trials take longer given that the transcripts must be ordered. As well, if it is a frivolous appeal by the debtor, calculated only to obtain time, then there is the possibility that the creditor will move to quash the appeal immediately rather than wait for the hearing.

However, the debtor, who has a frivolous appeal and intends to appeal only to delay the enforcement of the judgment, should be made aware of section 163(1)(f) of the Bankruptcy and Insolvency Act which provides that a debtor who puts any of his creditors to unnecessary expense by a frivolous or vexatious defence to any action properly brought against him, which will include an appeal, and then later goes bankrupt, then that fact may be considered on his discharge.

## SETTLEMENT CONSIDERATIONS

The discussion of settlement negotiations comes at the end of this paper not because it should be the last consideration, but rather because settlement should be one of the primary considerations at every step of the litigation. Preferably counsel will begin settlement discussions once she has placed the debtor in some position of strength. In cases such as these, this position of strength will often result after the debtor has been

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<sup>55</sup> Section 19(1) of the *Courts of Justice Act*, R.S.O. 1990, c.C. 43

<sup>56</sup> Section 6(1) of the *Courts of Justice Act*, R.S.O. 1990, c.C. 43

<sup>57</sup> Rule 63.01 of the *Rules of Civil Procedure*

<sup>58</sup> Rule 63.03(3) of the *Rules of Civil Procedure*

successful on an interlocutory motion, for example for production, or has successfully defended a motion for summary judgment.

Perhaps the most difficult aspect of acting for the debtor is how to deal with statutory declarations. More often than not, a creditor, especially a financial institution, will require the debtor to provide a statutory declaration before agreeing to settle. The problems with doing this are twofold. The first is procedural: for once the debtor has disclosed his assets by way of statutory declaration, the creditor is in possession of information that it normally would not be entitled to until after it has obtained a judgment and conducted examinations in aid of execution. The second is an ethical dilemma for counsel: what to do when you know the debtor is not disclosing all assets in his statutory declaration or when the debtor tells counsel that he will not disclose all assets.

The first problem can be solved using a variety of methods. The method chosen will depend upon how close to settlement the parties are and the degree of trust counsel has in opposing counsel and the creditor. The first method is to conduct settlement discussions on the basis of a hypothetical net worth. The debtor would not deliver a statutory declaration. Instead, counsel would advise opposing counsel that presuming the debtor has a net worth of \$X and exigible assets worth \$Y, is the creditor prepared to settle. Final settlement would be contingent upon the statutory declaration establishing the net worth and exigible assets of \$X and \$Y, respectively. The advantages of this method are that not only is the debtor not swearing under oath to a statutory declaration, but also the debtor is not identifying the assets themselves. This method is helpful where there is little trust between the parties.

The second method is to deliver a statutory declaration to counsel for the creditor in draft, with the conditions that no copies will be made, the original will be returned to the debtor and the information will not be used against the debtor. While this method discloses the identity of the assets, it makes it more difficult for the creditor to record the assets of the debtor. This method can be used where there is only limited trust between the creditor and debtor and the creditor insists upon full disclosure of assets before settlement.

The second problem of how much of the debtor's assets to disclose and what to disclose is a difficult one. On the one hand, there is a duty of confidentiality to the debtor, the client, and consequently counsel cannot disclose assets that our client instructs not to. On the other hand, counsel cannot knowingly mislead the court or other counsel. Again, not only is it contrary to the *Rules of Professional Conduct*, but doing so will also impact negatively on counsel's credibility, making it more difficult to settle. In the result, if counsel knows that the debtor intends to perjure himself by swearing a statutory declaration that is false, counsel can no longer act. A positive duty to withdraw will occur where counsel is instructed to do something inconsistent with her duty to the court or where the client is guilty of dishonourable conduct in the proceedings, or is taking a position solely to harass or maliciously injure another, or while the continued retainer will lead to a breach of the *Rules of Professional Conduct*<sup>59</sup>. There is no difference between a false statement under oath at trial and one in a statutory declaration.

The disclosure by the debtor of his assets to counsel is not without risks if the debtor later goes bankrupt. Before the debtor is bankrupt clearly anything disclosed to counsel is governed by solicitor-client privilege (except information in furtherance of the commission of a crime)<sup>60</sup>.

However, once the debtor becomes bankrupt, the debtor's property is passed to his Trustee in Bankruptcy. What does not pass is the debtor's legal right, power or authority to waive the debtor's solicitor-client privilege in respect of professional legal advice and opinions rendered to the debtor.<sup>61</sup>

However, even though the Trustee in Bankruptcy cannot waive the solicitor-client privilege, the debtor's counsel can be compelled to disclose information respecting the bankrupt's

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<sup>59</sup> Rule 8, Commentary 8 of the *Rules of Professional Conduct*

<sup>60</sup> Rule 4, commentary 10 and 11 of the *Rules of Professional Conduct*

<sup>61</sup> *Re Chilcott and Clarkson Co. Ltd.* (1984) 48 O.R. (2d) 545, (O.C.A.), *Re Bre-X Minerals Ltd.* [1998] A.J. No. 1370 (Alta. Q.B.)

affairs. The Honourable Mr. Justice Lacourciere stated in *Re Chilcott and Clarkson Co. Ltd.*:

“In our view, the appellant [the counsel] can be compelled to disclose all information regarding the bankrupt’s affairs, transactions and the whereabouts of his property, etc. which do not require the disclosure of communications made to the appellant for the purpose of giving legal advice. These communications with respect to property are not privileged ...The privilege attaches, however, to all information requested by the client for the purpose of obtaining professional advice and assistance and given for that purpose: *Solosky v. The Queen* [1980] 1 S.C.R. 821, 105 D.L.R. (3d) 745, 50 C.C.C. (2d) 495. This fundamental privilege normally can only be waived by the client or lost in special circumstances which do not pertain in the present case”<sup>62</sup>.

Such special circumstances will include cases where the Court is satisfied that there has been some fraudulent conduct or a fraudulent preference.<sup>63</sup>

There is always the tension between how much of the debtor's assets to use to defend the action versus the use of the assets to settle the action. It is a good practice at the outset to earmark certain funds for defence and have a strategy in place should the defence not be successful or the debtor run out of resources.

## **RETAINER ARRANGEMENTS WITH THE DEBTOR**

There are a number of important considerations that counsel must be aware of when representing a debtor prior to judgment. Often, the last person who financed the debtor is on the other end of the lawsuit for which counsel is being retained. But the debtor may not have adequate funds to meet his everyday expenses, before the unusual expense of legal fees. Counsel should have the debtor sign a proper retainer agreement, which should provide for some form of security for payment such as a guarantor or collateral security, if available. If a third person is involved independent legal advice may be required to ensure that there are no disputes in the future. If there is a potential of recovery of funds in the future, then an irrevocable direction as to funds may be helpful. If the debtor cannot provide an adequate initial retainer, then it may be helpful to obtain a consent to act in

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<sup>62</sup> *Re Chilcott and Clarkson Co. Ltd.*, supra at page 548 (O.C.A.)

<sup>63</sup> *Pax Management Ltd. v. Canadian Imperial Bank of Commerce* (1987) 14 B.C.L.R. (2d) 257 (C.A.)

person from the debtor, which counsel has the discretion to serve and file, should the retainer promises not be kept by the debtor.

Another concern is if the debtor wishes to pay in cash. The debtor may have signed documentation with a financial institution, which requires all receipts of the business to be deposited in the account at the financial institution. Counsel does not want her retainer to be in jeopardy. It is better to receive a certified cheque from a third party rather than cash. However if cash is the method of payment it may be advisable to have the debtor confirm in writing the source of the funds. Counsel must confirm all arrangements in writing.

If there is a *mareva* injunction outstanding against the debtor then counsel must be careful in dealing with funding of the retainer. A third party will often have to be involved to ensure that counsel is adequately retained without the risk of assisting in the breach of a court order. Counsel should be able to have the order amended to provide for the payment of legal fees, but that order may not be quickly obtainable.

Can the funds in counsel's trust account be garnished? Counsel will be pleased to know that there is now favourable case law that provides that a monetary retainer is not garnishable<sup>64</sup>. A properly drafted retainer agreement allows counsel to remove the funds from trust immediately.

## **CONCLUSION**

The representation of a debtor is always a challenging one. Without "good facts" there is often little to be done. But if there are some facts that point to unfair treatment of the debtor by the creditor, it may be possible to assist the debtor in reaching a favourable resolution.

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<sup>64</sup> *Re Toronto-Dominion Bank and Cooper, Sandler, West & Skurka* (1998) 37 O.R. (3d) 729 (Div. Ct.)