COURT FILE NO.	B201-996918, B201-997457, B201-997541
COURT	COURT OF KING'S BENCH OF ALBERTA IN BANKRUPTCY AND INSOLVENCY
JUDICIAL CENTRE	CALGARY
MATTER	IN THE MATTER OF THE BANKRUPTCY OF NOMODIC MODULAR STRUCTURES INC., AITHRA PROJECTS INC. AND NOMODIC MODULAR STRUCTURES (ONTARIO) LTD.
APPLICANT	NORTHERN VISION DEVELOPMENT LIMITED PARTNERSHIP
RESPONDENTS	FTI CONSULTING CANADA INC., in its capacity as Trustee in Bankruptcy of NOMODIC MODULAR STRUCTURES INC., AITHRA PROJECTS INC. and NOMODIC MODULAR STRUCTURES (ONTARIO) LTD.
DOCUMENT	**BOOK OF AUTHORITIES TO THE BRIEF OF LAW OF NORTHERN VISION DEVELOPMENT LIMITED PARTNERSHIP RE: TRUST CLAIM**

LL

JUDICIAL CENTRE OF CALGARY
FILED
Jun 18, 2024
by Email
CLERK OF THE COURT

C61021
Jun 27, 2024
COM

ADDRESS FOR SERVICE AND CONTACT INFORMATION OF PARTY FILING THIS DOCUMENT

Ryan F.T. Quinlan & Gil Miciak
Barrister & Solicitor
Phone: (780) 441-4336
Fax: (780) 428-9683
Email: rquinlan@dcllp.com;
gmiciak@dcllp.com

File 445-215880
DUNCAN CRAIG LLP
LAWYERS MEDIATORS
2800 Rice Howard Place
10060 Jasper Avenue
Edmonton, Alberta Canada T5J 3V9

TABLE OF AUTHORITIES

TAB 1

OOSTERHOFF ON TRUSTS:
TEXT, COMMENTARY AND MATERIALS

Eighth Edition
by

A.H. OOSTERHOFF
B.A., LL.B., LL.M.
of the Ontario Bar
Professor Emeritus, Faculty of Law
The University of Western Ontario

ROBERT CHAMBERS
B.Ed., LL.B. (Alta.), D.Phil. (Oxon.)
of the Alberta Bar
Professor of Property Law, Faculty of Laws University College London

MITCHELL McINNES
B.A., LL.B., LL.M., Ph.D. (Cantab.)
of the Alberta Bar
Professor, Faculty of Law
The University of Alberta

CARSWELL®

which a defendant might escape liability. First, he held that the plaintiff should be denied recovery if it culpably failed to take steps to prevent the transfer from occurring. Second, he held that the defendant should not be held liable, despite possession of constructive knowledge of the existence of a trust, if reasonable inquiries would not have actually revealed that the impugned transfer would constitute a breach of trust. Should those proposals be adopted?

17. Is the action in knowing receipt available within the context of a Torrens land titles system? See *Arthur v. Attorney General of the Turks & Caicos Islands (Turks and Caicos Islands)*.[248]

18. The executor of an estate opened a bank account in his name as "executor of A, deceased." The executor then drew on the account over a period of three years by issuing cheques, signed by him as "executor of A, deceased," in favour of a turf accountant.[249] The executor would take these cheques to the turf accountant after banking hours and receive cash for them, and the turf accountant would later cash them at the bank. The executor is now insolvent. Does the estate have an action against the turf accountant?[250]

19. The Supreme Court of Canada's decision in *Citadel Assurance* has been applied on a number of occasions.[251] In *Banton v. CIBC Trust Corp.*, however, the Ontario Court of Appeal failed to cite *Citadel Assurance*, curiously preferring to resolve the issue of knowing receipt instead on the basis of American authorities.[252]

18.6 TRUSTEES *DE SON TORT*

A person who, although not appointed a trustee, intermeddles in a trust by assuming some or all of the obligations of the trustee, is regarded as a constructive trustee of the trust property for the beneficiaries. In *Mara v. Browne*[253] A.L. Smith L.J. described such a person as follows:

> . . .if one, not being a trustee and not having authority from a trustee, takes upon himself to intermeddle with trust matters or to do acts characteristic of the office of trustee, he may thereby make himself what is called in law a trustee of his own wrong — i.e., a trustee de son tort, or, as it also termed, a constructive trustee.

248 [2012] UKPC 30. See also N. Hopkins, "Recipient Liability in the Privy Council" [2013] Conv. & Prop. Law. 61; L. Bennett Moses, "Knowing Receipt of Torrens Land in the Turks and Caicos Islands" (2013), 7 J. of Equity 74; M. Conaglen & A. Goymour, "Knowing Receipt and Registered Land" in C. Mitchell (ed.), *Constructive and Resulting Trusts* (Oxford: Hart, 2010) 159.

249 A "bookie" in the North American vernacular.

250 *Nelson v. Larholt* (1947), [1948] 1 K.B. 339, [1947] 2 All E.R. 751.

251 See, for example, *Waxman v. Waxman* (2002), 25 B.L.R. (3d) 1 (Ont. S.C.J.), additional reasons at [2002] O.J. No. 3533 (S.C.J.), additional reasons at (2003), 30 C.P.C. (5th) 121 (Ont. S.C.J.), varied (April 30, 2004), Doc. CA C38611, C38616, C38624 (Ont. C.A.); *Silverman Jewellers Consultants Canada Inc. v. Royal Bank* (2001), 53 O.R. (3d) 97 (C.A.); *Ontario (Director, Real Estate & Business Brokers Act) v. NRS Mississauga Inc.* (2003), 226 D.L.R. (4th) 361 (C.A.), additional reasons at (2003), 1 E.T.R. (3d) 220 (Ont. C.A.), leave to appeal refused 2003 CarswellOnt 5191 (S.C.C.).

252 (2001), 197 D.L.R. (4th) 212 (Ont. C.A.), leave to appeal refused (2001), 276 N.R. 395 (note) (S.C.C.), critiqued in M. McInnes, "Knowing Receipt and The Protection of Trust Property" (2002), 81 Can. Bar Rev. 171.

253 [1896] 1 Ch. 199 (C.A.). See also *Merritt v. Klijn*, 2002 ABQB 729.

As in other areas that we have examined, the choice of terminology is not necessarily the most illuminating. Lord Millett has suggested that, "[s]ubstituting dog Latin for bastard French, we would do better to describe such persons as *de facto* trustees."[254]

A trustee *de son tort* is a person who knowingly deals, as a trustee, with trust property. It would be a mistake, however, to believe that liability is based on dishonesty.[255] The doctrine often is triggered in good faith. Within a tight family unit, for example, a person may genuinely feel obliged or authorized to deal with another's property.[256] The doctrine is based instead on the fact of taking control of the property and administering it on behalf of the beneficiaries. The second half of that description is important. The label of "trustee *de son tort*" does not apply every time that a stranger knowingly deals with trust property. The person additionally must purport to act as a trustee. To judge from the case reports, that is an unusual occurrence. There are relatively few successful claims of trustee *de son tort*.[257]

Once a person has been adjudged to be a trustee *de son tort*, the remedy is simplicity itself. Someone who purports to act like a trustee is treated like a trustee.[258] The trustee *de son tort*'s responsibilities consequently are co-extensive with those of a true trustee: compensatory liability for breach is strict, tainted gains must be disgorged, property must be held on trust,[259] and so on.[260] Against that backdrop, it is not surprising to learn that the term "trustee *de son tort*" was adopted by analogy from the term "executor *de son tort*,"[261] and that both are manifestations of a larger principle. In equity, a person who improperly assumes a position generally is held to the standards of that position. A person who acts as a fiduciary assumes the responsibilities of a true fiduciary. Accordingly, for instance, a person who purports to act as an agent is liable to account to the "principal" in the same way as a true agent.[262]

Liability as a trustee *de son tort* requires that the person be in possession of the trust property, or at least be in a position to call for the property, so as to facilitate its administration. *Re Barney*[263] illustrates that rule. The testator appointed his widow to be his trustee and she continued to operate the testator's business. Two of the testator's friends agreed to help her by checking the business

254 *Aluminium Company Ltd. v. Salaam*, [2003] 2 A.C. 366 (H.L.) at 403.

255 *Re Preston* (1906), 13 O.L.R. 110 (Div. Ct.).

256 *Chambers v. Chambers Estate*, 2013 ONCA 511 (widower effectively renounced appointment as estate trustee, but continued to administer estate as trustee *de son tort*).

257 *Jasmine Trustees Ltd. v. Wells & Hind (a firm)*, [2008] Ch. 194.

258 *Montreal Trust Company of Canada* v. *Hickman*, 2001 NFCA 42 at [42].

259 Notice that the obligation to hold property on trust distinguishes the trustee *de son tort* from the other heads of constructive trustee. A person liable for knowing assistance or knowing receipt is treated as a pretend trustee, so as to facilitate the imposition of a personal debt in favour of the beneficiary. In contrast, the relationship between a beneficiary and a trustee *de son tort* is mediated through trust property.

260 *Maguire v. Maguire* (1921), 64 D.L.R. 204 (Ont. H.C.).

261 The latter is described in *Re O'Reilly (No. 2)* (1981), 28 O.R. (2d) 481 (H.C.) at 485-486.

262 *Blyth v. Fladgate*, [1891] 1 Ch. 337.

263 [1892] 2 Ch. 265.

accounts regularly and an arrangement was made with the bank whereby the bank would not honour the trustee's cheques unless the two friends' initials appeared on them. The two friends were held not liable as trustees *de son tort* in proceedings by the testator's children because they did not have title to the property.

Re Barney can be contrasted with *Maguire v. Maguire*.[264] The deceased was a guardian for the plaintiff, her nephew. The plaintiff persuaded her to lend a sum of money from his estate to a third party. She consulted the individual defendant, the plaintiff's older brother and, at his suggestion, gave him the money to lend to the third party. The individual defendant lent the money to the third party as intended, taking back a note which he turned over to his aunt. The third party defaulted and was judgment-proof. The plaintiff then sued his brother and his aunt's estate. The latter was not liable because the plaintiff had executed a release in favour of his aunt after he reached the age of majority. The brother was held to be a trustee *de son tort* because he received trust money with notice, had possession of it and purported to act as trustee. He then breached the trust by lending the money without security. In the end the brother was held not liable because the plaintiff, in effect, adopted the transaction by not bringing action for five years after reaching the age of majority.

Notes and Questions

1. A trustee decided to put trust money into a joint account with X on the ground that the moneys would be more secure that way. X was not required to co-sign any of the trustee's cheques. When a loss occurred, the beneficiaries sued X. What is the result?[265]

2. A died intestate in respect of certain real property which B had been managing for him. After A's death B continued to collect the rents without telling the lessees of A's death. B placed the funds in a separate account. In due course A's heirs were located and they wish to bring action against B to recover the funds. What cause of action do A's heirs have?[266]

3. A died possessed of real property of his own and real property in respect of which he was a trustee for others under the will of X. He devised the former to his sister, B. B assumed to act as trustee under X's will and sold some real property belonging to that trust. She allowed C to take the proceeds and to apply them for his own use in breach of trust. After B's death, X's beneficiaries sued B's estate. What is the result?[267]

4. I Ltd. lent money on mortgages. It did not do so directly, but acted through V Ltd., a mortgage broker. V Ltd. would make proposals of suitable investment opportunities to I Ltd. and, if the latter agreed, it would advance money to V Ltd. V Ltd. would then lend I Ltd.'s money and money of other investors to the borrower and take a mortgage in return, which it held in trust for the investors in the proportions in which they had contributed. Typically, therefore, I Ltd. did not advance the full amount of a mortgage, but participated in it with others. RD was the president and major shareholder of V Ltd. and made all policy decisions. BD was another director of V Ltd.

264 (1921), 64 D.L.R. 204 (Ont. H.C.).
265 *Constantine v. Ioan* (1969), 67 W.W.R. 615 (B.C. S.C.).
266 *Lyell v. Kennedy* (1889), 14 App. Cas. 437.
267 *Life Association of Scotland v. Siddal* (1861), 3 De. G. F. & J. 58, 45 E.R. 800.

I Ltd. agreed to participate in the usual fashion in a mortgage to Mr. L. There was to be a first mortgage in favour of V Ltd. on certain property (lot A) owned by Mrs. L, together with a charge on Mrs. L's interest as unpaid vendor in another property (lot B).

Later Mrs. L exchanged her interest in lot B for another property (lot C) and V Ltd.'s charge on lot B was discharged and replaced with a charge on lot C. The defendants did not have a fraudulent intention in doing so.

Mr. and Mrs. L then defaulted on the loan and V Ltd. went into liquidation. I Ltd. and the other investors released the mortgage in consideration of an amount much less than that owing. I Ltd. brings an action for breach of trust against V Ltd., RD and BD. What is the appropriate result?[268]

5. A bank lent K $180,000 as a deposit on a share purchase on the understanding that the funds would be held in trust by K's lawyer, B, and would be returned if the purchase did not take place. Subsequently, B informed K that $100,000 of money held in the trust account was going to be used to cover fees owed by K to the law firm. The bank brought an action for the return of the funds. What is the appropriate result?[269]

268 *Island Realty Investments Ltd. v. Douglas* (1985), 19 E.T.R. 56 (B.C. S.C.).
269 *Royal Bank v. Fogler, Rubinoff* (1991), 84 D.L.R. (4th) 724 (Ont. C.A.).

TAB 2

Air Canada v. M & L Travel Ltd.

Supreme Court Reports

Supreme Court of Canada

Present: La Forest, Sopinka, Gonthier, Cory, McLachlin, Iacobucci and Major JJ.

1993: April 26 / 1993: October 21.

File No.: 22416

[1993] 3 S.C.R. 787 | [1993] 3 R.C.S. 787 | [1993] S.C.J. No. 118 | [1993] A.C.S. no 118

Ross Valliant, appellant; v. Air Canada, respondent.

ON APPEAL FROM THE COURT OF APPEAL FOR ONTARIO (69 paras.)

Case Summary

Trusts — Directors of closely held corporation — Business of corporation a travel agency — Agreement between travel agency and airline for ticket sales — Receipts less commission to be forwarded to airline — Notwithstanding separate trust account for money from ticket sales, money placed in travel agency's general account — Business difficulties resulting in directors making independent and contradictory instructions to bank as to operating account — Bank withdrawing amount owing it on line of credit to travel agency pursuant to terms of credit agreement — Airline suing directors personally for monies owing it — Whether relationship between travel agency and airline one of trust or of debtor and creditor — If trust relationship, whether directors personally liable for breach of trust by corporation.

Appellant borrowed money on a personal loan, invested it in a travel agency and paid the interest from the agency's general banking account. He became one of the agency's two directors and its vice-president. While both directors had signing authority, the day-to-day operation of the business was left to the other director. The travel agency, on becoming a member of IATA, signed a passenger sales agency agreement with IATA (conferring the right to sell air carrier tickets and receive commissions) and a passenger sales agency agreement with Air Canada (authorizing the agency to receive blank airline ticket stock for Air Canada and to issue tickets directly to the public). Funds collected from the sale of Air Canada tickets were to be held in trust by the [page788] travel agency and were to be paid twice a month to Air Canada. These payments were regularly made until March 1979.

The travel agency obtained an operating line of credit from a chartered bank in 1978. The monies advanced under the line of credit and interest thereon constituted a demand loan in favour of the Bank. Both directors personally guaranteed the loan and authorized the Bank to remove any monies owing on the loan at any time from the agency's general account. Although a trust account was set up by the managing director for the deposit of the airline funds held by the agency, these funds were maintained in the agency's general operating bank account.

A dispute arose between the directors in April 1979. The managing director discovered cancelled cheques for the instalment payments on appellant's personal loan. It was his understanding that appellant had agreed to cease making the payments for the time being and he stopped payment on the last instalment cheque. Appellant suspected the managing director of misappropriating funds and stopped payment on all cheques and withdrawals. At this time, the travel agency owed Air Canada $25,079.67 for ticket sales.

The travel agency was closed for 10 days. Both directors, through their solicitors, negotiated for the purchase by one of the other's interest and both, during this time, made efforts to pay Air Canada. Appellant testified that he opened a trust account, drew cheques for the monies that were still in the company account, withdrew the stop payment orders, and attempted to transfer the funds into the new trust account. The Bank refused to transfer the funds or to honour the cheques made out to Air Canada because of the conflicting instructions from the two

directors. The Bank, after sending demand notices, withdrew the full amount owing it under the line of credit from the travel agency's general account.

Air Canada sued the travel agency and both directors personally for the money owed to it for ticket sales. Its claim against the travel agency was successful but the claim against the two directors was dismissed. Air Canada successfully appealed the judgment as it related to the two directors and judgment was entered against them as well. At issue here were: (1) whether the relationship between travel agency and respondent was one [page789] of trust, or one of debtor and creditor; and (2) if the relationship was one of trust, under what circumstances could the directors of a corporation be held personally liable for breach of trust by the corporation, and were those circumstances present here. The legal issue raised by this second ground of appeal concerned the standards for the imposition of personal liability to be applied to strangers who participate in a breach of trust. Although involving a corporation, the case fell to be resolved on trust principles, and does not raise general questions of the personal liability of directors for the acts of the corporation.

Held: The appeal should be dismissed.

Per La Forest, Sopinka, Gonthier, Cory, Iacobucci and Major JJ.: The relationship was conceded to be one of trust. The wording of the agreement evidenced an intention to create a trust. Respondent was the object of the trust and the money collected for ticket sales its subject matter. Given the intention to create a trust in the agreement between the travel agency and respondent, the absence of a prohibition on the commingling of funds could be considered but was not determinative of the type of relationship. The setting up of the trust account and the fact that the IATA agreement allowed the travel agency to affect Air Canada's legal responsibilities indicated a relationship consistent with a trust relationship. The travel agency breached the trust when it failed to account to the respondent for the monies collected through sales of Air Canada tickets.

The imposition of personal liability on a stranger to a trust depends on whether the stranger's conscience is sufficiently affected to justify the imposition of personal liability. A stranger to the trust can be held liable as a constructive trustee for breach of trust (trustee de son tort). The stranger, although not appointed a trustee, takes on him- or herself to act as trustee and to possess and administer trust property and becomes liable if he or she commits a breach of trust while acting as a trustee. This type of liability is inapplicable here because the directors did not personally take possession of trust property or assume the office or function of trustees.

[page790]

Strangers to the trust can also be personally liable for breach of trust if they knowingly participate in a breach of trust. They either were acting as a trustee in receipt and chargeable with trust property (a constructive trusteeship termed "knowing receipt") or they knowingly assisted in a dishonest and fraudulent design on the part of the trustees (termed "knowing assistance"). Since the "knowing receipt" category did not apply here, the only basis upon which the directors could be held personally liable was as constructive trustees under the "knowing assistance" head of liability. This basis of liability raises two main issues: the nature of the breach of trust and the degree of knowledge required of the stranger.

The knowledge requirement for this "knowing assistance" type of liability is actual knowledge; recklessness or wilful blindness will suffice. A person will be deemed to have known of the trust if it was imposed by statute. If the trust was contractually created, then whether the stranger knew of the trust will depend on his or her familiarity or involvement with the contract.

The receipt of a benefit as a result of the breach of trust will be neither a sufficient nor a necessary condition for the drawing of an inference that a stranger knew of the breach. Constructive notice has been found to be insufficient to bind the stranger's conscience so as to give rise to personal liability. While cases involving recklessness or wilful blindness indicate a want of probity which justifies imposing a constructive trust, the carelessness involved in

constructive knowledge cases will not normally amount to a want of probity, and will therefore be insufficient to bind the stranger's conscience.

Whether the breach of trust was fraudulent and dishonest must be considered, not whether the appellant's actions should be so characterized. The stranger will be liable if he or she knowingly assisted the trustee in a fraudulent and dishonest breach of trust. Therefore, it is the corporation's actions which must be examined. Where the trustee is a corporation, rather than an individual, the inquiry as to whether the breach of trust was dishonest and fraudulent may be more difficult to conceptualize, because the corporation can only act through human agents who are often the strangers to the trust whose liability is in issue. The appellant's actions were [page791] relevant to this examination, given the extent to which the travel agency was controlled by the defendant directors.

The breach of trust by the travel agency was dishonest and fraudulent from an equitable standpoint. The taking of a knowingly wrongful risk resulting in prejudice to the beneficiary is sufficient to ground personal liability. As a party to the contract between itself and the respondent, the travel agency knew that the Air Canada monies were held in trust for the respondent, and were not for the general use of the travel agency. It set up trust accounts, but never used them. It also knew that any positive balance in its general account was subject to the Bank's demand. By placing the trust monies in the general account which were then subject to seizure by the Bank, the travel agency took a risk to the prejudice of the rights of the respondent beneficiary, Air Canada. It had no right to take this risk.

Appellant participated or assisted in the breach of trust. He dealt with the funds in question -- he stopped payment on all cheques, opened a trust account, and attempted to withdraw the stop payment orders and to transfer the funds into the new trust account in order to pay the respondent. The breach of trust was directly caused by the conduct of the defendant directors. Their actions in stopping payment on the cheques to protect their own interests not only prevented payment on cheques issued to Air Canada but also precipitated the seizure by the Bank of the only funds available in the unprotected general account. The directors are personally liable for the breach of trust as constructive trustees provided that the requisite knowledge on the part of the directors is proved.

The knowledge requirement will not generally be a difficult hurdle to overcome in cases involving directors of closely held corporations. Such directors, if active, usually have knowledge of all of the actions of the corporate trustee. Here, however, the appellant was not as closely involved with the day-to-day operations as was the other director. He nevertheless knew of the terms of the agreement between the travel agency and the respondent airline because he signed that agreement and he knew that the trust funds were being deposited in the general bank account, which was subject to the demand loan from the Bank. This constitutes actual knowledge [page792] of the breach of trust because even without subjective knowledge of the breach of trust, given the facts of which he did have subjective knowledge, he was wilfully blind to the breach, or reckless in his failure to realize that there was a breach. Furthermore, appellant received a benefit from the breach of trust, in that his personal liability to the Bank on the operating line of credit was extinguished. Therefore, he knowingly and directly participated in the breach of trust, and is personally liable to the respondent airline for that breach.

Per McLachlin J.: The relationship between the corporation and Air Canada was one of trust, not debtor and creditor. Appellant was clearly liable as a constructive trustee for the breach of trust which the corporation committed respecting Air Canada's account.

A number of issues should not be decided here but rather left for consideration in cases in which they might arise. A stranger to a trust must know of his or her participation in a breach of trust to be personally liable for it. It was not necessary, however, to decide whether subjective knowledge (actual knowledge of the breach or wilful blindness and recklessness) or objectively determined knowledge (what a reasonably diligent person would have known) is necessary. The evidence here met the higher standard of subjective knowledge. It was also unnecessary to decide whether any breach could give rise to liability or whether the breach had to be fraudulent or dishonest because the breach here was fraudulent and dishonest in the sense that it involved a risk to the property to the prejudice of the beneficiary. Lastly, a decision as to whether liability could be imposed in the absence of personal benefit did not need to be made because appellant benefitted personally from the breach.

Cases Cited

By Iacobucci J.

Considered: Wawanesa Mutual Insurance Co. v. J. A. (Fred) Chalmers & Co. (1969), 7 D.L.R. (3d) 283; Henry Electric Ltd. v. Farwell (1986), 29 D.L.R. (4th) 481; Andrea Schmidt Construction Ltd. v. Glatt (1979), 25 O.R. (2d) 567; R. v. Lowden (1981), 27 A.R. 91; Stephens [page793] Travel Service International Pty. Ltd. v. Qantas Airways Ltd. (1988), 13 N.S.W.L.R. 331; M. A. Hanna Co. v. Provincial Bank of Canada, [1935] S.C.R. 144; In re Penn Central Transportation Co., 328 F.Supp. 1278 (1971), rev'd 486 F.2d 519 (1973); In re Montagu's Settlement Trusts, [1987] Ch. 264; Selangor United Rubber Estates, Ltd. v. Cradock (No. 3), [1968] 2 All E.R. 1073; Barnes v. Addy (1874), L.R. 9 Ch. App. 244; Baden, Delvaux & Lecuit v. Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France S.A., [1983] B.C.L.C. 325 (Ch.), aff'd [1985] B.C.L.C. 258 (C.A.); Belmont Finance Corp. v. Williams Furniture Ltd. (No. 1), [1979] 1 All E.R. 118; Carl-Zeiss-Stiftung v. Herbert Smith & Co. (No. 2), [1969] 2 All E.R. 367; MacDonald v. Hauer (1976), 72 D.L.R. (3d) 110; Scott v. Riehl (1958), 15 D.L.R. (2d) 67; Horsman Bros. Holdings Ltd. v. Panton & Panton, [1976] 3 W.W.R. 745; Trilec Installations Ltd. v. Bastion Construction Ltd. (1982), 135 D.L.R. (3d) 766; Austin v. Habitat Development Ltd. (1992), 94 D.L.R. (4th) 359; disapproved: In re Morales Travel Agency, 667 F.2d 1069 (1981); referred to: Myrta Forastieri v. Eastern Air Lines, Inc., 18 Avi. 17,145 (1983); Canadian Pacific Air Lines, Ltd. v. Canadian Imperial Bank of Commerce (1987), 61 O.R. (2d) 233, aff'd (1990), 71 O.R. (2d) 63 (note); Bank of N.S. v. Soc. Gen. (Can.), [1984] 4 W.W.R. 232; McEachren v. Royal Bank (1990), 78 Alta. L.R. (2d) 158; Henry v. Hammond, [1913] 2 K.B. 515; Air Traffic Conference v. Downtown Travel Center, Inc., 14 Avi. 17,172 (1976); Air Traffic Conference of America v. Worldmark Travel, Inc., 15 Avi. 18,483 (1980); International Sales and Agencies Ltd. v. Marcus, [1982] 3 All E.R. 551; Karak Rubber Co. v. Burden (No. 2), [1972] 1 All E.R. 1210; Lee v. Sankey (1873), L.R. 15 Eq. 204; Soar v. Ashwell, [1893] 2 Q.B. 390; Shields v. Bank of Ireland, [1901] 1 I.R. 222; Gray v. Johnston (1868), L.R. 3 H.L. 1; Coleman v. Bucks and Oxon Union Bank, [1897] 2 Ch. 243; Fonthill Lbr. Ltd. v. Bk. Montreal, [1959] O.R. 451; Groves-Raffin Construction Ltd. v. Bank of Nova Scotia (1975), 64 D.L.R. (3d) 78; Lipkin Gorman v. Karpnale Ltd., [1992] 4 All E.R. 331 (Q.B.), rev'd in part, [1992] 4 All E.R. 409 (C.A.), rev'd in part on other grounds, [1992] 4 All E.R. 512 (H.L.).

By McLachlin J.

Referred to: MacDonald v. Hauer (1976), 72 D.L.R. (3d) 110; Henry Electric Ltd. v. Farwell (1986), 29 D.L.R. (4th) 481; Horsman Bros. Holdings Ltd. v. Panton & Panton, [1976] 3 W.W.R. 745; Trilec Installations Ltd. v. Bastion Construction Ltd. (1982), 135 D.L.R. (3d) 766; Andrea Schmidt Construction Ltd. v. [page794] Glatt (1979), 25 O.R. (2d) 567; Scott v. Riehl (1958), 15 D.L.R. (2d) 67.

Authors Cited

Pettit, Philip H. Equity and the Law of Trusts, 6th ed. London: Butterworths, 1989. Sullivan, Ruth. "Strangers to the Trust", [1986] Est. & Tr. Q. 217. Underhill, Sir Arthur. Law Relating to Trusts and Trustees, 14th ed. By David J. Hayton. London: Butterworths, 1987. Waters, Donovan W. M. Law of Trusts in Canada, 2nd ed. Toronto: Carswell, 1984.

APPEAL from a judgment of the Ontario Court of Appeal (1991), 2 O.R. (3d) 184, 77 D.L.R. (4th) 536, allowing an appeal from a judgment of Flanigan Dist. Ct. J. Appeal dismissed.
Peter J. Bishop, for the appellant. Guy L. Poppe and Harry G. Leslie, for the respondent.

Solicitors for the appellant: Peter J. Bishop & Associates, Ottawa. Solicitor for the respondent: Guy L. Poppe, Toronto.

The judgment of La Forest, Sopinka, Gonthier, Cory, Iacobucci and Major JJ. was delivered by

IACOBUCCI J.

1 This appeal concerns the personal liability of directors of a closely held corporation for breach of a trust by the corporation. The appellant was one of two directors of a small travel agency which contracted with the respondent airline to sell Air Canada tickets. Two main questions are raised on this appeal. First, was the relationship between the corporation and the respondent airline one of trust? Second, if so, is the appellant director personally liable for the breach of trust by the corporation? The legal issue raised by this second ground of appeal concerns the standards for the imposition of personal liability to be applied to strangers who participate in a breach of trust. Although involving a corporation, the case falls to be resolved on trust principles, and does not raise [page795] general questions of the personal liability of directors for the acts of the corporation.

I. Background

2 In 1973, the defendant Phil Martin and one Ross Linton incorporated M & L Travel Limited (M & L) to carry on the business of a travel agency in Ottawa. In 1975, Linton withdrew from the business and Martin continued by himself. In 1977, Martin wanted M & L to become a member of the International Air Transport Association (IATA) so that he could receive larger commissions and issue tickets directly to customers. To become a member, M & L had to fulfil certain requirements. These included having working capital of at least $20,000 and the sponsorship of a major airline. Therefore, in the fall of 1977, Martin invited the appellant Valliant to become a shareholder and invest in M & L. In January 1978, Valliant invested $25,550 in M & L and acquired 50 percent of the issued shares. Valliant obtained this money through a personal loan on which he was required to pay monthly instalments of $752. The trial judge found that Martin had agreed that Valliant could withdraw this amount from M & L's account on a monthly basis until the personal loan was paid in full.

3 Martin became President of M & L and Valliant its Vice-President, and they were its sole directors. Each had signing authority, but Martin ran the day-to-day business. Valliant, who had no experience with the travel agency business, dropped in occasionally and worked full time, for a salary, only when Martin was ill or on vacation. In November 1978, Valliant brought his wife into the travel agency to deal with problems with M & L's books. She was given signing authority and worked part time for the agency until April 1979.

4 The IATA accepted the membership application of M & L based on sponsorship by Air Canada. M & L entered into two written agreements. The first was a passenger sales agency agreement between IATA and M & L, executed on September 14, 1978 [page796] and signed by Martin as President. This agreement conferred on M & L the right to sell air carrier tickets and receive commissions. Valliant was familiar with the contents of this agreement. The second agreement, also called a passenger sales agency agreement, was entered into between M & L and Air Canada on March 15, 1979 and was signed by Valliant as Vice-President. This agreement authorized M & L to receive blank airline ticket stock from Air Canada and to issue tickets directly to the public. Funds collected from the sale of Air Canada tickets were to be held in trust by M & L and paid twice a month to Air Canada. Until March 1979, these payments were regularly made. The agreement contained the following clause:

> All monies, less applicable commissions to which the Agent is entitled hereunder, collected by the Agent for air passenger transportation (and for which the Agent has issued tickets or exchange orders) shall be the property of the Airline, and shall be held in trust by the Agent until satisfactorily accounted for to the airline. All such monies, less applicable commissions to which the Agent is entitled hereunder, shall be remitted to the Airline by the Agent in accordance with the Airline's accounting procedures.

5 On August 30, 1978, M & L obtained an operating line of credit of $15,000 from the Provincial Bank of Canada in Ottawa (the Bank). Martin and Valliant personally guaranteed the loan and authorized the Bank to remove from the general account of M & L any monies at any time owing on the loan. The monies advanced under the line of credit and interest thereon constituted a demand loan in favour of the Bank.

6 Also in 1978, Martin set up trust accounts on behalf of M & L for the deposit of the airline funds. For unexplained reasons, these accounts were never used. Instead, M & L maintained a general operating account with the Bank. Funds from all sources, including the sale of Air Canada tickets, were placed in this account. General operating

expenses, the interest on the line of credit, [page797] Valliant's personal loan payments, and Martin's salary were all paid out of this account.

7 In April 1979, a dispute arose between Martin and Valliant. Martin, concerned about the poor cash flow position of the agency, went into the office on April 5, 1979. He found the cancelled cheques for the instalment payments on Valliant's personal loan. Martin thought that Valliant had agreed to cease making the payments for the time being, and therefore, Martin called the Bank and stopped payment on the last instalment cheque. He took the day's receipts and a number of cancelled cheques to his lawyer. On April 6, 1979, Valliant noticed the missing funds and documents, and suspected that Martin was misappropriating funds. He changed the locks on the doors and called the Bank and stopped payment on all cheques and withdrawals. At this time, M & L owed Air Canada $25,079.67 for ticket sales.

8 Between April 6 and April 16, 1979, the business of M & L was closed. Martin and Valliant, through their solicitors, negotiated for the purchase by one of the other's interest. During this time, both Valliant and Martin made efforts to pay Air Canada. Valliant, in particular, testified that he opened a trust account, drew cheques for the monies that were still in the company account, withdrew the stop payment orders, and attempted to transfer the funds into the new trust account. However, the Bank refused to transfer the funds or to honour the cheques made out to Air Canada because of the conflicting instructions from Martin and Valliant. The Bank, now aware of the financial and managerial difficulties facing M & L, sent a demand notice to Valliant, M & L, and probably Martin on April 23, 1979. On April 24, 1979, the Bank withdrew $15,184.11 from the operating account, satisfying in full the demand note relating to the line of credit personally guaranteed by both Martin and Valliant.

9 Air Canada sued M & L and Martin and Valliant personally for the $25,079.67 owed to it for ticket sales. At trial, Air Canada succeeded against M & [page798] L but the trial judge dismissed the claim against Martin and Valliant. The Ontario Court of Appeal allowed the appeal of Air Canada and entered judgment against Martin and Valliant as well.

II. Judgments Below

A. Ontario District Court (Flanigan Dist. Ct. J.)

10 The trial judge held that there was clearly a trust relationship between Air Canada and the travel agency, and that the travel agency had breached that trust by failing to protect Air Canada's interest. However, the more difficult question was whether Martin and Valliant were personally liable for breach of trust.

11 The trial judge stated that the only way in which liability could be imposed on the individual defendants is if they had taken it upon themselves to possess and administer trust property for the beneficiary as if they were trustees. Each individual would then be a trustee de son tort. However, the trial judge concluded:

> ... in this case there is no assumption, in my view, by the individual defendants to assume this trust. It is true, in signing the bank documents they gave the bank the right to do as they did but right up until the last moment they were trying each in their own way effectively or not, to protect the interest of Air Canada to keep their own interest alive by preserving the business of the travel agency... . So, I see nothing mala fides in the actions of the individual defendants and I think they were inept in some of their actions but, they were in no way, in my view, trustees that breached a trust so far as Air Canada is concerned.

Therefore, the trial judge dismissed the claim against the individual defendants.

B. Ontario Court of Appeal (1991), 2 O.R. (3d) 184 (Griffiths J.A.)

12 Griffiths J.A. began by noting that it was not contested that there was a trust relationship [page799] between Air Canada and M & L, and that M & L was liable for breach of that trust. He also agreed with the trial judge that the individual defendants in this case could not be classified as trustees de son tort. In Law of Trusts in Canada (2nd ed. 1984), Professor Donovan Waters states that to be held liable as a trustee de son tort, the trustee must have possession and control of the trust property. To have that possession and control, the trustee must have some legal right or title to the trust property. In this case, the trial judge properly found that neither Martin nor Valliant had

assumed legal control or possession of the trust funds, since the funds were at all times administered in the name of M & L.

13 Griffiths J.A. held that M & L was clearly liable for breach of contract since it failed to remit the funds as required. However, as directors, Martin and Valliant could not be held personally liable for that breach of contract. It was therefore necessary, for Martin and Valliant to be potentially personally liable, that M & L also be found to have been in breach of trust. Griffiths J.A. concluded at p. 194:

> ... on the authority of Canadian Pacific Airlines Ltd. v. Canadian Imperial Bank of Commerce (1987), 61 O.R. (2d) 233, ... affd Ont. C.A., Robins, Krever and Carthy JJ.A., January 19, 1990 (... 71 O.R. (2d) 63 (note) ...), that the agreement between Air Canada and the corporation clearly created a trust relationship between them with the result that any monies received by the corporation from the sale of Air Canada tickets were impressed with a trust.

14 Griffiths J.A. then went on to consider whether the directors could be personally liable for the breach by their corporation of a trust relationship created by contract. This issue, he noted, had not been considered in any reported Canadian or English cases. He reviewed several cases where the directors had been held personally liable for breaches of trust imposed by statute, including Wawanesa Mutual Insurance Co. v. J. A. (Fred) Chalmers & Co. (1969), 7 D.L.R. (3d) 283 (Sask. Q.B.); Henry Electric Ltd. v. Farwell (1986), 29 D.L.R. (4th) 481 (B.C.C.A.); [page800] and Andrea Schmidt Construction Ltd. v. Glatt (1979), 25 O.R. (2d) 567 (H.C.).

15 Griffiths J.A. also referred to Myrta Forastieri v. Eastern Air Lines, Inc., 18 Avi. 17,145 (D.P.R. 1983), a U.S. decision involving facts similar to the present case. In that case, the court held, at pp. 17,148-17,149 that:

> Irrespective of good faith or intent, in an instance wherein the corporation had a duty to pay out funds from designated proceeds but such proceeds were used for other purposes, the directors were held personally liable because they had a duty to see that the funds were used for the agreed-upon purpose and they could not excuse themselves on the grounds that they did not dissipate or misappropriate the funds nor were in other respects derelict in their duty... .
>
> ...
>
> We agree, therefore, that failure to remit funds collected by a corporate agent which belong to its principal airline gives rise to personal liability of those corporate employees who participate in the conversion. The imposition of such liability presumes, however, that the responsible persons actually had possession or control over the property such that it could be said that their conduct constitutes participation. Under the circumstances of the present case the joint control over the financial affairs and operations of this very closely held corporation by the two individual plaintiffs/counterdefendants supports a finding that if conversion occurred, it was a joint act of those two persons. They shared ownership of the corporation equally; they shared management of the business operations equally; they shared equally in the special compensation arrangements set up for themselves; and most important, they shared control over the corporate accounts since all checks issued required both their signatures... .

16 Griffiths J.A. concluded that Wawanesa v. Chalmers, Henry Electric Ltd. v. Farwell and Andrea Schmidt Construction Ltd. could not be distinguished [page801] on the basis that the trust was created by statute. Instead, he held, at p. 203, that:

> What is significant in those cases is that the shareholders and directors that were held responsible were the sole owners and directors and were the sole directing and operating minds of the corporations... . For the purposes of this appeal, I adopt the reasoning of the United States District Court of Puerto Rico in Myrta Forastieri v. Eastern Air Lines, supra, that it is just and equitable to impose personal liability on directors who participate in the breach of trust by the corporation because, in effect, they have participated in a conversion of trust funds.

17 Griffiths J.A. then reviewed the facts which justified the imposition of personal liability in the case at bar. First, both Martin and Valliant had at least some control over the operation of the business, and both had signing authority. Second, it was Martin and Valliant as the operating minds of M & L who deposited the trust funds in the

general operating account and paid operating expenses out of that account. Third, M & L had a duty to (at p. 204) "keep these monies separate, to earmark them as funds held for Air Canada and, at the very least, to advise the bank that such funds, separately maintained, were trust funds". Since this was not done, M & L committed a breach of trust. Finally, the Bank seized the funds from the account because Martin and Valliant had both stopped payment on cheques issued on the account: "The movement of these directors, acting solely in their own interest to stop payment on cheques, not only prevented payment on cheques issued to Air Canada, but precipitated the seizure by the bank of the only funds available in the unprotected general account" (p. 204). Therefore, Griffiths J.A. concluded at pp. 204-5:

> In my view, this is an appropriate case to impose personal liability on Martin and Valliant for the breach of trust. They were the sole owners and operating minds of the corporation. They directed and authorized the [page802] deposit of funds from Air Canada sales in the general account without in any way designating these funds as trust funds. They permitted these funds to be intermingled with other funds and they drew cheques on these funds in complete disregard of the trust obligations imposed under the agreement with Air Canada, an agreement which conferred on the corporation of which they were the sole shareholders the important privilege of selling Air Canada tickets directly to the public. Martin and Valliant permitted Air Canada funds to be placed in a general account that was overdrawn without adequate controls and, in particular, without advising the bank that these funds were trust funds, with the result that these funds were exposed to appropriation by the bank to satisfy the corporation's loan guaranteed by Martin and Valliant. In failing to exercise proper control over the trust funds, both Martin and Valliant received a benefit in that their personal liability to the bank was extinguished.

18 The steps taken by Martin and Valliant to protect the interests of Air Canada were inept, and too little too late. In any event, these steps were taken to preserve the travel agency and not to protect Air Canada's interest. Griffiths J.A. therefore concluded that Martin and Valliant were both parties to the conversion of trust funds and should be held personally liable.

III. Issues

19 As mentioned at the outset, there are two main issues raised in this case. First, was the relationship between M & L and the respondent one of trust, or one of debtor and creditor? Second, if the relationship was one of trust, then under what circumstances can the directors of a corporation be held personally liable for breach of trust by the corporation, and are those circumstances present in this case?

IV. Analysis

1. The Nature of the Relationship between M & L and Air Canada

20 In this Court, the appellant initially argued that the relationship between M & L and the respondent [page803] airline was one of debtor and creditor, rather than one of trust. However, at the hearing, the appellant properly conceded that the relationship was one of trust. Given this concession, I will consider this question only briefly.

21 The appellant relied on the fact that the agreement between the airline and M & L did not require it to keep the proceeds of Air Canada tickets in a separate account or trust fund, or to remit the funds forthwith. Rather, M & L was permitted to keep such funds for a period of up to 15 days, and then for a further 7-day grace period. Furthermore, M & L was liable for the total sale price of all tickets sold, less its commission, regardless of whether it had actually collected the full amount from its customers. That is, M & L was free to sell Air Canada tickets on credit to its customers. Prior to his concession on this point, the appellant submitted that, in these circumstances, M & L was not a trustee of the sale proceeds of the Air Canada tickets.

22 In concluding that the relationship between M & L and the airline was one of trust, the Court of Appeal relied on Canadian Pacific Air Lines, Ltd. v. Canadian Imperial Bank of Commerce (1987), 61 O.R. (2d) 233. Although the Court of Appeal's decision in that case (1990), 71 O.R. (2d) 63 (note), was brief, the reasons of the trial judge, at p. 237, went into greater depth:

> In order to constitute a trust, an arrangement must have three characteristics, known as the three certainties: certainty of intent, of subject-matter and of object. The agreement ... is certain in its intent to create a trust. The subject-matter is to be the funds collected for ticket sales. The object, or beneficiary, of the trust is also clear; it is to be the airline. The necessary elements for the creation of a trust relationship are all present. I find that such a relationship did exist between CP and the two travel agencies.

23 This analysis is clearly applicable to the facts of the present case. That the intent of the agreement is to create a trust is evident from the following wording: "All monies, less applicable commissions [page804] to which the Agent is entitled hereunder, collected by the Agent for air passenger transportation (and for which the Agent has issued tickets or exchange orders) shall be the property of the Airline, and shall be held in trust by the Agent until satisfactorily accounted for to the airline." The object of the trust is the respondent airline, and its subject-matter is the funds collected for ticket sales.

24 While the presence or absence of a prohibition on the commingling of funds is a factor to be considered in favour of a debt relationship, it is not necessarily determinative. See R. v. Lowden (1981), 27 A.R. 91 (C.A.), at pp. 101-2; Bank of N.S. v. Soc. Gen. (Can.), [1984] 4 W.W.R. 232 (Alta. C.A.), at p. 238; McEachren v. Royal Bank (1990), 78 Alta. L.R. (2d) 158 (Q.B.), at p. 183; Stephens Travel Service International Pty. Ltd. v. Qantas Airways Ltd. (1988), 13 N.S.W.L.R. 331 (C.A.), at p. 341. In R. v. Lowden, supra, McGillivray C.J.A. stated as follows at pp. 101-2:

> Undoubtedly a direction that moneys are to be kept separate and apart is a strong indication of a trust relationship being created. It does not appear to me, however, that the converse is necessarily so. In the case of a travel agent, how he handled the funds handed to him for the purchase of a ticket would, as far as the public is concerned, be something that they would not have reason to think about. It would be a matter of internal management. The fact that there is no specific discussion about moneys being kept separate and apart from other moneys does not detract from the fact that the money is paid for a particular purpose, namely the obtaining of tickets for specific flights or reservations at named accommodation for a particular period.

25 The appellant relied on the decision of this Court in M. A. Hanna Co. v. Provincial Bank of Canada, [1935] S.C.R. 144. In that case, the Court dealt with the relationship between a supplier of coal and its sales agent. The Court concluded that the relationship was one of debtor-creditor, citing the fact that the parties had specifically cancelled a portion of their agreement requiring the separation of the funds collected by the sales agent. The sales [page805] agent paid the supplier by cheques drawn on its general account. The supplier's acquiescence to this practice, and the fact that the agent had use of the funds before payment came due, indicated to this Court that the parties viewed their relationship as one of debtor-creditor. The Court relied on the following passage from Henry v. Hammond, [1913] 2 K.B. 515, at p. 521:

> It is clear that if the terms upon which the person receives the money are that he is bound to keep it separate, either in a bank or elsewhere, and to hand that money so kept as a separate fund to the person entitled to it, then he is a trustee of that money and must hand it over to the person who is his cestui que trust. If on the other hand he is not bound to keep the money separate, but is entitled to mix it with his own money and deal with it as he pleases, and when called upon to hand over an equivalent sum of money, then, in my opinion, he is not a trustee of the money, but merely a debtor.

26 This decision was distinguished in Qantas, supra, at p. 348, by Hope J.A., dealing with facts similar to the present case:

> As it seems to me, ... the decision ... has no relevance to the circumstances of the present case where, on the proper construction of the agreement, a trust was expressly created, and where the distinction between an express and a constructive trust does not affect the resolution of the rights of the parties.

Since there was clear language in the agreement that the funds were to be held in trust, Hope J.A. remarked that there would have to be extremely strong indications to alter the plain meaning of those words. On the question of the commingling of funds, Hope J.A. stated at p. 341 that "I do not understand why the absence of an express separate account provision should cut down the effect of the express provision for a trust...." This holding is

consistent with the Canadian authorities. See R. v. Lowden, supra, at pp. 101-2; Bank of N.S. v. Soc. Gen. (Can.), supra, at p. 238; McEachren v. Royal Bank, supra, at p. 183.

[page806]

27 The majority of U.S. cases have concluded that relationships similar to the one in the present case are trust relationships. See Air Traffic Conference v. Downtown Travel Center, Inc., 14 Avi. 17,172 (N.Y. 1976); Air Traffic Conference of America v. Worldmark Travel, Inc., 15 Avi. 18,483 (N.Y. 1980); Myrta Forastieri, supra.

28 However, a contrary finding was made in In re Morales Travel Agency, 667 F.2d 1069 (1st Cir. 1981), at pp. 1071-72, in which the court held that the terms of the IATA agreement between the airline and the travel agency were inadequate to give rise to a trust upon the proceeds from tickets sold by the agency to its customers:

> To be sure, Resolution 820(a) recited, in general terms, that the agent was to hold whatever monies it collected in trust for the carrier until accounted for, and that these monies were the carrier's property until settlement occurred. However, talismanic language could not throw a protective mantle over these receipts in the absence of a genuine trust mechanism. Here the relationship remained in practical fact that of debtor-creditor. The contract nowhere required Morales to keep the proceeds of Eastern's ticket sales separate from any other funds, whether Morales' own funds or the proceeds of other airlines' ticket sales. Nor was any specific restriction placed upon Morales' use of the supposed trust funds. Morales was left free to use what it received for its own benefit rather than Eastern's, and to transform the receipts into assets with no apparent encumbrance, upon which potential creditors might rely. The use of the word "trust" and the designation of the airline as title-holder, in a contract which is not publicly filed, would not save potential creditors from relying on such assets as office equipment, accounts receivable, and a bank account solely in the name of the agency. In the absence of any provision requiring Morales to hold the funds in trust by keeping them separate, and otherwise restricting their use, the label "trust" could in these circumstances and for present purposes have no legal effect. See In re [page807] Penn. Central Transportation Co., 328 F.Supp. 1278 (E.D.Pa. 1971); Scott on Trusts 12.2 (3d ed.).

29 The Morales court relied on the District Court decision of In re Penn Central Transportation Co., 328 F.Supp. 1278 (Pa. 1971). This decision was subsequently reviewed by the U.S. Court of Appeals, 3rd Circuit, which concluded that a relationship of trust did exist, and that the commingling of funds was only one indication of a debtor-creditor relationship and was not necessarily conclusive (486 F.2d 519 (1973)). Rosenn J. held at p. 525 that the "[c]ommingling of monies has minimal significance in the extraordinary operations of interline railroads... . Normal operation conditions with innumerable daily collections of various categories preclude practically and economically any effective daily segregation [of funds]." The Morales decision and those which purport to follow it are therefore of questionable persuasion and contrary to other decisions.

30 In conclusion, it is well established that the nature of the relationship between the parties is a matter of intention. In the present case, the relationship of trust is further evidenced by the express prohibition restricting the use of the funds, and the supervision and control of the carrier over the financial dealings of M & L. Since there is clear evidence of intention to create a trust in the agreement between M & L and the respondent airline, the absence of a prohibition on the commingling of funds is not determinative, although it may be a factor to be taken into account by the trial judge, as it was here. Moreover, in the present case M & L acted in accordance with that intention and set up trust accounts, which, although never used, confirm that the relationship was viewed by the directors as a trust relationship. Finally, it must be noted that the nature of the relationship is consistent with trust as the IATA agreement allowed M & L to affect Air Canada's legal responsibilities.

[page808]

2. Personal Liability of the Directors as Constructive Trustees

(a) General Principles

31 Having found that the relationship between M & L and the respondent airline was a trust relationship, there is no

question that M & L's actions were in breach of trust. M & L failed to account to the respondent for the monies collected through sales of Air Canada tickets. What remains to be decided is whether the directors of M & L should be held personally liable for the breach of trust on the basis that they were constructive trustees. Whether personal liability is imposed on a stranger to a trust depends on the basic question of whether the stranger's conscience is sufficiently affected to justify the imposition of personal liability. See In re Montagu's Settlement Trusts, [1987] Ch. 264, at p. 285. The authorities reflect distinct approaches to answer this question depending on the circumstances of the case, and it is to these that I shall now turn.

32 There are two general bases upon which a stranger to the trust can be held liable as a constructive trustee for breach of trust. First, although not directly relevant to this appeal, strangers to the trust can be liable as trustees de son tort. Such persons, although not appointed trustees, "take on themselves to act as such and to possess and administer trust property". See Selangor United Rubber Estates, Ltd. v. Cradock (No. 3), [1968] 2 All E.R. 1073, at p. 1095. In the Selangor case, Ungoed-Thomas J. went on to describe the distinguishing features of such constructive trustees:

> ... (a) they do not claim to act in their own right but for the beneficiaries, and (b) their assumption to act is not of itself a ground of liability (save in the sense of course of liability to account and for any failure in the duty so assumed), and so their status as trustees precedes the [page809] occurrence which may be the subject of claim against them.

Thus a trustee de son tort will not be personally liable simply for the assumption of the duties of a trustee, but only if he or she commits a breach of trust while acting as a trustee. See Barnes v. Addy (1874), L.R. 9 Ch. App. 244; Underhill and Hayton, Law Relating to Trusts and Trustees (14th ed. 1987), at p. 351; Philip H. Pettit, Equity and the Law of Trusts (6th ed. 1989), at p. 152.

33 This type of liability is inapplicable to the present case because the directors of M & L did not personally take possession of trust property or assume the office or function of trustees. Both the trial judge and the Court of Appeal concluded that neither of the directors had assumed legal control or possession of the funds which were to be held in trust for the respondent airline. In the words of Griffiths J.A., at p. 193, "[s]uch funds were, at all material times, administered, at least, in the name of the corporation. Certainly, it cannot be said that either Martin or Valliant were administering the trust funds on behalf of the beneficiary Air Canada."

34 Second, strangers to the trust can also be personally liable for breach of trust if they knowingly participate in a breach of trust. The starting point for a review of the bases of this kind of personal liability is Barnes v. Addy, supra, which involved an estate, for which three trustees had been designated by the testator. The will allowed for the appointment of new trustees without the consent of any other party, but did not allow for a decrease in the number of trustees. Two of the trustees died and a rift developed between the family and the third trustee, who wished to retire. He instructed his solicitor to prepare an instrument appointing Barnes, who was the husband of one of the beneficiaries, as sole trustee. The solicitor advised him against having only one trustee, but prepared the instrument on the instructions of his client. Barnes' solicitor approved the appointment. Barnes invested the trust funds for his own purposes and [page810] went bankrupt. The beneficiaries sued the previous trustee, his solicitor and Barnes' solicitor for breach of trust. The action against the solicitors was dismissed on the basis that they had no knowledge of, or any reason to suspect, a dishonest design in the transaction, and that they did not receive any trust property.

35 Lord Selborne L.C., at pp. 251-52, set out the ways in which a non-trustee can become responsible for a trust:

> Those who create a trust clothe the trustee with a legal power and control over the trust property, imposing on him a corresponding responsibility. That responsibility may no doubt be extended in equity to others who are not properly trustees, if they are found either making themselves trustees de son tort, or actually participating in any fraudulent conduct of the trustee to the injury of the cestui que trust. But, on the other hand, strangers are not to be made constructive trustees merely because they act as the agents of trustees in transactions within their legal powers, transactions, perhaps of which a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on the part of the trustees.

In addition to a trustee de son tort, there were traditionally therefore two ways in which a stranger to the trust could be held personally liable to the beneficiaries as a participant in a breach of trust: as one in receipt and chargeable with trust property and as one who knowingly assisted in a dishonest and fraudulent design on the part of the trustees. The former category of constructive trusteeship has been termed "knowing receipt" or "knowing receipt and dealing", while the latter category has been termed "knowing assistance".

36 The former category of "knowing receipt" of trust property is inapplicable to the present case because it requires the stranger to the trust to have [page811] received trust property in his or her personal capacity, rather than as an agent of the trustees. See Baden, Delvaux & Lecuit v. Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France S.A., [1983] B.C.L.C. 325 (Ch.), appeal dismissed, [1985] B.C.L.C. 258 (C.A.); International Sales and Agencies Ltd. v. Marcus, [1982] 3 All E.R. 551; Karak Rubber Co. v. Burden (No. 2), [1972] 1 All E.R. 1210 (Ch.), at pp. 1234-35; Belmont Finance Corp. v. Williams Furniture Ltd. (No. 1), [1979] 1 All E.R. 118 (C.A.), at pp. 129, 134; Underhill, supra, at p. 360; Pettit, supra, at pp. 159-60. See, contra, Lee v. Sankey (1873), L.R. 15 Eq. 204. As I have already noted, the courts below found that the directors of M & L did not personally control the trust funds in the present case, and this finding was not challenged before us.

37 Thus the only basis upon which the directors could be held personally liable as constructive trustees is under the "knowing assistance" head of liability. To repeat, in Barnes v. Addy, supra, at p. 252, Lord Selborne L.C. stated that persons who "assist with knowledge in a dishonest and fraudulent design on the part of the trustees" will be liable for the breach of trust as constructive trustees. See also, Soar v. Ashwell, [1893] 2 Q.B. 390 (C.A.). This basis of liability raises two main issues: the nature of the breach of trust and the degree of knowledge required of the stranger.

(b) Degree of Knowledge of the Stranger

38 The latter point may be quickly addressed. The knowledge requirement for this type of liability is actual knowledge; recklessness or wilful blindness will also suffice. See Belmont Finance, supra, at pp. 130, 136; In re Montagu's Settlement Trusts, supra, at pp. 271-72, 285; Carl-Zeiss-Stiftung v. Herbert Smith & Co. (No. 2), [1969] 2 All E.R. 367 (C.A.), at p. 379. In the latter case, Sachs L.J. stated that to be held liable the stranger must have [page812] had "both actual knowledge of the trust's existence and actual knowledge that what is being done is improperly in breach of that trust -- though, of course, in both cases a person wilfully shutting his eyes to the obvious is in no different position than if he had kept them open." Whether the trust is created by statute or by contract may have an impact on the question of the stranger's knowledge of the trust. If the trust was imposed by statute, then he or she will be deemed to have known of it. If the trust was contractually created, then whether the stranger knew of the trust will depend on his or her familiarity or involvement with the contract.

39 If the stranger received a benefit as a result of the breach of trust, this may ground an inference that the stranger knew of the breach. See Shields v. Bank of Ireland, [1901] 1 I.R. 222, at p. 228; Gray v. Johnston (1868), L.R. 3 H.L. 1, at p. 11, per Lord Cairns, L.C.; Selangor, supra, at p. 1101; Coleman v. Bucks and Oxon Union Bank, [1897] 2 Ch. 243, at p. 254; Waters, supra, at p. 401; Fonthill Lbr. Ltd. v. Bk. Montreal, [1959] O.R. 451 (C.A.), at p. 468; Groves-Raffin Construction Ltd. v. Bank of Nova Scotia (1975), 64 D.L.R. (3d) 78 (B.C.C.A.), at pp. 116-17. The receipt of a benefit will be neither a sufficient nor a necessary condition for the drawing of such an inference.

40 The reason for excluding constructive knowledge (that is, knowledge of circumstances which would indicate the facts to an honest person, or knowledge of facts which would put an honest person on inquiry) was discussed in In re Montagu's Settlement Trusts, supra, at pp. 271-73, 275-85. Megarry V.-C. held, at p. 285, that constructive notice was insufficient to bind the stranger's conscience so as to give rise to personal liability. While cases involving recklessness or wilful blindness indicate a "want of probity which justifies imposing a constructive trust", Megarry V.-C., at p. 285, held that the carelessness involved in constructive knowledge cases will not normally amount to a want of probity, and will therefore be insufficient to bind the stranger's conscience. See [page813] also, Lipkin Gorman v. Karpnale Ltd., [1992] 4 All E.R. 331 (Q.B.), at pp. 341-49, 351-57, rev'd in part, [1992] 4 All E.R. 409 (C.A.), at pp. 416-18, rev'd in part on other grounds, [1992] 4 All E.R. 512 (H.L.).

(c) Nature of the Breach of Trust

41 With regard to the first issue, the nature of the breach of trust, the authorities can be divided into two lines. Most of the English authorities have followed the Barnes v. Addy standard which requires participation by the stranger in a dishonest and fraudulent design. See Carl-Zeiss-Stiftung, supra, at p. 379; Belmont Finance, supra, at p. 135; Pettit, supra, at pp. 154-56; Underhill, supra, at pp. 355-57. An extensive review of the authorities was undertaken by Ungoed-Thomas J. in the Selangor case. He concluded as follows at pp. 1104-5:

> I come to the third element, "dishonest and fraudulent design on the part of the trustees". I have already indicated my view, for reasons already given, that this must be understood in accordance with equitable principles for equitable relief.
>
> I therefore cannot accept the suggestion that, because an action is not of such a dishonest and fraudulent nature as to amount to some crime, that it is not fraudulent and dishonest in the eyes of equity -- or that an intention eventually to restore or give value for property -- which it was suggested might provide a good defence to a criminal charge -- would of itself make its appropriation and use in the meantime, with its attendant risks and deprivation of the true owner, unobjectionable in equity, and thus make what would otherwise be dishonest and fraudulent free from such objection.
>
> It was suggested for the plaintiff company that "fraudulent" imports the element of loss into what is dishonest, so that the phrase means dishonest resulting in loss to the claimant. It seems to me unnecessary and, indeed, undesirable to attempt to define "dishonest and [page814] fraudulent design", since a definition in vacuo, without the advantage of all the circumstances that might occur in cases that might come before the court, might be to restrict their scope by definition without regard to, and in ignorance of, circumstances which should patently come within them. The words themselves are not terms of art and are not taken from a statute or other document demanding construction. They are used in a judgment as the expression and indication of an equitable principle and not in a document as constituting or demanding verbal application and, therefore, definition. They are to be understood "according to the plain principles of a court of equity" to which Sir Richard Kindersley, V.-C., referred [in Bodenham v. Hoskins, (1852), 21 L.J.Ch. at p. 873; [1843-60] All E.R. Rep. at p. 697], and these principles, in this context at any rate, are just plain, ordinary commonsense. I accept that "dishonest and fraudulent", so understood, is certainly conduct which is morally reprehensible; but what is morally reprehensible is best left open to identification and not to be confined by definition.

42 In Belmont Finance, supra, at p. 135, Goff L.J. discussed the approach taken on this issue by Ungoed-Thomas J. in Selangor, supra:

> If and so far as Ungoed-Thomas J intended, as I think he did, to say that it is not necessary that the breach of trust in respect of which it is sought to make the defendant liable as a constructive trustee should be fraudulent or dishonest, I respectfully cannot accept that view. I agree that it would be dangerous and wrong to depart from the safe path of the principle as stated by Lord Selborne LC [in Barnes v. Addy, supra] to the uncharted sea of something not innocent (and counsel for the plaintiff conceded that mere innocence would not do) but still short of dishonesty.
>
> In my judgment, therefore, it was necessary in this case ... to prove, that the breach of trust by the directors [who were the trustees] was dishonest.

43 In the same case, Buckley L.J. stated at p. 130:

> [page815]
>
> ... I do not myself see that any distinction is to be drawn between the words 'fraudulent' and 'dishonest'; I think they mean the same thing, and to use the two of them together does not add to the extent of dishonesty required.
>
> ...
>
> The plaintiff has contended that in every case the court should consider whether the conduct in question was so unsatisfactory, whether it can be strictly described as fraudulent or dishonest in law, as to make

> accountability on the footing of constructive trust equitably just. This, as I have said, is admitted to constitute an extension of the rule as formulated by Lord Selborne LC [in Barnes v. Addy, supra]. That formulation has stood for more than 100 years. To depart from it now would, I think, introduce an undesirable degree of uncertainty to the law, because if dishonesty is not to be the criterion, what degree of unethical conduct is to be sufficient? I think we should adhere to the formula used by Lord Selborne LC. So in my judgment the design must be shown to be a dishonest one, that is to say, a fraudulent one.

44 In the oft-cited case of Baden, Delvaux, supra, at p. 406, Peter Gibson J. reviewed the authorities on this point:

> As to the second element the relevant design on the part of the trustee must be dishonest and fraudulent. In Selangor [1968] 2 All ER 1073 at 1098, 1104 Ungoed-Thomas J held that this element must be understood in accordance with equitable principles for equitable relief and that conduct which is morally reprehensible can properly be said to be dishonest and fraudulent for the purposes of that element. But in Belmont Finance Corp Ltd v Williams Furniture Ltd [1979] Ch 250 the Court of Appeal made clear that it is not sufficient that there should be misfeasance or a breach of trust falling short of dishonesty and fraud. For present purposes there is no distinction to be drawn between the two adjectives 'dishonest' and 'fraudulent' (see Belmont at 267). It is common ground between the parties that I can take as a relevant description of fraud 'the taking of a risk to the prejudice of another's rights, which risk is known to be one which there is no right to take' (R v Sinclair [1968] 3 All ER 241).

[page816]

45 The English "fraudulent and dishonest design" analysis was adopted by the Saskatchewan Court of Appeal in MacDonald v. Hauer (1976), 72 D.L.R. (3d) 110. In that case, one of the trustees opened a margin account in his own name for the purpose of securities trading. He pledged securities belonging to the estate for which he was trustee with a broker as security for the margin, and gave his business associate Hauer his power of attorney on the account. The profits on the account were to be shared equally between the trustee and Hauer. The estate's securities were eventually sold by Hauer. Bayda J.A. (as he then was) found Hauer liable in equity for breach of trust as a constructive trustee. Relying on Barnes v. Addy, supra, Bayda J.A. held at p. 121 that the three essential elements for finding a stranger to a trust to be a constructive trustee were: "(1) assistance by the stranger of a nominated trustee (2) with knowledge (3) in a dishonest and fraudulent design on the part of the nominated trustee (or fraudulent or dishonest disposition of the trust property)", although it should be noted that Bayda J.A. appears later in his analysis also to rely on a passage from Selangor, supra, which is characteristic of the second approach, discussed below.

46 Barnes v. Addy was also followed in Scott v. Riehl (1958), 15 D.L.R. (2d) 67 (B.C.S.C.). In that case, the two defendants were the directors of a construction company. The directors had failed to comply with the provisions of the Mechanics' Lien Act, 1956, S.B.C. 1956, c. 27, requiring certain monies to be held in trust. All monies received were deposited into one bank account, which was always overdrawn. The director and president of the corporation, Riehl, "knew that monies deposited, such as those received from the plaintiffs, must [not] be used for the general purposes of the company in abuse of the trust created by s. 3 of the Act. He knowingly created, maintained and operated this unlawful system. The company was the instrument of its operation, but he was the director" [page817] (p. 70). Wilson J. (as he then was) concluded at pp. 73-74 as follows:

> ... on the facts here Riehl, as agent received and misdirected trust funds. The acts of reception and application of these particular monies may not physically have been his, but they were entirely directed by him, with the possible, although not proven, collusion of the defendant Schumak. Riehl received a benefit, through the payment of his salary out of the account into which these trust funds were paid. His complicity in the misappropriation of these funds is proven; it was not an act of negligence or a mistake of judgment but a wrongful act knowingly done. In these circumstances not only the principal but the agent is liable.
>
> I have not ignored the numerous cases cited to me by defence counsel in which it has been held that directors are not personally responsible to strangers for acts done by them on behalf of the company but are at most responsible to the company. I only say that none of these cases goes so far as to say that where a fraudulent breach of trust known by the director to be fraudulent, is done by the company at his

> direction, so that he is not only a party to but the instigator of the fraudulent breach of trust and benefits from the breach of trust he is not to be held liable.

47 In Wawanesa Mutual Insurance Co., supra, the defendant corporation Chalmers was the agent of the plaintiff insurance company, Wawanesa. The defendant Mislowski was the sole shareholder, president, general manager, and the only active director of Chalmers. There was no written agency agreement between Chalmers and Wawanesa, but a provision in The Saskatchewan Insurance Act, R.S.S. 1960, c. 77, provided that an agent who received monies as premiums for a contract of insurance was "deemed to hold the premium in trust for the insurer" and liable to pay out to the insurer such monies less commission within 15 days after demand. The insurance company sued both the corporation and Mislowski for unpaid insurance premiums collected by the corporation, [page818] which had been deposited into the corporation's general account from which office expenses and salaries had been paid. Mislowski also had a construction business with a separate general account, but he constantly transferred funds between the insurance and construction accounts. The trial judge held the corporation liable for breach of trust, and then proceeded to discuss the liability of Mislowski at p. 287:

> The conversion of the trust funds to other purposes was a wrongful and illegal act or series of acts. There can be no doubt that the breach was inspired and directed by Mislowski who made all the corporate decisions. See Underhill's Law Relating to Trusts & Trustees, 11th ed., p. 558:
>
> > ... the liability for breach of trust is not confined to express trustees, but extends to all who are actually privy to the breach.

The trial judge therefore concluded that Mislowski was also liable for Wawanesa's loss.

48 There is, however, a second line of Canadian authority, holding that a person who is the controlling or directing mind of a corporate trustee can be liable for an innocent or negligent breach of trust if the person knowingly assisted in the breach of trust. That is, in these cases, proof of fraud and dishonesty has not been required. In Horsman Bros. Holdings Ltd. v. Panton & Panton, [1976] 3 W.W.R. 745 (B.C.S.C.), which involved similar facts to those in Scott v. Riehl, supra, counsel for the beneficiary of the statutory trust conceded that the breach of trust was "innocent", that is, that the defendant directors had no knowledge that they were committing a breach of trust by conducting the corporation's affairs in the way in which they did. However, he relied upon the decision in Scott v. Riehl in support of the contention that the defendant directors should nonetheless be personally liable [page819] for the corporate breach of trust. Craig J. held as follows at pp. 750-51:

> Counsel for the defendants seeks to distinguish the Riehl case on the ground that Wilson J. was dealing with a "fraudulent" breach of trust whereas in this case I am dealing with an "innocent" breach of trust. I am not sure that Wilson J. was dealing with a "fraudulent" breach of trust in the Riehl case, but, even if he were, I think that his remarks are equally applicable to an "innocent" breach of trust. If a person deals with the funds, which are within the meaning of s. 3, in a manner inconsistent with the trust, he breaches the trust, even though he may do so "innocently".
>
> ...
>
> Accordingly, I find that the defendants did breach the trust provisions of s. 3 and that they are liable to the plaintiff for this breach.

49 This analysis was adopted by the British Columbia Court of Appeal in Trilec Installations Ltd. v. Bastion Construction Ltd. (1982), 135 D.L.R. (3d) 766. On facts similar to Horsman Bros., supra, the beneficiaries of a trust under the Builders Lien Act, R.S.B.C. 1979, c. 40, sued the corporate trustee and its director for breach of trust. The defendant director argued, at p. 767, that "by simply depositing the trust moneys in the corporate appellant's general bank account from which it was taken by others than the beneficiaries of the trust", there was no breach of trust. Carrothers J.A. noted that the defendant director and corporate president, who had personally made the deposit of the funds in question, had conceded that he knew when he made the deposit that the funds probably would be taken, as in fact they were, by persons other than the trust beneficiaries. Carrothers J.A. concluded that the defendant director had committed a breach of trust by failing to preserve the trust monies for the trust

beneficiaries, and instead depositing the monies for the general purposes of the trustee corporation. [page820] Therefore, he was personally liable for his breach of trust.

50 The Ontario Court of Appeal in the present case relied heavily on Henry Electric, supra, in which the British Columbia Court of Appeal dealt with facts very similar to the present case, although involving a statutory trust under the Builders Lien Act, R.S.B.C. 1979, c. 40. Farwell was the owner and sole director of the corporation. Carrothers J.A. held, at pp. 485-86, that he was the single operating mind of the corporation and was personally liable for the corporate breach of trust:

> In my view Farwell, as the sole director and shareholder of the Farwell company, was the exclusive operating mind of that company and was correctly held liable for the breach of trust first by putting the general account of the Farwell company in jeopardy to satisfy its loan from its banker and subsequently by allowing the deposit of trust funds into the general account of the corporation for general purposes without adequate account controls thus exposing the trust funds to withdrawal unilaterally by the bank for purposes in breach of the trust. While the bank did not forewarn either the Farwell company or Farwell of this particular application of contract moneys against the Farwell company's indebtedness to the bank, this action was foreseeable and ought to have been foreseen and guarded against.
>
> Farwell was clearly a director of the Farwell company who knowingly assented to or acquiesced in the breach of trust and he is personally liable for breach of trust in addition to the corporation. I do not make the quasi-criminal finding that Farwell has committed an offence under the provisions of s. 2(2) of the Act, but rather that Farwell is civilly liable for the breach of trust contemplated by those provisions.
>
> ...
>
> It is also not to be overlooked that, in addition to foreseeability by Farwell of the breach of trust which occurred, Farwell personally benefited from the breach [page821] by reduction of his personal liability on his guarantee to the bank in respect of the Farwell company loan.

51 Esson J.A. (as he then was) dissented, relying on Scott v. Riehl, supra. He distinguished that case on the grounds that the one bank account was always overdrawn, and Riehl knew that the trust monies deposited in that account should not have been used for the general purposes of the company in abuse of the trust. Nevertheless, he accepted "that a person in Mr. Farwell's position can be liable without proof of fraud." He relied on s. 2 of the statute which provided that the trustee "shall not appropriate or convert any part of (the trust moneys) to his own use, or to any use not authorized by the trust". Esson J.A. noted at p. 489 that under s. 2, "[t]he unauthorized use may not be fraudulent and yet the agent may be liable for his part in bringing about the breach if he be the instigator of the breach and benefit from it."

52 Nonetheless, Esson J.A. held that there had been no breach of trust by the company, as there had been no appropriation or conversion of trust funds to the use of the company or any use not authorized by the trust. Esson J.A. stated that the act in that case, as distinct from Scott v. Riehl, was not a wrongful act knowingly done, although it may have been an act of negligence. Esson J.A. found, contrary to the majority's finding, that the bank's unilateral act of withdrawal of the trust monies from the general account was not reasonably foreseeable by Farwell. Esson J.A. concluded as follows at p. 491:

> To put the trust funds into a pot, without any other element of fault, does not, in my view, constitute appropriation or conversion of the fund to the trustee's own use or any use not authorized by the trust. Unless there was a breach of trust, the potential benefit to Mr. Farwell from the act of the bank, by reducing the company's indebtedness and thus his indebtedness on his guarantee, is not relevant. It may be that the statute which creates [page822] the trust should impose liability upon persons who are the directing mind of corporate trustees and who fail to ensure that the trust funds are dealt with in the most prudent manner possible. But as the law stands there was on these facts no basis for imposing liability on the director.

53 The second line of authority, in which proof of fraud and dishonesty is not required, was also adopted in Ontario in Andrea Schmidt Construction Ltd., supra. That case involved a mortgage between Blendcraft Construction (the mortgagor) and a real estate investment corporation called Burnac (the mortgagee). The parties had agreed that a

portion of monies advanced under the mortgage would be applied to reduce Blendcraft's indebtedness under an unrelated mortgage, known as the Thompson mortgage, also held by Burnac. The advance given by Blendcraft to Burnac for this purpose was subject to a trust under The Mechanics' Lien Act, R.S.O. 1970, c. 267. Schmidt, an unpaid contractor, sued Blendcraft, its director, and Burnac for breach of trust. The trial judge imposed personal liability on Mr. Glatt, the sole shareholder, director and officer of Blendcraft for breach of trust by the corporation with respect to the monies held in trust under The Mechanics' Lien Act. The trial judge concluded as follows at pp. 575-76:

> There remains to be considered the liability of Mr. Glatt. He was the sole officer, director and shareholder of Blendcraft. His evidence was that he had no personal dealings with or liability to Schmidt [the beneficiary of the trust] and that all his dealings were as an officer of Blendcraft as were all his dealings with Burnac. While that may be correct as far as it goes, every act of Blendcraft including its breach of trust was expressly directed by Glatt. Glatt was aware that Blendcraft was committing a breach of trust. It was Glatt, as agent of Blendcraft, who acquiesced in the misdirection of trust funds. He received a benefit from the diversion in that his liability as covenantor on the Thompson mortgage was reduced. The situation in this case is similar to the situations in the two cases in British Columbia cited by counsel: Scott et al. v. Riehl & Schumak (1958), 15 D.L.R. (2d) 67, 25 W.W.R. 525; and Horsman Bros. [page823] Holdings Ltd. et al. v. Panton & Panton, [1976] 3 W.W.R. 745. In both those cases, directors were held liable for breach of a mechanics' lien trust committed by their respective corporations. No reason was advanced to me as to why the principles in those cases should not be applied in Ontario. Therefore, Schmidt should also have judgment against Glatt.

54 In Austin v. Habitat Development Ltd. (1992), 94 D.L.R. (4th) 359 (N.S.C.A.), the signing officer of a management company improperly diverted monies from a trust account managed for the owners of an apartment building to his own use. The other signing officer stood by, did not inform the owners and misrepresented the state of the trust account. The Nova Scotia Court of Appeal held that the company and the signing officers were fiduciaries in breach of their duty and were liable to repay the monies. Hallett J.A., concurring in the result, relied upon Barnes v. Addy, supra, Selangor, supra, and the Court of Appeal decision in the present case. He concluded, at p. 363, that "[i]t is clear from these authorities that if a director with knowledge actively participates in the conversion of trust funds, he may be found personally liable to the beneficiaries of the trust." Hallett J.A. described a conversion of trust property as follows at pp. 363-64:

> A conversion is an act of wilful interference without justification with property, including money, in a manner inconsistent with the right of the owner whereby the owner is deprived of the use or possession of the property. The transfer of the trust funds to Eastland Group was a conversion of the [beneficiaries'] money.

55 For the majority, Freeman J.A. held that Robinson, the director who had diverted the funds, was liable for the breach of trust he committed as agent for the corporate trustee, which was also liable as principal. With regard to Whitewood, the signing [page824] officer who stood by, Freeman J.A. stated that he shared complicity with Robinson. Freeman J.A. noted, at pp. 372-73, that the difference between that case and the present case (referring to the Court of Appeal decision) was that "in the latter the converted funds were used for purposes of the company, which were incidentally beneficial to the shareholders, and were not flagrantly removed by a company officer acting for his own benefit." Because of the blatancy of the breaches of trust committed by the directors, Freeman J.A. held that they were both personally liable to the beneficiaries.

56 The modified standard found in many of the Canadian cases involving directors of a closely held corporation reflects a difficulty with the application of the strict Barnes v. Addy standard to cases in which the corporate trustee is actually controlled by the stranger to the trust. In Barnes v. Addy, Lord Selborne L.C., at p. 252, expressed concerns regarding the imposition of liability on strangers to the trust in the absence of participation in a fraudulent and dishonest design: "those who create trusts do expressly intend, in the absence of fraud and dishonesty, to exonerate such agents of all classes from the responsibilities which are expressly incumbent, by reason of the fiduciary relation, upon the trustees." Later in his reasons, Lord Selborne L.C. reiterated this position at p. 253: "if we were to hold that [a solicitor] became a constructive trustee by the preparation of such a deed, ... not having enabled any one, who otherwise might not have had the power, to commit a breach of trust, we should be acting ... without authority... ."

57 Generally, there are good reasons for requiring participation in a fraudulent and dishonest breach [page825] of trust before imposing liability on agents of the trustees:

> Unlike the stranger who takes title, an agent who disposes of trust property has no choice in the matter. He is contractually bound to act as directed by his principal the trustee. It is one thing to tell an agent that he must breach his contract rather than participate in a fraud on the part of his principal. It is quite another to tell him that he must breach his contract any time he believes his principal's instructions are contrary to the terms of the trust. This is to tell the agent that he must first of all master the terms of his principal's undertaking and, secondly, enforce his own understanding of what that undertaking entails. In effect, it burdens him with the duties of trusteeship upon the mere receipt of trust property as agent. As we have seen, however, properly understood, the role of agent is distinct from that of trustee. An agent is not to be made a trustee de son tort unless he voluntarily repudiates the role of agent and takes on the job of a trustee. So long as he chooses to remain an agent, his loyalties are to his principal, the trustee, and he should be free to follow the latter's instructions short of participating in a fraud.

Ruth Sullivan, "Strangers to the Trust", [1986] Est. & Tr. Q. 217, p. 246.

58 It must be remembered that it is the nature of the breach of trust that is under consideration at this point in the analysis, rather than the intent or knowledge of the stranger to the trust. That is, the issue here is whether the breach of trust was fraudulent and dishonest, not whether the appellant's actions should be so characterized. Barnes v. Addy clearly states that the stranger will be liable if he or she knowingly assisted the trustee in a fraudulent and dishonest breach of trust. Therefore, it is the corporation's actions which must be examined. The appellant's actions will also be relevant to this examination, given the extent to which M & L was controlled by the defendant directors. The appellant's conduct will be more directly scrutinized when the issue of knowledge is under consideration. [page826] It is unnecessary, therefore, to find that the appellant himself acted in bad faith or dishonestly.

59 Where the trustee is a corporation, rather than an individual, the inquiry as to whether the breach of trust was dishonest and fraudulent may be more difficult to conceptualize, because the corporation can only act through human agents who are often the strangers to the trust whose liability is in issue. Regardless of the type of trustee, in my view, the standard adopted by Peter Gibson J. in the Baden, Delvaux case, following the decision of the English Court of Appeal in Belmont Finance, supra, is a helpful one. I would therefore "take as a relevant description of fraud 'the taking of a risk to the prejudice of another's rights, which risk is known to be one which there is no right to take'." In my opinion, this standard best accords with the basic rationale for the imposition of personal liability on a stranger to a trust which was enunciated in In re Montagu's Settlement Trusts, supra, namely, whether the stranger's conscience is sufficiently affected to justify the imposition of personal liability. In that respect, the taking of a knowingly wrongful risk resulting in prejudice to the beneficiary is sufficient to ground personal liability. This approach is consistent with both lines of authority previously discussed.

60 In the instant case, as a party to the contract between itself and the respondent, M & L knew that the Air Canada monies were held in trust for the respondent, and were not for the general use of M & L. Trust accounts were set up by M & L in 1978, but never used. M & L also knew that any positive balance in its general account was subject to the Bank's demand. By placing the trust monies in the general account which were then subject to seizure by the Bank, M & L took a risk to the prejudice of the rights of the respondent beneficiary, Air Canada, which risk was known to be one which there was no right to take. See Baden, [page827] Delvaux, supra,; Scott v. Riehl, supra. Therefore, the breach of trust by M & L was dishonest and fraudulent from an equitable standpoint.

61 It is clear that the appellant participated or assisted in the breach of trust. As was the case in Horsman Bros., supra, the appellant dealt with the funds in question: in particular, he stopped payment on all cheques, and then opened a trust account and attempted to withdraw the stop payment orders and to transfer the funds into the new trust account in order to pay the respondent. The breach of trust was directly caused by the conduct of the defendant directors. As Griffiths J.A. observed, at p. 204, "[t]he movement of these directors, acting solely in their own interest to stop payment on cheques, not only prevented payment on cheques issued to Air Canada, but

precipitated the seizure by the bank of the only funds available in the unprotected general account." In such circumstances, the directors are personally liable for the breach of trust as constructive trustees provided that the requisite knowledge on the part of the directors is proved.

62 With respect to the knowledge requirement, this will not generally be a difficult hurdle to overcome in cases involving directors of closely held corporations. Such directors, if active, usually have knowledge of all of the actions of the corporate trustee. In the instant case, the analysis is somewhat more difficult to resolve, as the appellant was not as closely involved with the day-to-day operations as was the other director, Martin. However, the appellant knew of the terms of the agreement between M & L and the respondent airline, as he signed that agreement. The appellant also knew that the trust funds were being deposited in the general bank account, which was subject to the demand loan from the Bank. This constitutes actual knowledge of the breach of trust. That is, even if the appellant could argue that he had no subjective knowledge of the breach of trust, given [page828] the facts of which he did have subjective knowledge, he was wilfully blind to the breach, or reckless in his failure to realize that there was a breach. Furthermore, the appellant received a benefit from the breach of trust, in that his personal liability to the Bank on the operating line of credit was extinguished. Therefore, he knowingly and directly participated in the breach of trust, and is personally liable to the respondent airline for that breach.

V. Disposition

63 For the foregoing reasons, I would therefore dismiss the appeal with costs.

The following are the reasons delivered by

McLACHLIN J.

64 I agree with Justice Iacobucci that the relationship between the corporation and Air Canada was one of trust, not debtor and creditor. I also agree with his proposed disposition of the appeal. In my view, whatever view one adopts on the difficult issues discussed by my colleague, the appellant is clearly liable as a constructive trustee for the breach of trust which the corporation committed respecting Air Canada's account.

65 There is no debate on the first requirement for imposition of personal liability on a stranger to a trust: knowing participation in the breach. The next question is whether the required knowledge is subjective knowledge (i.e., actual knowledge of the breach or wilful blindness and recklessness) or objectively determined knowledge (what a reasonably diligent person would have known). Courts have divided on this issue. The courts in England require subjective knowledge. However, certain appellate courts in Canada have suggested that a subjectively determined standard of knowledge is not appropriate in the trust context, even for a stranger to the trust, and that where a stranger should reasonably have known that the trust was [page829] being breached by his or her actions, there may be circumstances where liability is appropriate. See MacDonald v. Hauer (1976), 72 D.L.R. (3d) 110 (Sask. C.A.), at p. 123; Henry Electric Ltd. v. Farwell (1986), 29 D.L.R. (4th) 481 (B.C.C.A.), at p. 485. In this case, as my colleague points out, the evidence meets the higher English standard of subjective knowledge, given that the appellant was wilfully blind. Accordingly, it is not necessary to decide whether in some cases, an objective test might suffice. That is a difficult and important question which I would prefer to leave to a case in which it squarely arises.

66 The second issue is the nature of the breach which can give rise to liability. Must it be fraudulent and dishonest, or does any breach suffice? Again, the authorities are divided; as Iacobucci J. discusses, a number of Canadian courts do not adopt the dominant English view that the breach must be fraudulent and dishonest: Horsman Bros. Holdings Ltd. v. Panton & Panton, [1976] 3 W.W.R. 745; Trilec Installations Ltd. v. Bastion Construction Ltd. (1982), 135 D.L.R. (3d) 766; Andrea Schmidt Construction Ltd. v. Glatt (1979), 25 O.R. (2d) 567 (H.C.). Again, it is not necessary to resolve the issue in this case, since here the breach was fraudulent and dishonest in the sense discussed by my colleague of involving a risk to the property to the prejudice of the beneficiary. Given the importance and difficulty of the question, I would prefer to leave it to a case where it squarely arises.

67 A final matter is the effect, if any, of the fact that the appellant benefitted personally from the breach. In some Canadian cases, this has been cited as a circumstance in favour of imposing liability on the stranger to the trust:

see Scott v. Riehl (1958), 15 D.L.R. (2d) 67; Henry Electric Ltd., supra, and Andrea Schmidt Construction Ltd., supra. My colleague cites it as relevant to establishing [page830] actual knowledge of the breach, and refers to it as a factor in his conclusion that the appellant is liable. Given that this factor is present in this case, it is not necessary to decide whether liability could be imposed in the absence of personal benefit. My colleague, I hasten to add, does not himself venture on this question.

68 While I agree with Iacobucci J. that on the facts here, liability is clearly made out, I would prefer to leave consideration of the questions to which I have referred to future cases in which they directly arise.

69 I would dismiss the appeal.

TAB 3

Parliamentary Archives, HL/PO/JU/4/3/1160

HOUSE OF LORDS

BARCLAYS BANK LIMITED

v.

QUISTCLOSE INVESTMENTS LIMITED

Lord Reid
Lord of Morris Borthy-y-Gest
Lord Guest
Lord Pearce
Lord Wilberforce

Lord Reid

my lords,

I agree with the speech of my noble and learned friend, Lord Wilberforce. I would only add that I am by no means satisfied that this House would be precluded from holding, in such circumstances as exist in this case, that notice of the trust received by the Bank after they had received the money could be effective.

I would dismiss this appeal.

Lord Morris of Borth-y-Gest

my lords,

I am in agreement with the speech of my noble and learned friend, Lord Wilberforce, which I have had the advantage of reading.

I would dismiss the appeal.

Lord Guest

my lords,

I have had the advantage of reading the opinion of my noble and learned friend, Lord Wilberforce. I agree with it and would dismiss the appeal.

Lord Pearce

my lords,

I have had the advantage of reading the opinion of my noble and learned friend, Lord Wilberforce. I entirely agree with it. Accordingly, I would
dismiss the appeal.

Lord Wilberforce

my lords,

The events with which the present appeal is concerned took place in the final weeks preceding the collapse of Rolls Razor Ltd., an enterprise of which the moving spirit was Mr. John Bloom. The Company's audited accounts for the year 1963 showed a considerable trading profit: an interim dividend of 80 per cent, had been paid, and the figures admitted of the payment of a substantial final dividend. On 14th May, 1964, the Directors, at a Board meeting, agreed to recommend a final payment of 120 per cent. But the Company had no liquid resources to enable it to pay this dividend, which required a net sum, after deduction of tax, of £209,719 8s. 6d. On 4th June, 1964, its overdraft with the Appellant Bank was £485,000, against a limit of £250,000, and on that day the Bank by letter to Mr. Leslie Goldbart, one of the Directors, required this situation to be rectified, and stated that it would be unable to help in the payment of the final dividend unless this was made within the overdraft limit of £250,000.

The Annual General Meeting of Rolls Razor Ltd. was held on 2nd July, 1964, and payment of the 120 per cent, dividend was approved. No date was fixed by the approving resolution, but the Directors contemplated that payment would be made on 24th July. Approval of the dividend made the Company a debtor in respect of the net amount to its shareholders. Provision of the sum required to pay it, as also of finance to enable the Company to continue trading, was the subject of negotiations by Mr. Bloom during the early part of July. He succeeded in obtaining the money needed to pay the dividend from the Respondent Company, which he owned or controlled. At a Board meeting of the latter held on 15th July, 1964, it was resolved that a loan of £209,719 8s. 6d. be made to Rolls Razor Ltd. " for the purpose of that Company paying the final dividend on 24th July " next". On the same day, a cheque for that sum was drawn by the Respondent Company in favour of Rolls Razor Ltd. Rolls Razor Ltd. sent this cheque to the Appellant Bank's City Branch Office together with a covering letter on the notepaper of Rolls Razor Ltd., also dated 15th July, 1964, signed by Mr. Goldbart and addressed to Mr. G. H. Parker, a joint Manager of that Branch in the following terms: —

" Dear Mr. Parker,

" Confirming our telephone conversation of to-day's date, will you
" please open a No. 4 Ordinary Dividend Share Account.

" I enclose herewith a cheque valued at £209,719 8s. 6d. . . . being
" the total amount of dividend due on the 24th July 1964. Will you
" please credit this to the above mentioned account.

" We would like to confirm the agreement reached with you this
" morning that this amount will only be used to meet the dividend due
" on the 24th July 1964."

From an answer to an interrogatory administered to the Bank in the course of the action, it appeared that, in the telephone conversation referred to in this letter, Mr. Goldbart had informed Mr. Parker that arrangements had been made with an unspecified person to lend or otherwise provide money for the purpose of paying the dividend due to be paid by Rolls Razor Ltd. on 24th July, 1964.

The Appellant Bank had, on 8th June, 1964, opened an Ordinary Dividend No. 4 account. The Respondents' cheque for £209,719 8s. 6d. was specially cleared and credited to this account on 17th July, 1964. Mr. Bloom was unable to raise further sufficient finance and on 17th July, 1964, the Directors of Rolls Razor Ltd., resolved to put the Company into voluntary liquidation ; the Appellant Bank was so informed. On or about 20th July it amalgamated all the accounts of the Company except the Ordinary Dividend No. 4 account. On 5th August, 1964, the Respondent's solicitors demanded repayment from Rolls Razor Ltd. of the sum of £209,719 8s. 6d. but repayment was not made and no demand at this time was made upon the Appellant Bank. The effective resolution for the liquidation of Rolls Razor Ltd. was passed on 27th August, 1964, and on the following day the Appellant Bank set off the credit balance on Ordinary Dividend No. 4 account against part of the debit balance on Rolls Razor Ltd.'s other accounts. There followed in due course demand by the Respondents for repayment of this sum by the Bank and the present proceedings.

Two questions arise, both of which must be answered favourably to the Respondents if they are to recover the money from the Bank. The first is whether as between the Respondents and Rolls Razor Ltd. the terms upon which the loan was made were such as to impress upon the sum of £209,719 8s. 6d. a trust in their favour in the event of the dividend not being paid. The second is whether, in that event, the bank had such notice of the trust or of the circumstances giving rise to it as to make the trust binding upon them.

It is not difficult to establish precisely upon what terms the money was advanced by the Respondents to Rolls Razor Ltd. There is no doubt that the loan was made specifically in order to enable Rolls Razor Ltd. to pay

the dividend. There is equally, in my opinion, no doubt that the loan was made only so as to enable Rolls Razor Ltd. to pay the dividend and for no other purpose. This follows quite clearly from the terms of the letter of Rolls Razor Ltd. to the Bank of 15th July, 1964, which letter, before transmission to the Bank, was sent to the Respondents under open cover in order that the cheque might be (as it was) enclosed in it. The mutual intention of the Respondents and of Rolls Razor Ltd., and the essence of the bargain, was that the sum advanced should not become part of the assets of Rolls Razor Ltd., but should be used exclusively for payment of a particular class of its Creditors, namely, those entitled to the dividend. A

necessary consequence from this, by process simply of interpretation, must be that if, for any reason, the dividend could not be paid, the money was to be returned to the Respondents: the word " only " or " exclusively " can have no other meaning or effect.

That arrangements of this character for the payment of a person's Creditors by a third person, give rise to a relationship of a fiduciary character or trust, in favour, as a primary trust, of the creditors, and secondarily, if the primary trust fails, of the third person, has been recognised in a series of cases over some 150 years.

In *Toovey* v. *Milne* (1819) 2 Barn. & Ald. 683 part of the money advanced was, on the failure of the purpose for which it was lent (viz. to pay certain debts) repaid by the bankrupt to the person who had advanced it. On action being brought by the assignee of the bankrupt to recover it, the plaintiff was nonsuited and the nonsuit was upheld on a motion for a retrial. In his judgment Abbott C.J. said:

" I thought at the trial, and still think, that the fair inference from the
" facts proved was that this money was advanced for a special purpose,
" and that being so closed with a specific trust, no property in it passed
" to the assignee of the bankrupt. Then the purpose having failed, there
" is an implied stipulation, that the money shall be repaid. That has
" been done in the present case ; and I am of opinion that that repay-
" ment was lawful, and that the nonsuit was right."

The basis for the decision was thus clearly stated, viz., that the money advanced for the specific purpose did not become part of the bankrupt's estate. This case has been repeatedly followed and applied (see *Edwards* v. *Glynn* (1859) 2 E. & E. 29 ; *Re Rogers ex parte Holland and Hannen* (1891) 8 Morr. B.C. 243 ; *Re Drucker* [1902] 2 KB 237 C.A.; *Re Holley* [1915] 1 Hansell 181). *Re Rogers* was a decision of a strong Court of Appeal. In that case, the money provided by the third party had been paid to the creditors before the bankruptcy. Afterwards the trustee in bankruptcy sought to recover it. It was held that the money was advanced to the bankrupt for the special purpose of enabling his creditors to be paid, was impressed with a trust for the purpose and never became the property of the bankrupt. Lindley L.J. decided the case on principle but said that if authority was needed it would be found in *Toovey* v. *Milne* (u.s.) and other cases. Bowen L.J. said that the money came to the bankrupt's hands impressed with a trust and did not become the property of the bankrupt divisible amongst his creditors, and the judgment of Kay L.J., was to a similar effect.

These cases have the support of longevity, authority, consistency and, I would add, good sense. But they are not binding on your Lordships and it is necessary to consider such arguments as have been put why they should be departed from or distinguished.

It is said, first, that the line of authorities mentioned above stands on its own and is inconsistent with other, more modern, decisions. Those are cases in which money has been paid to a company for the purpose of obtaining an allotment of shares (see *Moseley* v. *Cressey's Co.* 1865 L.R. 1 Eq. 405 ; *Stewart* v. *Austin* L.R. 3 Eq. 299; *The Nanwa Gold Mines Ltd.* [1955] 1 W.L.R. 1080). I do not think it necessary to examine these cases in detail, nor to comment on them, for I am satisfied that they do not affect

the principle on which this appeal should be decided. They are merely examples which show that, in the absence of some special arrangement creating a trust (as was shown to exist in *Re Nanwa Gold Mines Ltd.*), payments of this kind are made upon the basis that they are to be included in the company's assets. They do not negative the proposition that a trust may exist where the mutual intention is that they should not.

The second, and main, argument for the Appellants was of a more sophisticated character. The transaction, it was said, between the Respondents' and Rolls Razor Ltd., was one of loan, giving rise to a legal action of debt. This necessarily excluded the implication of any trust, enforceable in equity, in the Respondents' favour: a transaction may attract one action or the other, it could not admit of both.

My Lords, I must say that I find this argument unattractive. Let us see what it involves. It means that the law does not permit an arrangement to be made by which one person agrees to advance money to another, on terms that the money is to be used exclusively to pay debts of the latter, and if, and so far as not so used, rather than becoming a general asset of the latter available to his creditors, at large, is to be returned to the lender. The lender is obliged, in such a case, because he is a lender, to accept, whatever the mutual wishes of lender and borrower may be, that the money he was willing to make available for one purpose only shall be freely available for others of the borrower's creditors for whom he has not the slightest desire to provide.

I should be surprised if an argument of this kind—so conceptualist in character—had ever been accepted. In truth it has plainly been rejected by the eminent judges who from 1819 onwards have permitted arrangements of this type to be enforced, and have approved them as being for the benefit of creditors and all concerned. There is surely no difficulty in recognising the co-existence in one transaction of legal and equitable rights and remedies : when the money is advanced, the lender acquires an equitable right to see that it is applied for the primary designated purpose (see *Re Rogers* (u.s.) where both Lindley L.J. and Kay L.J. explicitly recognised this): when the purpose has been carried out (i.e. the debt paid) the lender has his remedy against the borrower in debt: if the primary purpose cannot be carried out, the question arises if a secondary purpose (i.e. repayment to the lender) has been agreed, expressly or by implication: if it has, the remedies of equity may be invoked to give effect to it, if it has not (and the money is intended to fall within the general fund of the debtor's assets) then there is the appropriate remedy for recovery of a loan. I can appreciate no reason why the flexible interplay of law and equity cannot let in these practical arrangements, and other variations if desired : it would be to the discredit of both systems if they could not. In the present case the intention to create a secondary trust for the benefit of the lender, to arise if the primary trust, to pay the dividend, could not be carried out, is clear and I can find no reason why the law should not give effect to it.

I pass to the second question, that of notice. I can deal with this briefly because I am in agreement with the manner in which it has been disposed of by all three members of the Court of Appeal. I am prepared, for this purpose, to accept, by way of assumption, the position most favourable to the bank, i.e., that it is necessary to show that the bank had notice of the trust, or of the circumstances giving rise to the trust, at the time when they received the money, viz., on the 15th July, 1964, and that notice on a later date, even though they had not in any real sense given value when they received the money or thereafter changed their position, will not do. It is common ground, and I think right, that a mere request to put the money into a separate account is not sufficient to constitute notice. But on 15th July, 1964, the bank, when it received the

cheque, also received the covering letter of that date which I have set out above: previously there had been the telephone conversation between Mr. Goldbart and Mr. Parker, to which I have also referred. From these there is no doubt that the bank was told that the money had been provided on loan by a third person and was to be used only for the purpose of paying the dividend. This was sufficient to give them notice that it was trust money

and not assets of Rolls Razor Ltd.: the fact, if it be so, that they were unaware of the lender's identity (though the Respondent's name as drawer was on the cheque) is of no significance. I may add to this, as having some bearing on the merits of the case, that it is quite apparent from earlier documents that the bank were aware that Rolls Razor Ltd. could not provide the money for the dividend and that this would have to come from an outside source and that they never contemplated that the money so provided could be used to reduce the existing overdraft. They were in fact insisting that other or additional arrangements should be made for that purpose. As was appropriately said by Russell L.J., it would be giving a complete windfall to the bank if they had established a right to retain the money.

In my opinion, the decision of the Court of Appeal was correct on all points and the appeal should be dismissed.

(3l8779) Dd. 197022 150 10/68 St.S.

TAB 4

610 Opperman Drive
St. Paul, MN 55123
1-800-313-9378
Printed in the United States of America

ISBN: 978-0-314-61300-4
ISBN: 978-0-314-62130-6 (deluxe)

Black's Law Dictionary

Tenth Edition

EDITOR IN CHIEF

Bryan A. Garner, J.D., LL.D.
President, LawProse, Inc.
Distinguished Research Professor of Law
Southern Methodist University
Dallas, Texas

ASSOCIATE EDITORS

Karolyne H.C. Garner, J.D.
LawProse, Inc.
Dallas, Texas

Tiger Jackson, J.D., LL.M.
LawProse, Inc.
Dallas, Texas

Becky R. McDaniel, J.D.
LawProse, Inc.
Dallas, Texas

Jeff Newman, J.D.
LawProse, Inc.
Dallas, Texas

CONTRIBUTING LAWYER–EDITORS

Herbert J. Hammond
Dallas, Texas

Tony Honoré
Oxford, England

Brian Melendez
Minneapolis, Minnesota

Gary Muldoon
Rochester, New York

Ann Taylor Schwing
Sacramento, California

Fred Shapiro
New Haven, Connecticut

Joseph F. Spaniol Jr.
Bethesda, Maryland

PRONUNCIATION EDITOR

Charles Harrington Elster
San Diego, California

de bonis non administratis (dee **boh**-nis **non** ad-min-ə-**stray**-tis). [Law Latin] *Hist.* (17c) Of the goods not administered. • When the first administrator of an intestate estate dies or is removed, the second administrator is called an administrator *bonis non*, who administers the goods not administered by the previous executor.

de bonis non amovendis (dee **boh**-nis non ay-moh-**ven**-dis), *n.* [Latin "of goods not to be moved"] (18c) *Hist.* A writ directing the sheriffs of London to make sure that a defendant's goods are not removed while the defendant's writ of error on a judgment is pending.

de bonis propriis (dee **boh**-nis **proh**-pree-is), *n.* [Law Latin "of his own goods"] (17c) *Hist.* A judgment allowing execution on an administrator's individual property rather than the property of an estate, as when the administrator mismanages the estate. Cf. DE BONIS TESTATORIS.

de bonis testatoris (dee **boh**-nis tes-tə-**tor**-is), *n.* [Law Latin "of the goods of the testator"] (17c) *Hist.* A judgment awarding execution on a testator's property, rather than the individual property of an administrator. Cf. DE BONIS PROPRIIS.

de bonis testatoris ac si (dee **boh**-nis tes-tə-**tor**-is ak **sī**). [Law Latin "from the goods of the testator if he has any, and if not, from those of the executor"]. *Hist.* A judgment holding an executor responsible if the testator's estate is insufficient or if the executor falsifies a pleading as a release.

de bonne memoire (də **bawn mem**-wahr). [Law French] Of sound mind; of good memory. — Also spelled *de bone memorie*. See MIND AND MEMORY; COMPOS MENTIS.

de bono et malo (dee **boh**-noh et **mal**-oh), *n.* [Law Latin "for good and evil"] (18c) *Hist.* **1.** For good and evil. • A criminal defendant indicated full submission to the jury's verdict by placing himself or herself at the jury's mercy *de bono et malo*. — Also termed *de bien et de mal*. **2.** A special writ of jail delivery issued by the justices of assize to enable them to try all criminal defendants who were in jail where the court traveled. • Formerly, the judges were required to issue a separate writ for every prisoner. This was replaced by a general commission of jail delivery.

> "[T]hey have . . . a commission of general *gaol delivery*; which empowers them to try and deliver every prisoner, who shall be in the gaol when the judges arrive at the circuit town, whenever indicted, or for whatever crime committed. It was anciently the course to issue special writs of gaol delivery for each particular prisoner, which were called the writs *de bono et malo*: but, these being found inconvenient and oppressive, a *general* commission for all the prisoners has long been established in their stead. So that, one way or other, the gaols are cleared, and all offenders tried, punished, or delivered, twice in every year: a constitution of singular use and excellence." 4 William Blackstone, *Commentaries on the Laws of England* 267 (1769).

de bono gestu (dee **boh**-noh **jes**-t[y]oo). [Law Latin] (17c) For good behavior.

debt. (13c) **1.** Liability on a claim; a specific sum of money due by agreement or otherwise <the debt amounted to $2,500>. **2.** The aggregate of all existing claims against a person, entity, or state <the bank denied the loan application after analyzing the applicant's outstanding debt>. **3.** A nonmonetary thing that one person owes another, such as goods or services <her debt was to supply him with 20 international first-class tickets on the airline of his choice>. **4.** A common-law writ by which a court adjudicates claims involving fixed sums of money <he brought suit in debt>. — Also termed (in sense 4) *writ of debt*.

> "The action of debt lies where a party claims the recovery of a debt; that is, a liquidated or certain sum of money due him. The action is based upon contract, but the contract may be implied, either in fact or in law, as well as express; and it may be either a simple contract or a specialty. The most common instances of its use are for debts: (a) Upon unilateral contracts express or implied in fact. (b) Upon quasi-contractual obligations having the force and effect of simple contracts. (c) Upon bonds and covenants under seal. (d) Upon judgments or obligations of record. (e) Upon obligations imposed by statute." Benjamin J. Shipman, *Handbook of Common-Law Pleading* § 52, at 132 (Henry Winthrop Ballantine ed., 3d ed. 1923).

▸ **active debt.** (18c) *Civil law.* A debt due to another person.

▸ **ancestral debt.** (2002) An ancestor's debt that an heir can be compelled to pay.

▸ **antecedent debt.** (18c) **1.** *Contracts.* An old debt that may serve as consideration for a new promise if the statute of limitations has run on the old debt. See PRE-EXISTING-DUTY RULE. **2.** *Bankruptcy.* A debtor's prepetition obligation that existed before a debtor's transfer of an interest in property. • For a transfer to be preferential, it must be for or on account of an antecedent debt. See PREFERENTIAL TRANSFER.

▸ **bad debt.** (17c) A debt that is uncollectible and that may be deductible for tax purposes. Cf. *zombie debt*.

▸ **bonded debt.** (18c) A debt secured by a bond; a business or government debt represented by issued bonds.

▸ **book debt.** (17c) A debt that comes due in the ordinary course of business, as an integral part of doing business.

▸ **community debt.** (1877) A debt that is chargeable to the community of husband and wife. See COMMUNITY PROPERTY.

▸ **consumer debt.** (1935) A debt incurred by someone primarily for a personal, family, or household purpose. • Some jurisdictions also treat debt incurred for an agricultural purpose as a consumer debt.

> "What are 'consumer' debts? Section 101(8) defines a consumer debt as follows: 'consumer debt means debt incurred by an individual primarily for a personal, family, or household purpose.' The touchstone is the debtor's use of the money. The nature of the collateral, the business of the creditor and the form of the loan are all irrelevant. A loan of $25,000 from a Credit Union to pay for a child's education is a consumer debt, but the same loan used to finance the opening of an accounting business is not a consumer debt. This is so irrespective of the nature of the collateral put up for the debt." David G. Epstein et al., *Bankruptcy* § 7-45, at 579 (1993).

▸ **contingent debt.** (17c) A debt that is not presently fixed but that may become fixed in the future with the occurrence of some event.

▸ **contract debt.** (18c) An amount, usu. fixed, payable under a contract.

▸ **convertible debt.** (1858) A debt whose security may be changed by a creditor into another form of security.

▸ **debt by simple contract.** See *simple-contract debt*.

▸ **debt by special contract.** See *special-contract debt*.

▸ **debt by specialty contract.** See *special-contract debt*.

▸ **debt contracted. 1.** A debt arising from a contract. **2.** More broadly, arising from either a contract or tort.

> "Illustrations of what Mr. Bishop calls 'the elasticity of statutes' may be found in the meaning which different courts have attached to the words 'debt,' or the expression 'debt contracted,' in statutes imposing upon stockholders a personal liability to pay the corporate debts. . . . In such a statute the word 'debt,' and the words 'debts contracted,' have been held to embrace a judgment recovered in an action for slander; and the same expression has been held to embrace a judgment for costs in an action for a tort, and also a judgment in an action for deceit, since in the latter case the plaintiff might have waived the tort and sued upon the contract." Seymour D. Thompson, *A Treatise on the Liability of Stockholders in Corporations* § 57, at 62–63 (1879).

▸ **debt of record.** (17c) A debt evidenced by a court record, such as a judgment.

▸ **desperate debt.** (16c) **1.** Uncollectable debt. **2.** A debt taken on by one who is either insolvent or on the verge of insolvency.

▸ **distressed debt.** (1991) A debt instrument issued by a company that is financially troubled and in danger of defaulting on the debt, or in bankruptcy, or likely to default or declare bankruptcy in the near future.

▸ **exigible debt.** (1936) A liquidated and demandable debt; a matured claim.

▸ **fixed debt.** (1847) Generally, a permanent form of debt commonly evidenced by a bond or debenture; long-term debt. — Also termed *fixed liability*.

▸ **floating debt.** (18c) Short-term debt that is continuously renewed to finance the ongoing operations of a business or government.

▸ **forgiven debt.** (17c) Debt that the creditor has written off as uncollectible.

▸ **fraudulent debt.** (18c) A debt created by fraudulent practices.

▸ **funded debt.** (18c) **1.** A state or municipal debt to be paid out of an accumulation of money or by future taxation. **2.** Secured long-term corporate debt meant to replace short-term, floating, or unsecured debt.

▸ **future debt.** *Scots law.* A debt that is to become due at some definite future date, as distinguished from a pure or contingent debt.

▸ **general debt.** (16c) A governmental body's debt that is legally payable from general revenues and is backed by the full faith and credit of the governmental body.

▸ **hypothecary debt.** (1883) A lien on an estate.

▸ **individual debt.** (*usu. pl.*) (18c) Debt personally owed by a partner, rather than by the partnership.

▸ **installment debt.** (1927) A debt that is to be repaid in a series of payments at regular times over a specified period.

▸ **judgment debt.** (18c) A debt that is evidenced by a legal judgment or brought about by a successful lawsuit against the debtor.

▸ **junior debt.** See *subordinate debt*.

▸ **legal debt.** (17c) A debt recoverable in a court of law.

▸ **liquidated debt.** (18c) A debt whose amount has been determined by agreement of the parties or by operation of law.

▸ **liquid debt.** (17c) A debt that is due immediately and unconditionally.

▸ **long-term debt.** (1917) Generally, a debt that will not come due within the next year.

▸ **mutual debts.** (18c) Cross-debts of the same kind and quality between two persons. Cf. SETOFF (2).

▸ **national debt.** See NATIONAL DEBT.

▸ **nondischargeable debt.** (1908) A debt (such as one for delinquent taxes) that is not released through bankruptcy.

▸ **passive debt.** (1835) A debt that, by agreement between the debtor and creditor, is interest-free.

▸ **preferential debt.** (1880) A debt that is legally payable before others, such as an employee's wages.

▸ **privileged debt.** (18c) A debt that has priority over other debts if a debtor becomes insolvent; a secured debt.

▸ **public debt.** (16c) A debt owed by a municipal, state, or national government.

▸ **pure debt.** See *pure obligation* under OBLIGATION.

▸ **secured debt.** (18c) A debt backed by collateral.

▸ **senior debt.** (1927) A debt that takes priority over other debts. • Senior debts are often secured by collateral.

▸ **short-term debt.** (1918) Collectively, all debts and other liabilities that are payable within one year. — Also termed *current liability*.

▸ **simple-contract debt.** (1814) A debt that is either oral or written but is not of record and not under seal. — Also termed *debt by simple contract*.

▸ **special-contract debt.** (18c) A debt due, or acknowledged to be due, by an instrument under seal, such as a deed of covenant or sale, a lease reserving rent, or a bond. — Also termed *debt by special contract*; *debt by specialty contract*; *specialty debt*.

> "Any contract in short whereby a determinate sum of money becomes due to any person, and is not paid but remains in action merely, is a contract of debt. And, taken in this light, it comprehends a great variety of acquisition; being usually divided into debts of *record*, debts by *special*, and debts by simple contract." 2 William Blackstone, *Commentaries on the Laws of England* 464 (1766).

▸ **subordinate debt.** (1945) A debt that is junior or inferior to other types or classes of debt. • Subordinate debt may be unsecured or have a low-priority claim against property secured by other debt instruments. — Also termed *junior debt*.

▸ **subprime debt.** (1998) The debt created by a loan made to a borrower with a high risk of default. See PRIME LENDING RATE.

▸ **unliquidated debt.** (18c) A debt that has not been reduced to a specific amount, and about which there may be a dispute.

▸ **unsecured debt.** (1843) A debt not supported by collateral or other security.

▸ **zombie debt.** (2006) *Slang.* Old debt that a creditor or collector has given up on collecting and sold to another party who undertakes fresh collection efforts. Cf. *bad debt*.

debt adjustment. See DEBT POOLING (1).

debt capital. See CAPITAL.

patron. (15c) **1.** A customer or client of a business, esp. a regular one. **2.** A licensee invited or permitted to enter leased land for the purpose for which it is leased. **3.** Someone who protects, supports, or champions some person or thing, such as an institution, social function, or cause; a benefactor.

patronage (**pay**-trə-nij). (16c) **1.** The giving of support, sponsorship, or protection. **2.** All the customers of a business; clientele. **3.** The power to appoint persons to governmental positions or to confer other political favors. — Also termed (in sense 3) *political patronage*. See SPOILS SYSTEM.

patronizing a prostitute. (1956) The offense of requesting or securing the performance of a sex act for a fee; PROSTITUTION. Cf. SOLICITATION (3).

patronus (pə-**troh**-nəs), *n.* [Latin] **1.** *Roman law.* Someone who had manumitted a slave, and was therefore entitled to certain services from the slave. **2.** ADVOWEE. Pl. ***patroni*** (pə-**troh**-nī).

patruus (**pa**-troo-əs), *n.* [Latin] *Roman & civil law.* A father's brother; a paternal uncle.

patruus magnus (**pa**-troo-əs **mag**-nəs), *n.* [Latin] (16c) *Roman & civil law.* A grandfather's brother; a great-uncle.

patruus major (**pa**-troo-əs **may**-jər), *n.* [Latin] *Roman law.* A great grandfather's brother.

patruus maximus (**pa**-troo-əs **mak**-sə-məs). See ABPATRUUS.

pattern, *n.* (1883) A mode of behavior or series of acts that are recognizably consistent <a pattern of racial discrimination>.

pattern jury charge. See *model jury instruction* under JURY INSTRUCTION.

pattern jury direction. See *model jury instruction* under JURY INSTRUCTION.

pattern jury instruction. See *model jury instruction* under JURY INSTRUCTION.

pattern of racketeering activity. (1972) Two or more related criminal acts that amount to, or pose a threat of, continued criminal activity. • This phrase derives from the federal Racketeer Influenced and Corrupt Organizations Act. See RACKETEERING.

pattern-or-practice case. (1970) A lawsuit, often a class action, in which the plaintiff attempts to show that the defendant has systematically engaged in discriminatory activities, esp. by means of policies and procedures. • Typically, such a case involves employment discrimination, housing discrimination, or school segregation. A plaintiff must usu. show that a defendant's behavior forms a pattern of actions or is embedded in routine practices but inferences of executive or official complicity may be drawn from a consistent failure to respond to complaints or implement corrective measures.

pattern similarity. See *comprehensive nonliteral similarity* under SIMILARITY.

paucital (**paw**-si-təl), *adj. Rare.* See IN PERSONAM.

Pauline privilege. (1901) *Eccles. law.* The doctrine that a baptized person's marriage to a never-baptized person may be dissolved under certain circumstances, when dissolution is beneficial to the Roman Catholic Church. • The privilege is ordinarily exercised when (1) the marriage was valid, (2) the baptized spouse now wishes to marry a Catholic, and (3) at the time of the marriage, both parties were unbaptized in any faith. Before the privilege can be exercised, four conditions must be satisfied: (1) the unbaptized spouse must have deserted the baptized spouse without just cause, (2) the unbaptized spouse must still be unbaptized, (3) the baptized spouse must make the proper appeals to the Church, and (4) the Church must rule that the privilege is exercisable. There is uncertainty about the extent of the privilege. Cf. PETRINE PRIVILEGE.

pauper. (16c) A very poor person, esp. one who receives aid from charity or public funds; INDIGENT. See IN FORMA PAUPERIS.

pauperies (**paw**-pər-eez), *n.* [Latin "impoverishment"] *Roman law.* Damage done by a domesticated four-footed animal. • The animal's owner was liable for the damage or was required to give the animal to the injured person. For an etymological treatment of the term, see Alan Watson, "The Original Meaning of *Pauperies*," in *Legal Origins and Legal Change* 129 (1991). See *actio de pauperie* under ACTIO.

pauper's affidavit. See *poverty affidavit* under AFFIDAVIT.

pauper's oath. See OATH.

pawn, *n.* (15c) **1.** An item of personal property deposited as security for a debt; a pledge or guarantee. • In modern usage, the term is usu. restricted to the pledge of jewels and other personal chattels to pawnbrokers as security for a small loan. **2.** The act of depositing personal property in this manner. **3.** The condition of being held on deposit as a pledge. **4.** PIGNUS (1). Cf. BAILMENT (1). — **pawn,** *vb.*

pawnbroker, *n.* (17c) Someone who lends money, usu. at a high interest rate, in exchange for personal property that is deposited as security by the borrower. • If the money is not paid back, the pawnbroker may sell the personal property. Cf. MONEYLENDER. — **pawnbroking,** *n.*

> "Pawnbrokers are those who make a business of loaning money on the security of corporeal property, rather than incorporeal property, such as corporate stock. In many countries, as in France, the business of pawnbroking is carried on as a public institution, so that money may be borrowed by the poor at a reasonable rate of interest. In England and in the United States, however, it is carried on, just as any other enterprise, by individuals; but in almost all of the states of this country the business is to a greater or less degree regulated by special statutes." Armistead M. Dobie, *Handbook on the Law of Bailments and Carriers* 174 (1914).

pawnee. (18c) Someone who receives a deposit of personal property as security for a debt.

pawnor. (1846) Someone who deposits an item of personal property as security for a debt. — Also spelled *pawner.*

pax in maribus (**paks** in **mar**-i-bəs). [Latin] *Hist.* Peace on the seas.

pax in terris (**paks** in **ter**-is). [Latin] *Hist.* Peace on the lands.

pax regis (**paks ree**-jis), *n.* [Latin "the king's peace"] (17c) *Hist.* **1.** The king's guarantee of peace and security of life and property to all within his protection. See KING'S PEACE. **2.** VERGE (1).

pay, *n.* (14c) **1.** Compensation for services performed; salary, wages, stipend, or other remuneration given for work done.

▸ **danger pay.** Additional compensation that a worker is paid for doing dangerous work. — Also termed *damage money.*

▸ **equal pay.** (18c) Pay that is based on kind and quality of work done, such that two or more employees earn the same amount for the same work, and not according to any individual or group characteristic unrelated to ability, qualification, or performance.

▸ **fair pay.** (18c) Pay that is reasonably related to the competitive market value of the employee's skill and job performance.

▸ **deferred pay.** Any type of postponed compensation for services performed.

▸ **half pay. 1.** Fifty percent of the compensation for services performed. **2.** Reduced pay; esp., a reduced allowance paid to an officer when not in actual service or after retirement.

▸ **hazard pay.** (1956) Special compensation for work done under unpleasant or unsafe conditions.

▸ **performance-related pay.** (1982) Compensation that is increased if the worker does an especially effective job; a bonus or other salary enhancement given on grounds of exemplary results on the job.

▸ **redundancy pay.** See SEVERANCE PAY.

2. The act of paying or being paid. **3.** Someone considered from the viewpoint of reliability and promptness in meeting financial obligations. **4.** Metaphorically, retribution or punishment.

pay, *vb.* (13c) **1.** To give money for a good or service that one buys; to make satisfaction <pay by credit card>. **2.** To transfer money that one owes to a person, company, etc. <pay the utility bill>. **3.** To give (someone) money for the job that he or she does; to compensate a person for his or her occupation; COMPENSATE (1) <she gets paid twice a month>. **4.** To give (money) to someone because one has been ordered by a court to do so <pay the damages>. **5.** To be profitable; to bring in a return <the venture paid 9%>.

payable, *adj.* (14c) (Of a sum of money or a negotiable instrument) that is to be paid. • An amount may be payable without being due. Debts are commonly payable long before they fall due. Cf. DUE AND PAYABLE.

▸ **payable after sight.** (18c) Payable after acceptance or protest of nonacceptance. See *sight draft* under DRAFT (1).

▸ **payable at call.** (1860) Payable immediately upon demand.

▸ **payable at sight.** (18c) Payable immediately upon presentation. See *bill payable at sight* under BILL (6).

▸ **payable on demand.** (17c) Payable when presented or upon request for payment; payable at once at any time.

▸ **payable to bearer.** (18c) Payable to anyone holding the instrument.

▸ **payable to order.** (17c) Payable only to a specified payee.

payable, *n.* See *account payable* under ACCOUNT.

payable date. See DATE.

pay any bank. (1902) A draft indorsement that permits only banks to acquire the rights of a holder until the draft is either returned to the customer initiating collection or specially indorsed by a bank to a person who is not a bank. UCC § 4-201(b). • A bank normally endorses an item "Pay any bank" when forwarding it for collection, regardless of the type of indorsement (if any) the item carries at first receipt. The indorsement protects the collecting bank by preventing the item from straying from the regular bank-collection process.

payback. (18c) **1.** The act or an instance of repaying someone. **2.** The return on an investment, esp. an investment of capital. **3.** *Slang.* Revenge or retribution, esp. of a petty nature.

payback method. (1953) An accounting procedure that measures the time required to recover a venture's initial cash investment.

payback period. (1953) The length of time required to recover a venture's initial cash investment, without accounting for the time value of money.

paycheck, *n.* (1864) **1.** A check in payment of a salary or wages. **2.** The amount in wages that someone earns.

payday, *n.* (16c) **1.** A day scheduled for issuance of paychecks. **2.** The day on which stock transfers must be paid for.

payday advance. See *payday loan* under LOAN.

payday loan. See LOAN.

paydown, *n.* (1967) A loan payment in an amount less than the total loan principal.

payee. (18c) One to whom money is paid or payable; esp., a party named in commercial paper as the recipient of the payment. Cf. PAYOR.

payer. See PAYOR.

paygrade, *n.* (1883) The rank of an employee, esp. military personnel, based on a scale of salaries or wages.

pay-if-paid clause. See CLAUSE.

paying quantities. (1873) *Oil & gas.* An amount of mineral production from a single well sufficient to justify a reasonably prudent operator to continue producing from that well. • Most jurisdictions interpret the language "for so long thereafter as oil and gas is produced" in habendum clauses to mean so long as paying quantities are produced. See HABENDUM CLAUSE.

paylist, *n.* See PAYROLL (1).

paymaster, *n.* (16c) A corporate or governmental officer in charge of paying salaries or wages to employees. — **paymastership,** *n.*

payment. (14c) **1.** Performance of an obligation by the delivery of money or some other valuable thing accepted in partial or full discharge of the obligation. **2.** The money or other valuable thing so delivered in satisfaction of an obligation.

▸ **advance payment.** (16c) A payment made in anticipation of a contingent or fixed future liability or obligation.

▸ **balloon payment.** (1935) A final loan payment that is usu. much larger than the preceding regular payments and that discharges the principal balance of the loan. See *balloon note* under NOTE (1).

▸ **benefactor payment.** (1985) The payment of a defense attorney's fees by a third party rather than by the defendant. • Benefactor payments raise ethical questions about who the attorney's loyalty is with (the client or

▸ **economic refugee.** Someone who migrates to another country solely for better job prospects and a higher standard of living. • Although the person may apply for asylum, the desire to escape poverty or low pay does not qualify someone as a refugee. — Also termed *economic migrant*.

refugeeism. (1848) The quality, state, or condition of being a refugee.

refund, *n.* (18c) **1.** The return of money to a person who overpaid, such as a taxpayer who overestimated tax liability or whose employer withheld too much tax from earnings. **2.** The money returned to a person who overpaid. **3.** The act of refinancing, esp. by replacing outstanding securities with a new issue of securities. — **refund,** *vb.*

refund annuity. See ANNUITY.

refund-anticipation check. See CHECK.

refund-anticipation loan. See LOAN.

refunding. See FUNDING (2).

refunding bond. See BOND (2).

re-funding bond. See BOND (3).

refusal. (15c) **1.** The denial or rejection of something offered or demanded <the lawyer's refusal to answer questions was based on the attorney–client privilege>. **2.** An opportunity to accept or reject something before it is offered to others; the right or privilege of having this opportunity <she promised her friend the first refusal on her house>. See RIGHT OF FIRST REFUSAL.

refusal hearing. See HEARING.

refusal to deal. *Antitrust.* **1.** A company's decision not to do business with another company. • A business has the right to refuse to deal only if it is not accompanied by an illegal restraint of trade. **2.** The unjust rejection of a proposal or the restriction of the quantity or quality of a necessary good or service in order to ensure that the rejecting party can carry out an illegal act or achieve an improper purpose.

refusal to pay. See VEXATIOUS DELAY.

refus de justice (ruu-**foo** də zhoos-**tees**). See DENIAL OF JUSTICE.

refusenik, *n.* (1981) *Slang.* Someone who steadfastly declines to take part in something or to obey a law.

refutantia (ref-yoo-**tan**-shee-ə), *n.* [Law Latin] *Hist.* An acquittance or an acknowledgment renouncing all future claims.

refutation. The act of disproving or overthrowing an argument, opinion, doctrine, or theory by effective disputation or countervailing proof; esp., an advocate's demonstration of the invalidity or falsity of an adversary's contention.

▸ **anticipatory refutation.** A preemptive refutation of a contention before an adversary has made it.

> "Anticipatory refutation is essential for five reasons. First, any judge who thinks of these objections even before your opponent raises them will believe that you've overlooked the obvious problems with your argument. Second, at least with respect to the obvious objections, responding only after your opponent raises them makes it seem as though you are reluctant, rather than eager, to confront them. Third, by systematically demolishing counterarguments, you turn the tables and put your opponent on the defensive. Fourth, you seize the chance to introduce the opposing argument in your own terms and thus to establish the context for later discussion. Finally, you seem more even-handed and trustworthy." Antonin Scalia & Bryan A. Garner, *Making Your Case: The Art of Persuading Judges* 16 (2008).

refute, *vb.* (16c) **1.** To prove (a statement) to be false. **2.** To prove (a person) to be wrong. Cf. REBUT.

Reg. *abbr.* (1904) **1.** REGULATION. **2.** REGISTER.

reg, *n.* (*usu. pl.*) (1904) *Slang.* REGULATION (3) <review not only the tax code but also the accompanying regs>.

regale episcoporum (ri-**gay**-lee ə-pis-kə-**por**-əm). *Eccles. law.* The temporal rights and privileges of a bishop.

regalem habens dignitatem (ri-**gay**-ləm **hay**-benz dig-ni-**tay**-təm). [Law Latin] *Hist.* Having royal dignity.

regalia (ri-**gay**-lee-ə). (16c) **1.** *Hist.* Rights and privileges held by the Crown under feudal law. • *Regalia* is a shortened form of *jura regalia*.

▸ ***regalia majora*** (mə-**jor**-ə). [Latin "greater rights"] (18c) The Crown's greater rights; the Crown's dignity, power, and royal prerogatives, as distinguished from the Crown's rights to revenues.

▸ ***regalia minora*** (mi-**nor**-ə). [Latin "lesser rights"] (17c) The Crown's lesser rights; the Crown's lesser prerogatives (such as the rights of revenue), as distinguished from its royal prerogatives.

2. *Hist.* Feudal rights usu. associated with royalty, but held by the nobility.

> "Counties palatine are so called *a palatio*; because the owners thereof, the earl of Chester, the bishop of Durham, and the duke of Lancaster, had in those counties *jura regalia*, as fully as the king hath in his palace . . . ." 1 William Blackstone, *Commentaries on the Laws of England* 113 (1765).

3. Emblems of royal authority, such as a crown or scepter, given to the monarch at coronation. **4.** Loosely, finery or special dress, esp. caps and gowns worn at academic ceremonies.

regard, *n.* (14c) **1.** Attention, care, or consideration <without regard for the consequences>. **2.** *Hist. English law.* In England, an official inspection of a forest to determine whether any trespasses have been committed. **3.** *Hist. English law.* The office or position of a person appointed to make such an inspection.

regardant (ri-**gahr**-dənt), *adj.* (15c) *Hist. English law.* Attached or annexed to a particular manor <a villein regardant>. See VILLEIN.

regarder. (16c) An official who inspects a forest to determine whether any trespasses have been committed. — Also termed *regarder of the forest*.

reg. brev. *abbr.* REGISTRUM BREVIUM.

rege inconsulto (**ree**-jee in-kən-**səl**-toh). [Latin] (17c) *Hist.* A writ issued by a sovereign directing one or more judges not to proceed, until advised to do so, in a case that might prejudice the Crown.

regency. (15c) **1.** The office or jurisdiction of a regent or body of regents. **2.** A government or authority by regents. **3.** The period during which a regent or body of regents governs.

regent. (15c) **1.** Someone who exercises the ruling power in a kingdom during the minority, absence, or other disability of the sovereign. **2.** A governor or ruler. **3.** A member of the governing board of an academic institution, esp. a state university. **4.** *Eccles. law.* A master or professor of a college.

Reg. FD. See REGULATION FAIR DISCLOSURE.

reg. gen. *abbr.* REGULA GENERALIS.

Regiam Majestatem (**ree**-jee-əm maj-ə-**stay**-təm). [Latin "the (books of the) Royal Majesty"] *Scots law.* An ancient collection of Scottish laws, so called from its opening words. • The four-book collection is generally believed to be genuine, although its origins are widely disputed. It was partly copied from Glanville's treatise *De Legibus et Consuetudinibus Angliae*, as appears from the works' similarities and the fact that the Glanville treatise opens with the words *Regiam potestatem*. It was at one time believed to have been compiled by David I, but this supposition is unfounded. Still others believed that Edward I was responsible for the compilation as part of his efforts to take over Scotland and assimilate the laws of that country and England, but modern scholars reject this view. It was probably compiled by an unknown cleric shortly before 1320.

regicide (**rej**-ə-sɪd). (16c) **1.** The killing or murder of a monarch. **2.** Someone who kills or murders a monarch, esp. to whom one is subject. — **regicidal,** *adj.*

regime (rə-**zheem** *or* ray-**zheem**). (18c) **1.** A particular system of rules, regulations, or government <the community-property regime>. **2.** A particular administration or government, esp. an authoritarian one. — Also spelled *régime*.

▸ **international regime.** (1876) A set of norms of behavior and rules and policies that cover international issues and that facilitate substantive or procedural arrangements among countries.

▸ **legal regime.** (1850) A set of rules, policies, and norms of behavior that cover any legal issue and that facilitate substantive or procedural arrangements for deciding that issue.

▸ ***régime dotal*** (ray-**zheem** doh-**tahl**). *Hist. Civil law.* The right and power of a husband to administer his wife's dotal property, the property being returned to the wife when the marriage is dissolved by death or divorce. See *dotal property* under PROPERTY.

▸ ***régime en communauté*** (ray-**zheem** *on* koh-moo-noh-**tay** *or* kom-yoo-). *Hist. Civil law.* The community of property between husband and wife arising automatically upon their marriage, unless excluded by marriage contract.

regina (ri-**jɪ**-nə). (*usu. cap.*) (bef. 12c) **1.** A queen. **2.** The official title of a queen. **3.** In a monarchy ruled by a queen, the prosecution side in criminal proceedings. — Abbr. R. Cf. REX.

regio assensu (**ree**-jee-oh ə-**sen**-s[y]oo). [Latin] (17c) *Eccles. law.* A writ by which a sovereign assents to the election of a bishop.

regional fund. See MUTUAL FUND.

regionalism. (1871) Loyalty to a particular part of a country, usu. combined with a desire to see it become more politically independent.

regional securities exchange. See SECURITIES EXCHANGE.

regional stock exchange. See *regional securities exchange* under SECURITIES EXCHANGE.

register, *n.* (16c) **1.** An official list of the names of people, companies, etc.; esp., a book containing such a list. **2.** A governmental officer who keeps official records <each county employs a register of deeds and wills>. Cf. REGISTRAR.

▸ **electoral register.** (1817) An official list of the voters who may participate in an election.

▸ **probate register.** (1887) Someone who serves as the clerk of a probate court and, in some jurisdictions, as a quasi-judicial officer in probating estates.

▸ **register of deeds.** (18c) A public official who records deeds, mortgages, and other instruments affecting real property. — Also termed *registrar of deeds*; *recorder of deeds*.

▸ **register of land office.** (18c) *Hist.* A federal officer appointed for each federal land district to take charge of the local records and to administer the sale, preemption, or other disposition of public lands within the district.

▸ **register of wills.** (18c) A public official who records probated wills, issues letters testamentary and letters of administration, and serves generally as clerk of the probate court. • The register of wills exists only in some states.

3. See *probate judge* under JUDGE. **4.** A book in which all docket entries are kept for the various cases pending in a court. — Also termed (in sense 3) *register of actions*. **5.** *Eccles. law.* A record book of significant events occurring in a parish, including marriages, births, christenings, and burials. • Registers became required in England around 1530. — Abbr. Reg.

register, *vb.* (14c) **1.** To enter in a public registry <register a new car>. **2.** To enroll formally <five voters registered yesterday>. **3.** To make a record of <counsel registered three objections>. **4.** (Of a lawyer, party, or witness) to check in with the clerk of court before a judicial proceeding <please register at the clerk's office before entering the courtroom>. **5.** To file (a new security issue) with the Securities and Exchange Commission or a similar state agency <the company hopes to register its securities before the end of the year>. — Also termed *enregister*.

registered agent. See AGENT.

registered bond. **1.** (18c) A governmental or corporate obligation to pay money, represented by a single certificate delivered to the creditor. • The obligation is registered in the holder's name on the books of the debtor. See BOND (2). **2.** (1865) A bond that only the holder of record may redeem, enjoy benefits from, or transfer to another. See BOND (3). Cf. *bearer bond*.

registered broker. See BROKER.

registered check. See CHECK.

registered corporation. See CORPORATION.

registered dealer. See DEALER.

registered form. (1898) The condition of a security that specifies a person entitled either to the security itself or to rights it evidences, the transfer of the security being registrable on books maintained for that purpose by or on behalf of an issuer as stated on the certificate.

registered mail. See MAIL.

TAB 5

CITATION: Bonnie Cummings v. Peopledge HR Services Inc., 2013 ONSC 2781

COURT FILE NO.: CV 12-9896-00CL

DATE: 20130515

SUPERIOR COURT OF JUSTICE - ONTARIO

RE: BONNIE CUMMINGS IN HER CAPACITY AS ESTATE EXECUTRIX OF THE ESTATE OF THE LATE JOHN CUMMINGS, Applicant

AND:

PEOPLEDGE HR SERVICES INC., WINSTON PARK FINANCIAL SERVICES LTD., CMC FRASER LTD., 1624452 ONTARIO LIMITED, Respondents

BEFORE: Newbould J.

COUNSEL: *Joseph J. Bellissimo and Eleonore Morris*, for BDO Canada Limited
Geoff R. Hall, for the PMC-Sierra Ltd. and PMC-Sierra, Inc.
Jeffery Tighe, for Bonnie Cummings
Matthew Kanter, for Labatt Breweries of Canada LP
Michael McGraw, for Celergo Inc.

HEARD: May 9, 2013

ENDORSEMENT

[1] The receiver applies for a number of orders. The main issue is the method of distributing funds on hand to the various parties who have filed claims pursuant to a claims process previously authorized.

[2] Peopledge conducted business as a provider of payroll processing, human resources and benefits services. It serviced 152 Canadian customers and eight US customers. The estimated number of employees paid through its services was 9,926 in Canada and 482 in the US.

[3] Customers delivered funding for payrolls to Peopledge as well as payroll processing fees earned by Peopledge. Payroll funds were deposited into a "Canadian Consolidated Account" held with BMO to administer payrolls for customers with Canadian employees and a "US Consolidated Account" held with BMO Harris Bank in the US to administer payrolls for customers with US employees.

[4] There were no separate or designated trust accounts for deposits on a customer-by-customer basis. Thus when a customer deposited payroll funds, they were co-mingled with all other funds held in the particular Consolidated Account, including funds which had been deposited by other customers and with all funds from processing fees earned by Peopledge. Payroll payments were typically disbursed within three days. Payroll tax and other deductions could remain in the Consolidated Account for up to 45 days before being disbursed. Payroll processing fees earned by Peopledge and interest earned on the funds in the Consolidated Accounts were transferred to other corporate bank accounts held by Peopledge with BMO.

[5] The following claims relevant to this motion have been received by the receiver:

(a) Customer Deposit Claims (estimated aggregate claim amount of $5,714,718 for Canadian Customers and $180,000 for US Customers): claims for amounts paid to Peopledge for the purpose of funding payroll services for which Peopledge did not complete the payroll or remittance processing and payment in whole or in part, certain of which Customers have asserted trust entitlement in respect of their Customer Deposit Claims.

(b) Employee Claims ($106,669.10 with possible priority claim of $52,342.18): the receiver is aware that 18 former employees are owed a total of $106,669.10 based on the employees' WEPPA claims. Of this amount, employee priority claims comprise a possible $52,342.18.

(c) CRA Claims (aggregate claim amount of $59,359.37): CRA has made a source deduction claim and a HST against Peopledge, and as against 1624452 Ontario Limited for arrears of HST of $5,644.63.

(d) Secured Claims: Bonnie Cummings filed a claim on a secured and unsecured basis against all Debtors in the amount of $64,217.76 with respect to certain professional fees funded in connection with the receivership.[1]

(e) General Claims (estimated aggregate claim amount of $2,005,000): the majority of general claims were filed only as against Peopledge and are comprised of supplier, equity claims and Customer damage claims. Included in such claims is a General claim of $488,641.22 filed by Peopledge's former landlord. There are also certain general claims filed with unspecified claim amounts.

[6] The receiver has determined that Peopledge's records and accounting practices make it difficult to identify and trace the claims of specific Peopledge Customers. However, the Receiver has been able to determine the following:

(a) it appears all or a portion of payroll funds delivered to Peopledge by its Canadian Customers and its US Customers were intended by the respective Customer to be received and held by Peopledge segregated from other Peopledge funds and used to fund the respective Customer's payroll and governmental remittances;

(b) despite its obligations to maintain trust or segregated accounts for all or a portion of its Customers, Peopledge did not segregate funds received from any one Customer, although Peopledge did maintain two distinct, but co-mingled, payroll

[1] During argument I expressed the view that the claim of Bonnie Cummings should be paid in the same way that the other professional fees were to be paid pursuant to the request for payment in this motion for the reasons contained in her affidavit of April 25, 2013 and the supplement to the fourth report of the receiver. It was agreed that counsel for the receiver and for Ms. Cummings would work out the mechanics of her claim to be paid now.

accounts for its Canadian Customers and US Customers by way of the Canadian Consolidated Account and the US Consolidated Account;

(c) all funds received from Canadian Customers and US Customers were co-mingled in either the Canadian Consolidated Account or the US Consolidated Account;

(d) the co-mingling of funds within each of the Canadian Consolidated Account and the US Consolidated Account may be a breach of trust or a breach of Peopledge's contractual obligations to some or all of its Customers;

(e) the reporting ledgers and records of Peopledge did not track specific payments received from and made on behalf of Customers by Peopledge on a customer-by-customer basis;

(f) funds were continually moved between the Canadian Consolidated Account, the US Consolidated Account and the other accounts maintained by Peopledge in the operation of its business;

(g) the movement of funds between accounts also may be a breach of trust or a breach of Peopledge's contractual obligations to some or all of its Customers;

(h) the receiver's initial review of the books and records of Peopledge and the accounts of the Debtors has revealed significant movement of funds from Peopledge's accounts to the accounts of related companies or other unknown accounts, the majority of which funds have not been located; and

(i) the depletion of funds from the Canadian Consolidated Account and the US Consolidated Account also may be a breach of trust or a breach of Peopledge's contractual obligations to some or all of its Customers.

[7] Certain Customers have advised the receiver that they assert trust entitlements to funds in the receiver's possession.

[8] Based on the receiver's review of a small sample of Customer contracts in its possession, it appears that a Customer's arrangement with Peopledge will likely fall into one of three categories:

(a) Customers having written contracts with Peopledge that expressly require Peopledge to hold the Customer's payroll funds in trust;

(b) Customers having written contracts with Peopledge that do not expressly require the payroll funds to be held in trust but nevertheless require Peopledge to maintain some level of segregation of the payroll funds from other Peopledge funds; or

(c) Customers who did not have any written contract governing their relationship with Peopledge.

[9] The receiver and its counsel have determined that there are significant factual and legal issues surrounding any express trust claims which would require significant costs to be incurred by the estates to review and analyze whether any particular estate funds are held in trust for any particular claimant or Customer, including:

(a) assuming the existence of a written Customer agreement, reviewing each individual Customer contract with Peopledge to determine whether payroll funds delivered by the respective Customer were to be held in trust for the benefit of such Customer;

(b) determining whether there could be differences between individual Customer contracts in respect of the scope of "trust" entitlements created;

(c) determining whether, as between the Canadian Customers, there are priority issues between any trust Claims to the Canadian Customer account funds;

(d) determining whether, as between the US Customers, there are priority issues between any trust Claims to the US Customer account funds;

(e) determining whether there are priority issues as between competing trust claims between Canadian Customers and US Customers to the funds in the Canadian Customer account funds and the US Customer account funds;

(f) determining whether there are traceable trust claims of Customers to any other pool of funds held by the Receiver; and

(g) determining priority issues as between trust claims and any of the potential priority claims.

[10] It is clear that there will be insufficient funds in the estate to satisfy all of the claims in full and insufficient funds from the Canadian Customer account funds and the US Customer account funds to satisfy the Customer deposit claims in full. There are accepted Customer deposit claims of $5.7 million against available funds in the estate net of receivership costs of $2.9 million.

Analysis

[11] There are two main issues. The first is whether the Canadian and US Customer claims represent trust claims entitled to the entire Canadian Customer account funds and the US Customer account funds or whether they are unsecured claims like the other claimants so that all claimants would be entitled to these Customer account funds along with the other corporate bank account balances. The second is what method should be used to pay the Customer Customers in the event that they are to be treated as trust claimants. A third issue is the proper method of allocating receivership costs.

(a) Are the Customer claims to be treated as trust claims?

[12] I think it clear that it was never intended that Peopledge had any entitlement to the payroll funds deposited by a Customer other than the payroll processing fees earned by Peopledge. It is the receiver's view, which I accept, that all Customers provided their payroll funds to Peopledge on a same or similar "flow-through" basis regardless of the specific terms of their written contract, if any, with Peopledge. Payroll funds were deposited with Peopledge for a

specific and limited purpose, being the payment of employee wages and governmental and other remittances on behalf of the Customer.

[13] In these circumstances, it would appear to be inequitable to permit the general creditors of Peopledge other than the Customers who provided the funds to now be paid their claims from those funds. It was never intended that Peopledge or its creditors would have any beneficial interest in these funds. The issue is whether there is a basis in law to achieve this result. In my view there is.

[14] Mr. Hall submits that the proper legal framework for this case is that of a *Quistclose* trust. Funds were advanced to Peopledge for a specific purpose and a trust should be imposed in equity impressed to ensure that the funds are used solely for that purpose or returned to the parties who advanced the funds. This principle is based on the case of *Barclays Bank Ltd. v Quistclose Investments Ltd.*, [1970] AC 567 (HL).

[15] In *Quistclose*, a lender lent money to a company on the condition that the loan was to be used to pay a dividend. The lender's cheque was paid into a separate bank account at Barclays who knew the money was borrowed and who agreed the account would be used only to pay a dividend and for no other purpose. Before the dividend was paid, the company went into liquidation. It was held by Lord Wilberforce that the arrangements gave rise to a relationship of a fiduciary character or trust in favour of the lender who on the advancement of the loan had acquired an equitable right to see that it was applied for the designated purpose. Lord Wilberforce relied on authority that held that money advanced for a specific purpose did not become part of the bankrupt's estate. What was important was that it was the mutual intention of the parties that the payments to the company, as here, were not intended to be included in the company's assets. Lord Wilberforce stated:

> These cases have the support of longevity, authority, consistency and, I would add, good sense.

[16] If any particular Customer of Peopledge had a trust agreement with Peopledge, this *Quistclose* type of trust would not be necessary to impress the payroll funds advanced to

Peopledge with a trust. For any Customer of Peopledge without an express trust agreement, I accept that a trust as in *Quistclose* should be recognized.

[17] This result is consistent with modern Canadian authority such as *Soulos v. Korkontzilas*, [1997] 2 S.C.R. 217. It *Soulos*, McLachlin J. (as she then was) stated at para. 34 that a constructive trust may be imposed where good conscience so requires. She stated:

> 34. It thus emerges that a constructive trust may be imposed where good conscience so requires. The inquiry into good conscience is informed by the situations where constructive trusts have been recognized in the past. It is also informed by the dual reasons for which constructive trusts have traditionally been imposed: to do justice between the parties and to maintain the integrity of institutions dependent on trust-like relationships. Finally, it is informed by the absence of an indication that a constructive trust would have an unfair or unjust effect on the defendant or third parties, matters which equity has always taken into account. Equitable remedies are flexible; their award is based on what is just in all the circumstances of the case.

[18] Under the umbrella of good conscience, constructive trusts are recognized to remedy unjust enrichment and corresponding deprivation. See McLachlin J. in *Soulos* at para. 20 and 43. In this case, Peopledge and its general creditors would be enriched by having the ability to access the payroll funds advanced by Customers to Peopledge. The Customers, and their employees, would be deprived by not having the funds paid to them and there would be no juristic reason for this to occur. It was never intended that Peopledge, or its creditors, would have any beneficial interest in the payroll funds advanced by Customers.

[19] Accordingly, I conclude that the Canadian Consolidated Account should be treated as a trust account for the Canadian Customers who advanced payroll deposits to Peopledge and the US Consolidated Account should be treated as a trust account for the US Customers who advanced payroll deposits to Peopledge. It is clear that Peopledge purposely used separate accounts for its Canadian and US Customers.

(b) Appropriate distribution method

[20] Despite its obligations to maintain trust or segregated accounts for all or a portion of its Customers, Peopledge did not segregate funds received from any one Customer, although Peopledge did maintain two distinct, but co-mingled, payroll accounts for its Canadian Customers and US Customers by way of the Canadian Consolidated Account and the US Consolidated Account. All funds received from Canadian Customers and US Customers were co-mingled in either the Canadian Consolidated Account or the US Consolidated Account.

[21] The Receiver is of the view that a distribution methodology should be selected which best balances the relative benefits and prejudices to the Claimants, applies a reasonably justified principled approach to Claimants' distribution and seeks to reduce further professional cost to the greatest extent possible to maximize Claimants' recovery.

[22] The receiver proposes an interim distribution methodology which it believes best accomplishes those goals in the circumstances. In particular, the receiver has recommended the following:

(a) that the receivership costs be allocated on a *pro rata* basis against all property of the debtors in the possession of the receiver, including the Canadian Customer account funds, the US Customer account funds and the general estate funds), subject to two qualifications:

(i) first, the receivership costs should first be paid from the Ceridian referral fee prior to allocation to and payment from the other estate property;

(ii) second, in accordance with paragraph 17 of the claim process order, the receiver will continue to track all time incurred in reviewing, validating and resolving any discrepancies with each of the claimants on an individual basis and thus, if deemed appropriate by the Court at the time based upon the final reconciliation by the receiver, the specific fees and disbursements associated with such review and resolution of individual claims can be allocated to and payable from any future final distributions to such claimant;

(b) that only those claimants with proven Canadian Customer deposit claims receive a distribution from the Canadian Customer account funds which distributions be on a *pro rata* basis, subject to prior payment of the allocated portion of the receivership costs;

(c) that only those claimants with proven US Customer deposit claims receive a distribution from the US Customer account funds which distributions be on a *pro rata* basis, subject to prior payment of the allocated portion of the receivership costs;

(d) that the 162 HST claim, if and to the extent proven, be paid from the funds of 162 in priority to all other proven general claims but subject to prior payment of the allocated portion of the receivership costs;

(e) that the potential priority claims (other than the 162 HST claim), if and to the extent proven, be paid from the Peopledge general account funds in priority to all other proven general claims but subject to prior payment of the allocated portion of the receivership costs; and

(f) that any claimants with proven general claims (including the deficiency portion of any proven Canadian Customer deposit claims and proven US Customer deposit claims) receive a distribution from the remaining balance of the general account funds which distribution be on a *pro rata* basis subject to payment of any proven potential priority claims and the prior payment of the allocated portion of the receivership costs.

[23] The receiver has reviewed a number of possible scenarios for distributing the funds on hand. In coming to his recommended scenario, the receiver has had regard to the following:

(a) given the facts in this case, including the co-mingled nature of Peopledge's consolidated payroll accounts, no single Customer will likely be able to

successfully establish that any particular dollar in the estate is subject to an express trust in favour of such Customer;

(b) similarly, it is unlikely that any Customer would be able to successfully establish that it can trace any funds held in trust (if so established) into Peopledge's general accounts or the related companies' accounts;

(c) the time and expense that would be associated with reviewing, assessing and potentially litigating competing express trust claims is likely to be considerable and may be unwarranted given the number of Customers that have filed customer deposit claims (79 Customers for a total of $5,714,718) and the total funds in the estate ($2,914,148.09 after incurred and estimated continuing receivership costs);

(d) as with the potential express trust claims, the time and expense that would be associated with reviewing, assessing and potentially litigating such claims and remedies is likely to be considerable and may be unwarranted in the circumstances;

(e) given that it appears that all Customers would have provided their payroll funds to Peopledge on the same or similar "flow-through" basis regardless of the specific terms of their written contract, if any, with Peopledge and given the time and expense that would be required for the receiver to review and analyze all of the Customer contracts (including seeking to obtain copies of any contracts not found in Peopledge's records), it appears that a detailed review of all Customer contracts is also not be warranted in the circumstances;

(f) Claimants with general claims should not unduly benefit to the detriment of claimants with Customer deposit claims from Peopledge's breach of its trust or other obligations to the Customers;

(g) conversely, the general estate funds were not established by Peopledge to hold the payroll funds, and thus Claimants with general claims should not be unduly prejudiced by extending any Customer trust to the general estate funds;

(h) the Customer deposit claims represent approximately 81% of all claims filed and, together with the general claims of Customers as filed, the Customers represent approximately 89% of all claims filed;

(i) as between the Customers claiming against the Canadian Customer account funds or the US Customer account funds, as applicable, given the poor accounting practices of Peopledge it would likely be very time consuming and costly, if not impossible, to determine Customer entitlement based on accounting principles such as "first in, first out" or the "lowest intermediate balance rule" which the receiver understands has been applied in certain co-mingled trust cases (which may have different factual basis than the case at hand); and

(j) the receiver also notes that applying such accounting principles may unduly benefit or detriment any particular Customer simply based on the date selected for determination.

[24] There have been several cases in Ontario dealing with the method to be used in distributing money that was to be held in trust but co-mingled into an account from which money was improperly taken and not used for the purposes for which the money was advanced by claimants. The receiver points out that there have been two possible methods recently used in Commercial List cases. One method is referred to as the *pari passu ex post facto pro rata* method, or the "*pro rata*" method. The other is referred to as the Lowest Intermediate Balance Rule ("LIBR"). In my view the *pro rata* method recommended by the receiver is the appropriate method to use in this case. It is to be noted that no one who appeared contended for the LIBR method to be used.

[25] The *pari passu ex post facto pro rata* approach is a *pro rata* distribution to claimants based on the amount of their original contribution to a fund, regardless of when the fund was co-

mingled. Under the LIBR approach, a claimant to a mixed fund cannot assert a proprietary interest in the fund in excess of the smallest balance in the fund during the interval between the original contribution and the time when a claim with respect to that contribution is being made against the fund. With the LIBR method, a claimant's pro rata distribution from the fund is therefore based on the "lowest balance" of their original contribution, which, depending on the flux of intervals, can be deemed as $0. The method to be applied can have significant financial consequences for the parties.

[26] The appropriate method of allocating funds in a mingled trust fund was dealt with by Morden J.A. in *Ontario Securities Commission v. Greymac Credit Corp.* (1986), 55 OR (2d) 673 (CA), aff'd 59 OR (2d) 480 (SCC). That case stands for the proposition that the LIBR method should be used if the analysis can be done. In *Boughner v. Greyhawk Equity Partners Limited Partnership (Millenium)* [2013] O.J. No. 231 (C.A.) the Court of Appeal affirmed that the general rule enunciated in *Greymac* continued to be the appropriate method, absent an inability to undertake a tracing. The Court in *Boughner* stated:

> The general rule, and the preferred allocation method, in cases like this is, per *Greymac*, the LIBR method. In some cases, as in *Law Society*, this method will not be appropriate because, as Blair J.A. (*ad hoc*) said at para. 33, "it is manifestly more complicated and more difficult to apply." Thus the law in Ontario is as expressed by Morden J.A. in *Greymac* at para. 46:
>
> > While it might, possibly, be appropriate in some circumstances to recognize claims on the basis of a claimant's original contribution ... I do not think that it is appropriate where the contributions to the mixed fund can be simply traced, as in the present case.

[27] In *Law Society of Upper Canada v. Toronto-Dominion Bank* (1998), 42 OR (3d) 257 (CA), leave to appeal to Supreme Court of Canada dismissed [1999], S.C.C.A. No. 77, the Court of Appeal applied the *pari passu ex post facto pro rata* method in distributing money in a mixed trust account. In that case, Blair J. (*ad hoc* at the time) determined that it was not practicable to conduct a LIBR exercise.

[28] Brown J. applied the *pro rata ex post facto pro rata* method in a very similar case to the before me in *T.D. Bank v. 2026277 Ontario Inc.*, [2012] O.J. No. 2369. I agree with this approach.

[29] Unlike *Boughner*, this is not a case in which it is practically possible to make LIBR calculations. Based on the report of the receiver, the contributions to the mixed fund likely cannot be traced and the expense in attempting to do so would not be warranted.

[30] I am satisfied that the appropriate method of determining payments to Customers for payroll fund claims is the *pro rata ex post facto pro rata* method.

(c) Allocation of receivership costs

[31] The receiver recommends that the receivership costs shall be allocated on a *pro rata* basis against all property of the debtors in the possession of the receiver, including the Canadian Customer account funds, the US Customer account funds and the general estate funds, subject to two qualifications:

(a) first the receivership costs should first be paid from the Ceridian referral fee prior to allocation to and payment from the other estate property;

(b) second, in accordance with paragraph 17 of the Claim Process Order, the receiver will continue to track all time incurred in reviewing, validating and resolving any discrepancies with each of the Claimants on an individual basis and thus, if deemed appropriate by the Court at the time based upon the final reconciliation by the Receiver, the specific fees and disbursements associated with such review and resolution of individual Claims can be allocated to and payable from any future final distributions to such Claimant.

[32] The Ceridian referral fee arose pursuant to an agreement made between the receiver and Ceridian Canada Ltd., under which 72 customer payrolls were transferred to Ceridian, resulting in a net referral fee to the receiver of $461,055.26 for the benefit of the receivership estate. In formulating the proposed distribution scenario the receiver has not treated the Ceridian referral

fee as an estate asset for distribution purposes but has assumed the full utilization of it to pay receivership costs incurred with the balance of the receivership costs being allocated *pro rata* against the property.

[33] The Receiver has approached it on this basis given that the Ceridian referral fee is not an asset of the Peopledge estate that existed pre-receivership but is instead an asset that has been created solely as a result of the receivership and the agreement entered into between the receiver and Ceridian. Thus, the Ceridian referral fee can logically be first fully utilized to pay receivership costs before the pre-existing property of the estate is allocated to satisfy receivership costs. It does, however, result in the recovery for general claims, which include any Customer's general claims, to be 5.4% lower than if the Ceridian referral fee were included as an asset of the estate.

[34] In my view, the allocation of the receivership costs as proposed by the receiver is reasonable, and it is approved.

Other matters

[35] The other heads of relief sought are straightforward and are approved, including the approval of the conduct and activities of the receiver set out in its third and fourth reports. The fees and disbursements of the receiver and its counsel are reasonable and approved.

Newbould J.

Date: May 15, 2013

TAB 6

CA016498
Vancouver Registry

Court of Appeal for British Columbia

BETWEEN:

HER MAJESTY THE QUEEN IN RIGHT OF THE PROVINCE OF BRITISH COLUMBIA

PLAINTIFF
(APPELLANT)

AND:

NATIONAL BANK OF CANADA, THE GOVERNOR AND COMPANY OF ADVENTURERS OF ENGLAND TRADING INTO HUDSON BAY carrying on business as THE BAY, and COOPERS & LYBRAND LIMITED

DEFENDANTS
(RESPONDENTS)

Before: The Honourable Chief Justice McEachern
The Honourable Mr. Justice Legg
The Honourable Mr. Justice Hollinrake

W. A. Pearce, Q.C. and
J. Pottinger — Counsel for the Appellant

S.F. Dunphy — Counsel for the Respondents National Bank of Canada and Coopers & Lybrand Limited

M. R. Storrow, Q.C. and F. Lamer — Counsel for the Respondent The Governor and Company of Adventurers of England Trading into Hudson Bay carrying on business as The Bay

Place and Date of Hearing: Vancouver, British Columbia
June 21, 1994

Place and Date of Judgment: Vancouver, British Columbia
November 17, 1994

Written Reasons by:
The Honourable Mr. Justice Hollinrake

Concurred in by:
The Honourable Chief Justice McEachern
The Honourable Mr. Justice Legg

Court of Appeal for British Columbia

HER MAJESTY THE QUEEN IN RIGHT OF THE PROVINCE OF BRITISH COLUMBIA

v.

NATIONAL BANK OF CANADA, THE GOVERNOR AND COMPANY OF ADVENTURERS OF ENGLAND TRADING INTO HUDSON BAY carrying on business as THE BAY, and COOPERS & LYBRAND LIMITED

Reasons for Judgment of Mr. Justice Hollinrake:

1 This is an appeal where the Crown in an action in which it is the appellant before us asserts a right to funds paid to the receiver of a company now in bankruptcy by retailers who collected tobacco tax under the ***Tobacco Tax Act***, R.S.B.C. 1979, c. 404 and amending acts.

2 The judgment in the court below is reported at (1993), 75 B.C.L.R. (2d) 35.

3 Coopers & Lybrand Limited ("Coopers") was appointed as agent by The National Bank of Canada (the "Bank") on August 12, 1988 to realize upon security granted by Red Carpet Distribution Inc. ("Red Carpet") over inventory and accounts receivable pursuant to s. 178 of the ***Bank Act*** and a general assignment of book debts. Red Carpet was a tobacco wholesaler.

4 The Hudson's Bay Company (the "Bay") was a second secured creditor of Red Carpet on inventory and accounts receivable pursuant to separate security. Red Carpet was deemed to have made an assignment in bankruptcy effective August 30, 1988 following the failure of a proposal under the ***Bankruptcy Act*** made on that date.

5 Shoppers Drug Mart Store #243 (SDM) was and is a retailer which sells, along with a good many other products, tobacco goods. The Crown, in what it describes as a test case, claims $31,017.57, calculated as the tax payable upon tobacco products furnished under four invoices which were paid by SDM on September 20, 1988 to the receiver of Red Carpet.

6 There were three motions made in this case all under Rule 18A of the Rules of Court. Two of those motions were made by the Crown. One sought judgment against the Bank and Coopers generally. The other sought judgment against the Bay in the sum of $31,017.57 alleging that the Bay held in trust those monies which it had received from the Bank's receiver after the Bank's security was satisfied. The third motion was by the Bay to dismiss the Crown's claim as found in paras. 5 to 12 inclusive of the amended statement of claim.

7 The chambers judge said in her judgment that all three motions were before her. The order entered following the hearing of these motions refers to the application of the Crown for judgment against

the Bay and to the Bay's motion to dismiss the claims of the Crown as found in paras. 5 to 12 of the amended statement of claim. As I read the order of the court below no reference is made to the Crown's motion for judgment generally against the Bank and Coopers. The operative part of the order reads:

> THIS COURT ORDERS THAT:
>
> 1. The Plaintiff's application under Rule 18A of the Supreme Court Rules is dismissed; and
> 2. The Plaintiff's claims made at Paragraphs 5 to 12 of the Amended Statement of Claim and prayers (a) and (b) of the prayer for relief are therefore dismissed.

8 There is then before us the judgment of the court below dismissing the Crown's 18A motion for judgment against the Bay in the sum of $31,017.57 and the Bay's successful motion to strike out the claims of the Crown as found in paras. 5 to 12 of the amended statement of claim. Paras. 5 to 12 of that amended statement of claim read:

> 5. Every consumer who acquires tobacco in the Province of British Columbia is required at the time of purchase to pay the Provincial Crown a tax (S. 2(1) Tobacco Tax Act). The tax imposed by the Tobacco Tax Act is collected by the retail dealer at the time of sale and remitted to the Minister in the manner prescribed by the Regulations (S. 2(5) Tobacco Tax Act). Under theTobacco Tax Act Regulations every wholesale dealer in the Province is deemed to be a "collector" by the Minister (S. 4(8) Tobacco Tax Act Regulations). Red Carpet as a "collector" was required to remit taxes pursuant to S. 6 of the Tobacco Tax Act Regulations.
>
> 6. The collection scheme under the Tobacco Tax Act and Regulations required Red Carpet to remit tax to the Director appointed under the Tobacco Tax Act on the 20th day following the end of the 23rd day of the previous

month pursuant to an authorization made pursuant to S. 6(2) of the Tobacco Tax Act Regulations. Red Carpet agreed to remit taxes based upon its purchases of tobacco for the preceding month as aforesaid. Red Carpet's retail dealers in turn paid Red Carpet tobacco tax based upon sales of tobacco by Red Carpet to the retail dealers. Red Carpet's invoices to its dealers included the tax component on the tobacco.

7. At the time Red Carpet made its remittance each month to the Director, most of the tobacco which it had purchased in the previous month would have been sold by its retail dealers to consumers and tax paid on that tobacco. By the time Red Carpet's retail dealers paid their invoices to Red Carpet, most of the tobacco which they purchased would have been sold and tax collected on same. To the extent that Red Carpet's retail dealers prepaid tax to be collected, the monies which Red Carpet received from its retail dealers were imprest with a trust in favour of the retail dealers and the Plaintiff jointly, such that when the tobacco was ultimately sold the monies which Red Carpet held in trust for the retail dealers and the Crown was then held in trust for the Provincial Crown by operation of law and by reason of S. 15 of the Tobacco Tax Act. To the extent that Red Carpet prepaid tax to the Crown, the Crown in turn was obliged to remit any trust monies to retail dealers directly who had prepaid taxes to Red Carpet where the retail dealers were unable to sell the tobacco.

8. The Plaintiff states that as at August 11, 1988, Red Carpet owed the Crown the sum of $6,248,844 based upon purchases which it made for the period June 24, 1988 to July 23, 1988. In addition, Red Carpet purchased tobacco for the period July 24, 1988 to August 12, 1988 for which tobacco tax was payable in the amount of $2,679,511.

9. On August 12, 1988, the Bank appointed Coopers & Lybrand as its receiver to collect on the receivables of Red Carpet pursuant to its security. On August 30, 1988, Red Carpet was petitioned into bankruptcy.

10. The Plaintiff states that for tobacco which was purchased by Red Carpet between June 23, 1988 and August 12, 1988 taxes were paid by consumers in the Province of British Columbia totalling $8,928,355. Approximately $4.9 million was remitted to Red Carpet by its retail dealers prior to August 12, 1988 and approximately $4 million was collected by Coopers & Lybrand as agent for the Bank from Red Carpet's retail dealers after August

12, 1988. The monies which Red Carpet and Coopers & Lybrand received totalling $8,928,355 were at all material times the property of the Plaintiff. Further, at all material times, Red Carpet and Coopers & Lybrand were a fiduciary for those monies received from Red Carpet's retail dealers as aforesaid. The Plaintiff was the trust beneficiary of those monies.

11. With respect to monies collected by Red Carpet up to and including August 12, 1988, the Plaintiff states that these monies were wrongfully used by the Bank to retire the indebtedness of Red Carpet to the Bank. The Bank knew or ought to have known that a significant portion of all revenues received by Red Carpet from its retail dealers consisted of taxes, which tax monies were imprest with a trust by reason of S. 15 of the Tobacco Tax Act and/or by operation of law. Further, the Bank must be taken to have known that where tobacco was sold on credit the first payments made by retail dealers are deemed to include the full amount of the tax by reason of S. 13 of the Tobacco Tax Act Regulations. In causing Red Carpet to make payments on its indebtedness, or in appropriating cash on hand as at August 12, 1988, the Bank knowingly appropriated trust funds as aforesaid and in utilizing the monies for its own use breached its trust obligations to the Plaintiff wherein the Plaintiff sustained damages in the approximate sum of $4.9 million.

12. The monies collected by Coopers & Lybrand as the Bank's agent were similarly imprest with a trust. With respect to monies collected by Coopers & Lybrand after August 12, 1988 as agent for the Bank these monies were knowingly transferred to the Bank and/or The Bay when Coopers & Lybrand knew or ought to have known that the monies were the property of the Plaintiff and that it had a fiduciary obligation to remit these monies to the Plaintiff. These monies were misapplied by the Bank and The Bay to reduce the indebtedness of Red Carpet with them. Alternatively, the monies are presently held by The Bay in a trust account of its agent Peat Marwick. The Plaintiff states that at all material times the Bank and The Bay knew that the receivables as aforesaid included tobacco taxes and prepaid tobacco taxes and as such were obliged to hold the proceeds from same in trust as aforesaid. By misapplying the funds, The Bay and the Bank have breached their fiduciary obligations with the Plaintiff and the Plaintiff has sustained damages in the approximate sum of $4 million.

9 I set out now the relevant portions of the ***Tobacco Tax Act*** and ss. 5 and 6 of the regulations pursuant to that Act.

> **Tax on consumer**
> **2.** (1) Every consumer shall, at the time of making a purchase of tobacco, pay to Her Majesty in right of the Province a tax at the rate of
> . . .
> (5) The tax imposed by this Act shall be collected by the retail dealer at the time of the sale and shall be remitted to the minister at the time and in the manner prescribed by the regulations.
> (6) Every dealer shall be deemed to be an agent for the minister and as such shall levy and collect the tax imposed by this Act on the purchaser.
> . . .
> **15.** Every person who collects any tax under this Act shall be deemed to hold it in trust for Her Majesty in right of the Province and for the payment over of it in the manner and at the time provided under this Act or the regulations; and the amount, until paid, forms a lien and charge on the entire assets of that person, or his estate in the hands of any trustee, having priority over all other claims of any person.
> . . .
>
> TOBACCO TAX ACT REGULATIONS
> . . .
> **5.** every dealer who is not a collector shall collect the tax imposed by the act and shall pay over the tax to a collector on demand.
> **6.** (1) every collector shall
> (a) on or before the 20th day of each month in respect of the previous month, deliver to the director such return as he requires, and
> (b) remit with the return required by paragraph (a) the amount of the tax as computed in the return.
> (2) Notwithstanding subsection (1), the director may, upon application in writing, authorize a collector who maintains his records so that he closes his books at the end of a period that does not coincide with a calendar month but that is not longer in duration than 5 weeks, to deliver the report and remit the tax required by subsection (1) on or before the 20th day following the end of such period.

10 The chambers judge set out the legislative and administrative scheme in issue here in some detail, and I quote from her judgment (pp. 39-41, (B.C.L.R):

> *The Legislative Scheme and the Administrative Scheme*
>
> It is a striking fact that the manner in which taxes are collected under the *Tobacco Tax Act* is completely different from what one would expect from a reading of the Act. Subsection 2(1) states that "Every consumer shall, at the time of making a purchase of tobacco, pay to Her Majesty in Right of the Province a tax..." Subsection 2(5) provides that the tax shall be collected by the retail dealer at the time of sale and remitted to the Minister in the manner prescribed. Section 5 of the Regulations requires that every "dealer" (i.e., a person who sells tobacco either at the wholesale or retail level) must "collect the tax imposed by the Act" and "pay over the tax to a collector on demand". Subsection 6(1) of the Regulations requires that each "collector" (i.e., every dealer appointed by the Minister to act as his agent in collecting tax under the Act) file a return within 20 days of the end of each month in respect of that month and remit it with the amount of tax computed therein. Applying the definitions to the parties here, Red Carpet was both a "dealer" and a "collector", and each of its retail customers, such as the SDM store in the Crown's example, was both a "dealer" and "retail dealer" for purposes of the statute.
>
> Section 15 of the Act provides that every person who collects any tax under the Act shall be deemed to hold it in trust for Her Majesty and that the amount until paid "forms a lien and charge on the entire assets of that person ... having priority over all other claims of any person." Similar language to this, further supplemented, was of course at issue in *Henfrey Samson*.
>
> Constitutionally, the legislative scheme seems unassailable, as it imposes a "direct tax" - i.e., one intended to be imposed on the very person who is required to pay it: see *Atlantic Smoke Shops Ltd. v. Conlon*, [1943] 3 W.W.R. 113, [1943] A.C. 550, [1943] 2 All E.R. 393, [1943] 4 D.L.R. 81 (P.C.), at p. 122 [W.W.R.]. In practice, however, the tax is collected in a very different manner. It is, to quote Barr, J. in *423092 Ontario Ltd. v. Minister of National Revenue* also quoted

by our Court of Appeal in *Tseshaht Band v. British Columbia*, 69 B.C.L.R. (2d) 1, 94 D.L.R. (4th) 97, [1992] 4 C.N.L.R. 171, at p. 15 [B.C.L.R.], " 'a direct tax ... collected indirectly.' " The most important provision in this regard is s. 15 of the Regulations, which states:

> The Minister or the Director may, subject to the Act and the regulations, enter into agreement with collectors for the purpose of facilitating collection and payment of the tax.

On the strength of this provision, the Province requires that as a condition of being licensed under the Act to sell tobacco products, each wholesale dealer undertake to remit to the Province within 20 days of the end of each month or period, an amount based on its purchases of tobacco in the month or period. None of the parties was able to produce a copy of the agreement between Red Carpet and the Crown, but it was generally acknowledged that in accordance with this arrangement, Red Carpet normally remitted the appropriate amount to the Crown by the 21st of each month, based on its tobacco purchases in the previous month. The amount so paid then became one of Red Carpet's inventory costs and was assumedly passed along to its retail customers. In turn, the retailer assumedly passed the cost along to its customers, the tobacco consumers.

I say "assumedly" because there was no requirement of law, and no practice, under which the tax had to be passed along at either level: the wholesaler and retailer were free to sell at any price, including one that was less than cost, if they wished. It would appear they could even *give* the products away under the scheme. There was no requirement that they "break out" separately in the price charged for tobacco products, the amount of "tax" or the amount remitted by Red Carpet to the Crown; nor that they segregate any particular amount received on the sale of the products, retain it in any separate account, or file a return of tax collected. No such procedure was necessary, of course, because the Crown had already received what I will call its "tax substitute" at an earlier stage in the chain. (On this point, see *Tseshaht*, supra, at 15 and *Chehalis Indian Band et al v. British Columbia* (1988) 31 B.C.L.R. (2d) 333, 53 D.L.R. (4th) 761, [1989] 1 T.S.T. 3008, 2 T.C.T. 4017, [1989] 1 C.N.L.R. 62 (C.A.), at p. 340 [B.C.L.R.].) It relied on the marketplace to pass the added cost along to consumers at the end of that chain. In theory it received no more

> and no less than what it would have received had the tax been collected directly from retailers. (The Crown advised that it is the Province's practice to give a refund where an overpayment occurs as a result of the administrative scheme - where, for example, a retailer's stock is destroyed by fire.)
>
> (emphasis mine)

11 I think the trial judge was right in saying the sum of $31,017.57 the Crown seeks to recover is not the tax paid and collected from the consumer upon the tobacco products included in the four invoices, but funds which are a substitute for that tax.

12 I deal now with the facts as to how the sum of $31,017.57 was arrived at.

13 The first thing to note is that the owner of the SDM store was not concerned about the amount of tax being collected by the store from customers. He deposed from an examination of the invoices paid by his store to Red Carpet on September 20, 1988:

> I am satisfied that the tobacco products were sold to retail customers and taxes collected thereon prior to my payment to Coopers & Lybrand Ltd. on September 20, 1988 with the exception of the following tobacco products: .... These tobacco products had not been reordered when the payment was made on September 20, 1988 and accordingly I am not in a position to know how much of these tobacco products had in fact been sold as at September 20, 1988. However, these tobacco products were subsequently reordered and accordingly all of the tobacco products purchased with the subject invoices were in fact sold and taxes collected thereon. To the extent that some of these products would not have been sold prior to September 20, 1988, I would have considered my payment on

> September 20, 1988 with respect to these products to include the full tax component of the tobacco products which I expect to sell.

By this, I understand the owner to be saying that because of the administrative scheme, he did not concern himself with the amount of tax collected on sales. Instead, he paid invoices which included a component for tax, within 21 days of receipt of product, and he cannot say how much of the product was sold and how much remained on his shelves on the date of payment.

14 The calculation of this $31,017.57 is made by the Crown. This understanding is shared by the trial judge who said at p. 41 (B.C.L.R.):

> Not surprisingly then, the owner of the store involved in the SDM "test case", Mr. Bird, was not aware of the amount of "tax" being collected by him or being paid to Red Carpet from time to time. However, the Crown relies on the average turnover rate for tobacco products stated in Mr. Bird's affidavit to reach the conclusion that by the time SDM normally paid its invoices (within 21 days of receipt of the products), most if not all those products would have been sold.

15 The figure of $31,017.57 is calculated by the Crown from four invoices.

16 The last tax remitted to the Crown by Red Carpet was for products purchased from manufacturers in the period between May 21, 1988 through June 17, 1988. Based on Red Carpet's average turnover of tobacco product, the last tobacco product on which Red Carpet

had already paid tax left Red Carpet's Vancouver warehouse approximately 8 days after June 17, i.e. June 25. However, Red Carpet's inventory was not segregated in a fashion which would correspond to the inventory for the period of tobacco tax remittances, and accordingly there is no calculation available of Red Carpet's **actual** turn over of inventory. Therefore it is possible, although unlikely, that the tobacco products delivered in the four invoices included product on which tax had already been paid by Red Carpet in their monthly tax remittance. Counsel for the Crown did advise that the scheme permits the wholesaler to recoup from the tax collected any amount which he may have prepaid to the Crown.

17 In the next monthly period, Red Carpet's purchases from producers from June 18, 1988 until July 22, 1988, Red Carpet failed to remit its tobacco tax remittance due on August 11, 1988. Furthermore, there is no evidence of a tobacco tax remittance based on Red Carpet's purchases of tobacco from manufacturers from July 23, 1988.

18 The tobacco products, which are the subject matter of the test case, were delivered to SDM on July 20, 1988, July 27, 1988, August 4, 1988 and August 10, 1988. By the time SDM **usually** paid their invoices (i.e. 21 days following receipt of the tobacco products) most of the tobacco products on those invoices would have

been sold. With a few exceptions the tobacco products listed in the SDM invoices were sold to consumers prior to the payment of the amount owing under these invoices to Red Carpet on September 20, 1988.

19 The following is a hypothetical example of how the administrative scheme worked in the payment of the tobacco tax:

20 Day 1: Red Carpet as a wholesale dealer purchases one dollar of tobacco from a tobacco manufacturer. Red Carpet makes a record of this purchase for the tobacco tax remittance it is required to submit for the month 20 days after the end of the monthly period. The moneys to be remitted are what has been referred to as the "tax substitute" by the trial judge. On average all tobacco purchased on Day 1 would be sold to retail dealers like SDM by Day 8-10.

21 Day 2: Red Carpet delivers tobacco to SDM and invoices it. Let us say Red Carpet invoices SDM for three dollars. Red Carpet understands the two dollar markup to consist of inventory costs and profit. Part of the cost of the inventory is however the one dollar attributable to the tax substitute. The amount invoiced includes all of Red Carpet's costs, including an amount attributable to the tax substitute that Red Carpet will have to pay based on their purchase on Day 1. Red Carpet does not segregate out in any way, nor are they required to, the one dollar they are

charging SDM which is attributable to the tax substitute they **will** pay the Crown.

22 Day 3: The consumer purchases the tobacco from SDM for four dollars, let us say one dollar of which represents SDM's profit. SDM puts the purchase money in the cash register and then in a general operating account from which SDM pays suppliers, etc. Although there is no evidence of what kind of account SDM put the money earned from tobacco sales, it is agreed they did not segregate it in any way, nor did they segregate out any amount attributable to tobacco tax. At no time is any record made by SDM of the amount of the purchase money which is attributable to tobacco tax. In fact, SDM does not know the amount attributable to tobacco tax. All SDM knows is that it has been invoiced by Red Carpet for three dollars and Red Carpet has some arrangement with the Crown to take care of the tobacco tax.

23 Day 23: SDM pays its invoice to Red Carpet for the full three dollars. During the time between Day 3 when the tobacco was sold and Day 23 the one dollar the Crown calculates as being attributable to the tobacco tax has been in SDM's general operating account. No evidence is available as to the balance of this account during this time period and indeed whether it was in a credit position at all times.

24 SDM treated that one dollar as it treated the full three dollars: as part of its general revenue. When Red Carpet received the payment from SDM it put it in its general operating account where it was mixed with its other funds. It did not treat the one dollar which could be attributed to the tobacco tax any differently than the rest of SDM's payment or any other payments it received.

25 Day 28: For the purposes of this example, this is the end of the monthly period for each tobacco tax remittance. Red Carpet adds up all its purchases from tobacco manufacturers in the past 28 days (in this example only one purchase) and fills out the tobacco tax remittance form which provides for a calculation of the amount of one dollar that must be remitted with the form.

26 Day 48: Due date of tobacco tax remittance based on Red Carpet's purchases from manufacturers in the period from Day 1 to Day 28. Based on the Day 1 purchase the amount remitted would be one dollar. Again, this is the tax substitute.

27 In the case of the $31,017.57 at issue there are a few notable differences. This amount is calculated based on four invoices like the one made on Day 3 of the hypothetical example. The remittance on Day 48 was made with an NSF cheque, which is the subject of that portion of the Crown's amended statement of claim not at issue

before the chambers judge. Furthermore, three of the invoices involved were for deliveries which occurred between Day 28 and Day 48, and therefore did not form part of the tax remittance due on Day 48.

28 In addition, SDM did not pay the four invoices at issue to Red Carpet within the usual 21 days. The affidavit material suggests that on the date of Coopers' appointment, SDM's national head office directed the individual stores not to pay Red Carpet pending the receipt of legal advice. An agreement was reached between Coopers and SDM head office that the head office would direct individual stores to pay their account by 21 September. SDM #243 paid its account to Coopers on September 20, 1988. This payment was 61 days, 54 days, 47 days and 41 days following each respective delivery date of the products in the invoices.

29 The position of the Crown generally is that its right to what it asserts are tobacco tax moneys arises from:

1. Trust. The Crown says the three requirements of certainty of intention, subject matter and object are met. As to intention, the Crown says this comes expressly from s. 15 of the Act or alternatively it can be implied. As to subject matter the Crown says this has been established in the calculation of the figure of

$31,017.57. The object of the trust is clear on its face.

2. The relationship between the Crown and Red Carpet under the ***Tobacco Tax Act*** was one of principal and agent. An agent owes fiduciary duties in equity to his principal. Equity thus being invoked, it is open to the Crown to trace the sum of $31,017.57 into the hands of the Bay and thus assert a constructive trust or equitable lien over these funds. See: P.D. Maddaugh and J.D. McCamus, ***The Law of Restitution***, Canada Law Book Inc. 1990, p. 127.

3. The Bay has been unjustly enriched in the sum of $31,017.57 and that being so the Court should impose a constructive trust over that fund now being held in trust.

30 I deal firstly with the Crown's assertion of trust and express intention.

31 The starting point here is ***British Columbia v. Henfrey Samson Belair Ltd.***, [1989] 2 S.C.R. 24. The chambers judge referred to this case at the outset of her reasons and went on to say at p. 38 (B.C.L.R.):

> There, the Supreme Court of Canada held that a "deemed" trust created by statute in favour of the provincial Crown was not a "trust" for purposes of s. 67 of the *Bankruptcy Act*, R.S.C. 1985, C.B.-3 and therefore did not exempt the subject-matter of the trust from the normal scheme of distribution established under the Act. Here, the question is whether, under the "administrative

scheme" established by the Province of British Columbia for the collection of tax under the *Tobacco Tax Act*, a non-statutory or "ordinary" trust existed for the benefit of the Provincial Crown in respect of funds paid by tobacco retailers to the receiver of accounts of a wholesaler of tobacco products. The wholesaler is now bankrupt. If such a trust existed, or if a constructive trust is created, the funds so paid will fall outside the estate of the bankrupt in accordance with s. 67 of the *Bankruptcy Act* and may be traced or followed into the defendants' hands. If no such trust existed, and if none is constructed as a remedy for unjust enrichment, the Crown's claim against the defendants must fail and the Crown may be limited to its recourse against the bankrupt estate. I suspect that this recourse is likely to be fruitless.

32 In ***Henfrey Samson*** McLachlin, J. delivered the majority judgment and I quote at length from that judgment:

> The issue on this appeal is whether the statutory trust created by s. 18 of the British Columbia *Social Service Tax Act*, R.S.B.C. 1979, c. 388, gives the province priority over other creditors under the *Bankruptcy Act*, R.S.C. 1970, c. B-3.
>
> Tops Pontiac Buick Ltd. collected sales tax for the provincial government in the course of its business operations, as it was required to do by the *Social Service Tax Act*. Tops mingled the tax collected with its other assets. When the Canadian Imperial Bank of Commerce placed Tops in receivership pursuant to its debenture and Tops made an assignment in bankruptcy, the receiver sold the assets of Tops and applied the full proceeds in reduction of the indebtedness of the bank.
>
> The province contends that the *Social Service Tax Act* creates a statutory trust over the assets of Tops equal to the amount of the sales tax collected but not remitted ($58,763.23), and that it has priority over the bank and all other creditors for this amount.
>
> The Chambers judge held that the *Social Service Tax Act* did not create a trust and that the province did not have priority. On appeal the receiver conceded that the

legislation created a statutory trust, but contended that the chambers judge was correct in ruling that the Province did not have priority because the *Bankruptcy Act* did not confer priority on such a trust. The British Columbia Court of Appeal accepted this submission. The Province now appeals to this Court.

The section of the *Social Service Tax Act* which the Province contends gives it priority provides:

> **18.** (1) Where a person collects an amount of tax under this Act
> (a) he shall be deemed to hold it in trust for Her Majesty in right of the Province for the payment over of that amount to Her Majesty in the manner and at the time required under this Act and regulations, and
> (b) the tax collected shall be deemed to be held separate from and form no part of the person's money, assets or estate, whether or not the amount of the tax has in fact been kept separate and apart from either the person's own money or the assets of the estate of the person who collected the amount of the tax under this Act.
> (2) The amount of taxes that, under this Act,
> (a) is collected and held in trust in accordance with subsection (1); or
> (b) is required to be collected and remitted by a vendor or lessor
> forms a lien and charge on the entire assets of
> (c) the estate of the trustee under paragraph (a);
> (d) the person required to collect or remit the tax under paragraph (b); or
> (e) the estate of the person required to collect or remit the tax under paragraph (d).

The province argues that s. 18(1) creates a trust within s. 47(a) of the *Bankruptcy Act*, which provides:

> **47.** The property of a bankrupt divisible among his creditors shall not comprise
> (a) property held by the bankrupt in trust for any other person.

The respondent, on the other hand, submits that the deemed statutory trust created by s. 18 of the *Social Service Tax Act* is not a trust within s. 47 of the *Bankruptcy Act*, in that it does not possess the attributes of a true trust. It submits that the province's claim to the tax money is in fact a debt

falling under s. 107(1)(*j*) of the *Bankruptcy Act*, the priority to which falls to be determined according to the priorities established by s. 107.

> **107.** (1) Subject to the rights of secured creditors, the proceeds realized from the property of a bankrupt shall be applied in priority of payment as follows:
>
> . . .
>
> (*j*) claims of the Crown not previously mentioned in this section, in right of Canada or of any province, *pari passu* notwithstanding any statutory preference to the contrary.

. . .

To interpret s. 47(*a*) as applying not only to trusts as defined by the general law, but to statutory trusts created by the provinces lacking the common law attributes of trusts, would be to permit the provinces to create their own priorities under the *Bankruptcy Act* and to invite a differential scheme of distribution on bankruptcy from province to province.

Practical policy considerations also recommend this interpretation of the *Bankruptcy Act*. The difficulties of extending s. 47(*a*) to cases where no specific property impressed with a trust can be identified are formidable and defy fairness and common sense.

. . .

In summary, I am of the view that s. 47(*a*) should be confined to trusts arising under general principles of law, while s. 107(1)(*j*) should be confined to claims such as tax claims not established by general law but secured "by her Majesty's personal preference" through legislation. This conclusion, in my opinion, is supported by the wording of the sections in question, by the jurisprudence of this Court, and by the policy considerations to which I have alluded.

I turn next to s. 18 of the *Social Service Tax Act* and the nature of the legal interests created by it. At the moment of collection of the tax, there is a deemed statutory trust. At that moment the trust property is identifiable and the trust meets the requirements for a trust under the principles of trust law. The difficulty in this, as in most cases, is that the trust property

soon ceases to be identifiable. The tax money is mingled with other money in the hands of the merchant and converted to other property so that it cannot be traced. At this point it is no longer a trust under general principles of law. In an attempt to meet this problem, s. 18(1)(*b*) states that tax collected shall be deemed to be held separate from and form no part of the collector's money, assets or estate. But, as the presence of the deeming provision tacitly acknowledges, the reality is that after conversion the statutory trust bears little resemblance to a true trust. There is no property which can be regarded as being impressed with a trust. Because of this, s. 18(2) goes on to provide that the unpaid tax forms a lien and charge on the entire assets of the collector, an interest in the nature of a secured debt.

Applying these observations on s. 18 of the *Social Service Tax Act* to the construction of ss. 47(*a)* and 107(1)(*j*) of the *Bankruptcy Act* which I have earlier adopted, the answer to the question of whether the province's interest under s. 18 is a "trust" under s. 47(*a*) or a "claim of the Crown" under s. 107(1)(*j*) depends on the facts of the particular case. If the money collected for tax is identifiable or traceable, then the true state of affairs conforms with the ordinary meaning of "trust" and the money is exempt from distribution to creditors by reason of s. 47(*a*). If, on the other hand, the money has been converted to other property and cannot be traced, there is no "property held ... in trust" under s. 47(*a*). The province has a claim secured only by a charge or lien, and s. 107(1)(*j*) applies.

In the case at bar, no specific property impressed with a trust can be identified. It follows that s. 47(*a*) of the *Bankruptcy Act* should not be construed as extending to the province's claim in this case.

The province, however, argues that it is open to it to define "trust" however it pleases, property and civil rights being matters within provincial competence. The short answer to this submission is that the definition of "trust" which is operative for purposes of exemption under the *Bankruptcy Act* must be that of the federal Parliament, not the provincial legislatures. The provinces may define "trust" as they choose for matters within their own legislative competence, but they cannot dictate to parliament how it should be defined for purposes of the *Bankruptcy Act: Deloitte Haskins and Sells Ltd. v. Workers' Compensation Board*.

> Nor does the argument that the tax money remains the property of the Crown throughout withstand scrutiny. If that were the case, there would be no need for the lien and charge in the Crown's favour created by s. 18(2) of the *Social Service Tax Act*. The province has a trust interest and hence property in the tax funds so long as they can be identified or traced. But once they lose that character, any common law or equitable property interest disappears. The province is left with a statutory deemed trust which does not give it the same property interest a common law trust would, supplemented by a lien and charge over all the bankrupt's property under s. 18(2).

33 As I read the judgment of McLachlin, J. the underlying principle leading to her conclusions is that the provinces cannot legislate within their own spheres of activity such as "to create their own priorities under the *Bankruptcy Act* and to write a differential scheme of distribution on bankruptcy from province to province."

34 In her reasons for judgment under the heading "Implied Trust" the chambers judge said at pp. 42-44 (B.C.L.R.):

> Can it be said a trust cognizable under "general principles of law" existed in these circumstances, such that the result in *Henfrey Samson* is avoided? It is almost trite law that the three prerequisites to the creation of a trust, whether express or implied, are certainty of the settlor's intention to create a trust, certainty of the subject-matter of the trust, and certainty of objects: See Waters, *The Law of Trusts in Canada* 2nd ed. (1984), c. 5. In my view, the trust advocated by the Crown in respect of funds paid by retailers such as SDM to Coopers in satisfaction of Red Carpet's invoices clearly fails to meet the first two of these criteria.

Dealing first with intention, the Crown argues that SDM would have "expected" that "if Red Carpet did not pay the Crown as contemplated by the Administrative Scheme to which [SDM] was a party, Red Carpet would not appropriate the moneys to its own use but would remit the taxes and prepaid taxes to the Crown. Otherwise [SDM] would remain liable for payment of the taxes to the Crown." As a result of this expectation, says Mr. Pearce, a fiduciary relationship arose in equity which gives rise to an implied trust, or an in rem interest, in respect of the funds. In this regard, he quotes the following passage from Waters, at p. 1044:

> A fiduciary relationship arises in equity whenever one person places trust and confidence in another. The occasion for this trust and confidence may be that X permits his property to be in Y's hands for some particular purpose, or that X places Y in an office which he is to discharge for X such as the performance of a particular task.

These comments are made in the context of Dr. Waters' exploration of the tracing remedy. He goes on to note that courts of Equity historically imposed a "preliminary requirement of fiduciary relationship" for the remedy and that this requirement survived the adoption of the Judicature Acts in Canada although it is "now probably gone" as a condition for the imposition of a constructive trust and "may now be gone as a constituent element of the tracing remedy as well." I do not read this, however, as meaning that certainty of intent is not necessary for the existence of a trust: on the contrary, the example given contemplates that the property delivered or paid given by X to Y is *intended* to be used for a particular purpose for X's benefit. In a sense, Y is acting as the agent of X, if he is not already a fiduciary of some kind. He is not, as Mr. Dunphy said in his very able argument, intended to be free to use the money or property as he pleases.

Putting the Crown's case at its strongest, the evidence indicates that SDM knew or assumed that arrangements had been made at the wholesale level for the payment of the tax and that therefore SDM did not have to worry about the problem. This general "assumption" about the arrangements between the Crown and the wholesaler does not in my view constitute the specific intention necessary for the creation of a trust, express or

implied, in respect of tax collected by the retailer. The situation is not like that in *Lowndes Lambert Group Ltd. v. Specialty Underwriting Services Ltd.* (1986) 11 B.C.L.R. (2d) 308 (S.C.); *Barclay's Bank, Ltd. v. Quistclose Investments Ltd.*, [1970] A.C. 567, [1968] 3 All E.R. 651 (H.L.); *Salter & Arnold Ltd. v. Dominion Bank*, [1923] 3 W.W.R. 257, 4 C.B.R. 379 (Man.K.B.); or *McEachren v. Royal Bank of Canada* (1990), [1991] 2 W.W.R. 702, 2 C.B.R. (3d) 29, 78 Alta. L.R. (2d) 158 (Q.B.), where, had the person paying the money or delivering the property to another, been asked his intentions in doing so, he would likely have responded so that the recipient will carry out my specific intention and nothing else. Here, had the retailer been asked the same question, his reply would have been "to pay my debt to Red Carpet". The funds so paid were not intended or expected to remain SDM's property unless and until some calculation of tax was carried out and the appropriate amount remitted on SDM's behalf to the Crown. Indeed, as Mr. Bird's affidavit discloses (at para.4(i)), he assumed that Red Carpet had paid "the taxes" (as opposed to the tax substitute) at the wholesale level pursuant to its arrangement with the Crown. He expected that Red Carpet would be reimbursed for this cost when he paid his invoice, and that is what in fact happened: the funds paid to Red Carpet were deposited into its general account and mingled with its other funds, and SDM received a corresponding credit in its account with Red Carpet.

This is not to say that a trustee's mingling of trust funds with other funds precludes the creation of a trust in the first place, although one case, *Re Christie Grant, Ltd.*, [1922] 3 W.W.R. 1161, 3 C.B.R. 361, [1923] 1 D.L.R. 505 (C.A.), has held just that. (See the discussion in Waters, at pp. 1039-1140.) But where, as here, the "mingling" is in fact intended by the alleged settlor of the trust, or where segregation is *not* intended, certainty of intention becomes very uncertain indeed. This is my interpretation of the reasoning in *Red Carpet v. Lega Fabricating Ltd.* (1981), 29 B.C.L.R. 161, 126 D.L.R. (3d) 148 (C.A.), and in *Re Points of Call Holidays Ltd.* (1991), 54 B.C.L.R. (2d) 384, 5 C.B.R. (3d) 299, 41 E.T.R. 56 (S.C.). I also note my respectful agreement with the observation of Esson, C.J.B.C. in the latter case that the decision of the Supreme Court of Canada in *Lowden v. R.*, [1982] 2 S.C.R. 60, 22 Alta. L.R. (2d) 289, 68 C.C.C. (2d) 531, 139 D.L.R. (3d) 257, the case most strongly relied upon by Mr. Pearce in these proceedings, did not turn on the concept of trust.

35 The Crown says that the very words of s. 15 make it plain that "when retailers collect tax, the tax monies are subject to a trust for the benefit of the Provincial Crown and that when monies are remitted to wholesalers/"collectors" the same trust relationship is intended." (Crown factum). This was not dealt with by the chambers judge.

36 With respect, I do not think the Crown can rely on the statute to create the facts necessary to establish a trust under general principles of trust law. I think this would be contrary to the underlying principle in ***Henfrey Samson***. That principle being that the province cannot legislate to, in effect, create its own priorities contrary to those in the ***Bankruptcy Act***. If the province cannot deem a trust in order to accomplish this I cannot see how it can by legislation create facts through that legislation to accomplish the same end.

37 I turn now to the Crown's assertion in the alternative that on the facts there is an implied intention to create a trust. I have set out above how the chambers judge dealt with the issue of implied intention.

38 I think it significant that SDM did not, nor did it need to because of the manner in which the tax was being collected, concern itself with any records to demonstrate at the end of the day what funds were tax moneys on the sale of tobacco. I do not think there is any evidence to lead to the conclusion that SDM considered that these funds were trust funds at the time it made a sale of tobacco to its customer. In Mr. Bird's affidavit he deposes that these funds were not segregated. It can only be assumed there was intermingling by SDM of these so called trust funds with other funds derived from the sale of other products. I cannot see how it can be said that on remitting to Red Carpet SDM intended to remit trust funds. Any such inference, in my opinion, would not accord with the manner in which SDM handled these funds or the collection system set up by the province. I repeat the words of the chambers judge set out above at pp. 43-44 (B.C.L.R.):

> The situation is not like that in *Lowndes Lambert Group Ltd. v. Specialty Underwriting Services Ltd.* (1986) 11 B.C.L.R. (2d) 308 (S.C.); *Barclay's Bank Ltd. v. Quistclose Investments Ltd.*, [1970] A.C. 567, [1968] 3 All E.R. 651 (H.L.); *Salter & Arnold Ltd. v. Dominion Bank*, [1923] 3 W.W.R. 257, 4 C.B.R. 379 (Man. K.B.); or *McEachren v. Royal Bank* (1990), [1991] 2 W.W.R. 702, 2 C.B.R. (3d) 29, 78 Alta. L.R. (2d) 158 (Q.B.) where, had the person paying the money or delivering the property to another, been asked his intentions in doing so, he would likely have responded "so that the recipient will carry out my specific intention and nothing else." Here, had the retailer been asked the same question, his reply would have been "to pay my debt to Red Carpet". The funds so paid were not intended or expected to remain SDM's property unless and until some calculation of tax was carried out and the appropriate amount remitted on SDM's behalf to the Crown.

39 I agree with everything said in this passage. I am unable to see any facts from which a trust could be implied. I cannot view the relationship between SDM and Red Carpet as other than a debtor-creditor one. I think this follows from the manner in which the province chose to collect the tax.

40 I conclude the trust asserted by the Crown does not in law exist because of the lack of certainty of intention be it expressed or implied.

41 Having concluded there is no certainty of intention, either express or implied, it is not necessary for me to deal with certainty of subject matter. However, I do record here that the chambers judge concluded there was no certainty of subject matter saying at p. 44, (B.C.L.R.):

> Although it is unnecessary for me to do so, I also conclude that the second condition for the existence of a trust, certainty of subject matter, is not met, since on these facts it cannot be said with certainty how much of every dollar paid by retailers such as SDM to Red Carpet represented tobacco products in respect of which Red Carpet had already remitted its "tax substitute", and how much represented tobacco products in respect of which the Crown had yet to be paid. For this reason as well, the "share" of the funds to which the Crown as the alleged beneficiary of the trust would be entitled was not ascertainable.

42 I turn now to the tracing issue. This was not dealt with by the chambers judge.

43 The position of the Crown on this issue is set out in its factum as follows:

> Even if the Funds were not impressed with a trust, either express or implied, the Crown is still entitled to a remedy against Coopers/the Bank for breach of fiduciary duty and is entitled to trace the Funds into the hands of The Bay.

44 This aspect of the appeal deals with the dismissal of the Crown's Rule 18A application for judgment against the Bay in the sum of $31,017.57.

45 The basis for this submission of the Crown is that Coopers stepped into the shoes of Red Carpet which it says by the ***Tobacco Tax Act*** makes Coopers an agent of the Crown for collecting the tax.

46 For the purpose of dealing with this submission I will assume that even without the provisions of the Act deeming an agency relationship between the Crown and Red Carpet (s. 2(6)), Red Carpet was an agent of the Crown for the purpose of collecting the tax. I make that assumption notwithstanding the position taken by the Bank that Coopers cannot be an agent of the Crown for this purpose because by its appointment it is an agent of the Bank for the purpose of collecting Red Carpet's receivables. I will also assume that Red Carpet, being an agent of the Crown for this purpose, had fiduciary obligations to the Crown as agent thus invoking equity and the principles of tracing. My last assumption is that ***Re***

Hallett's Estate (1880), 13 Ch.D. 696 (C.A.) is the law of British Columbia when it comes to tracing.

47 The principle in ***Re Hallett's Estate*** that is significant to this case is that intermingling of trust funds does not of itself prevent tracing. In that case the court held that where there is intermingling the law presumes that the wrongdoer's funds are first taken from the intermingled fund and what remains are trust funds. At p. 727-8 Jessel M.R. said:

> Now, first upon principle, nothing can be better settled, either in our own law, or, I suppose, the law of all civilised countries, than this, that where a man does an act which may be rightfully performed, he cannot say that that act was intentionally and in fact done wrongly. ...
>
> When we come to apply that principle to the case of a trustee who has blended trust moneys with his own, it seems to me perfectly plain that he cannot be heard to say that he took away the trust money when he had a right to take away his own money. The simplest case put is the mingling of trust moneys in a bag with money of the trustee's own. Suppose he has a hundred sovereigns in a bag, and he adds to them another hundred sovereigns of his own, so that they are commingled in such a way that they cannot be distinguished, and the next day he draws out for his own purposes £100, is it tolerable for anybody to allege that what he drew out was the first £100, the trust money, and that he misappropriated it, and left his own £100 in the bag? It is obvious he must have taken away that which he had a right to take away, his own £100. What difference does it make if, instead of being in a bag, he deposits it with his banker, and then pays in other money of his own, and draws out some money for his own purposes? Could he say that he had actually drawn out anything but his own money? His money was there, and he had a right to draw it out, and why should the natural act of simply drawing out the money be attributed to anything except to his ownership of money which was at his bankers.

48 The rule enunciated in ***Re Hallett's Estate*** was further refined in ***James Roscoe (Bolton), Ltd. v. Winder***, [1915] 1 Ch. 62. In that case £455.18 of what was found to be trust funds were deposited by the trustee into his general personal account. Two days later he had withdrawn and spent for his own purposes that money with the exception of a remaining £25.18. Subsequently he paid more of his own money into the account, so that at the time of his death there was £358.5. The beneficiary applied to trace the funds for the full amount in the account at the trustee's death claiming it had a charge in the amount of £455.18.

49 Sargant J., in rejecting the beneficiary's claim that it had a continuing charge over the account in the amount of £455 said at pp. 68-69:

> ... the trust moneys cannot possibly be traced into this common fund, which was standing to the debtor's credit at this death to an extent of more than 25l, because although prima facie under the...rule in *Re Hallett's Estate*, any drawings out by the debtor ought to be attributed to the private moneys which he had at the bank and not to the trust moneys, yet, when the drawings out had reached such an amount that the whole of his private money part had been exhausted, it necessarily followed that the rest of the drawings must have been against trust moneys...You must for the purpose of tracing, which was the process adopted in *Re Hallett's Estate*, put your finger on some definite fund which either remains in its original state or can be found in another shape. That is tracing and tracing, by the very facts of this case, seems to be absolutely excluded except as to the 25*l* 18*s*."

50 This case has been applied by the Ontario Court of Appeal in ***Re Norman Estate*** (1951), O.R. 752 (C.A.). In addition, that Court acknowledged with approval the "lowest intermediate balance" rule in ***Re Ontario Securities Commission and Greymac Credit Corp.*** (1986), 55 O.R. (2d) 673 (C.A.) at pp. 687-8, affirmed and reasons of the Court of Appeal adopted, [1988] 2 S.C.R. 172. The headnote for this case says ***Roscoe*** was not followed. However, on a reading of the judgment I do not find this so. (See also ***Maddaugh and McCamus***, supra, at p. 153.) I also note the lowest intermediate balance rule was applied by Taylor J. (as he then was) in ***Coopers & Lybrand v. R. in right of Canada, et al*** (1981), 32 B.C.L.R. 71 (B.C.S.C.).

51 I think this result is a logical one and one that accords with principle. In A. W. Scott, ***Scott on Trusts***, 4th ed. by W.F. Fratcher, Little Brown & Co., 1989 §518.1, p. 640, the author says:

> ... the real reason for allowing the claimant to reach the balance [of the mixed fund] is that he has an equitable interest in the mingled fund which the wrongdoer cannot destroy as long as any part of the fund remains; <u>but there is no reason for subjecting other property of the wrongdoer to the claimants claim any more then to the claims of other creditors merely because the money happens to be put in the same place where the claimant's money formerly was, unless the wrongdoer actually intended to make restitution to the claimant.</u>"
>
> (emphasis mine)

52 In the case before us, in my opinion, the tracing exercise must logically commence from the time the moneys could arguably be

said to be the Crown's moneys. This must be at the time the tobacco tax is collected from consumers by SDM. The Crown argues that when Red Carpet is paid for its invoices by SDM the amount of those invoices which can be calculated to be attributable to tobacco tax is the starting point for the tracing exercise. This calculated amount is still "tax" as defined by the Act but can it be said to be identifiable as the actual tax paid over by the consumer at the time of purchase of the tobacco product from SDM? There is a difference between calculating what one is owed over a set period of time as opposed to tracing the funds that initially represented that debt in the form of money in the hands of the debtor.

53 The calculation leads to an in personam remedy in debt. The tracing leads to an in rem remedy by way of a constructive trust or equitable lien.

54 To trace the money from the time it is paid to SDM is, as I have said above, the only logical starting point. It follows that the $31,017.57 sought by way of judgment against the Bay must be the same $31,017.57 all the way through the administrative scheme commencing with the payment by the customer to SDM.

55 I also note here that if SDM had gone into bankruptcy, this case would be the same as the ***Henfrey Samson*** case on its facts. SDM

is the equivalent of the retailer Tops Pontiac in ***Henfrey Samson***. In ***Henfrey Samson*** there was intermingling on the part of Tops Pontiac and this meant the tax moneys could not be traced (see p. 34 (S.C.R.)). Here there is intermingling on the part of SDM and on the part of Red Carpet.

56 With SDM and Red Carpet having intermingled the "tax money" with all their other funds, and the time frame being as it is, I cannot see how this "tax money" could possibly be identified to permit successful tracing.

57 On this issue I conclude the Crown cannot succeed.

58 I turn now to the Crown's submission as to unjust enrichment and the imposition by the court of a remedial constructive trust over the $31,017.57.

59 The Crown says the Bay has been unjustly enriched in that "tax money", that by the provisions of the ***Tobacco Tax Act*** should properly be in the hands of the Crown, is now in the hands of the Bay.

60 The Crown submits the requirements for the imposition of a remedial constructive trust as set out in ***Pettkus v. Becker***, [1980] 2 S.C.R. 834 have been met. The respondents say that when this $31,017.57 came into the hands of Coopers and then to the Bay it

was not impressed with a trust but rather became part of the estate of Red Carpet in bankruptcy. They say that whether or not these funds are part of the estate of Red Carpet must be determined as at the date of bankruptcy. That is, if there was no trust at the date of bankruptcy - August 30, 1988 - the funds coming into the hands of Coopers were subject to the Bank's security. The $31,017.57 came into the hands of Coopers after August 30, 1988. In response to this the Crown says, and I quote from its factum:

> It is clear that a constructive trust can be deemed to have arisen when the duty to make restitution arose (i.e. upon the collection of the tax).

61 This assertion calls on the court to protect the Crown against the results of the method of collection devised by it. The collection scheme was such that on the collection of the "tax money" there was no obligation whatever on SDM or Red Carpet to remit those funds at the time of collection to the Crown. That is the reality. That is a reality resulting from the dictates of the Crown as found in the regulations to the Act which dictate the method of collection. The constructive trust is a remedy subject to equitable principles. I have some difficulty in the Crown asking the court to impose a constructive trust as at the time when the "tax money" was collected by SDM or Red Carpet where firstly, the facts giving rise to the need for such a trust result from the Crown's collection scheme devised by it, and secondly, the result of the imposition of such a trust would be to intervene in the

priority scheme of the ***Bankruptcy Act***. However, before the issue of remedy the Crown must establish there is an unjust enrichment.

62 In finding against the Crown on this issue the chambers judge said at pp. 45-6 (B.C.L.R.):

> Again, however, I find that none of the required elements exists in the case at bar. The Crown's argument that Coopers or the secured creditors will be "enriched" unless a constructive trust is imposed seems to be predicated on a breach of trust or duty on their part. I have found that no ordinary trust existed, and the Supreme Court of Canada has in the past ruled that a *deemed* trust is ineffective in the context of the *Bankruptcy Act*. Thus I cannot see how the Crown can succeed in the argument that the secured creditors have been "enriched" in a manner that equity should remedy. The creditors have not received and will not receive anything more than what they were owed by Red Carpet. Nor were the funds received by Coopers and the secured creditors at the expense of the Crown in particular. The Crown is only one of several creditors who will suffer loss, and that loss is a result of Red Carpet's *bankruptcy*, not of a wrongful act on the part of the defendants or a mistake on the part of the Crown. In short, the juristic reason for the loss in this case is the operation of the *Bankruptcy Act*. No case was cited to me in which the operation of a statute has been the occasion for a constructive trust remedy, however unfair or unjust the statute may seem. I therefore conclude that the Crown also fails on this branch of its claim.

63 In my opinion, the trial judge was right in concluding there is no unjust enrichment here. The fact is the Bay lays claim to this $31,017.57 by reason of it being a secured creditor and the priority provisions of the ***Bankruptcy Act***. In ***Atlas Cabinets & Furniture Ltd. v. National Trust Co.*** (1990), 45 B.C.L.R. (2d) 99, Lambert J.A. in this Court said at p. 110:

But it is important to understand what is meant by "enrichment", by "deprivation", and by "juristic reason" in the context of a commercial relationship where ordinary and extraordinary flows of funds are part of the reality and purpose of the relationship. To my mind the key to the correct interpretation and application of the decisions of the Supreme Court of Canada on this subject to a commercial relationship is to focus on the "unjust" element of "unjust enrichment". In that respect it is worthwhile to go back to the impetus given to this cause of action by the decision of the House of Lords in *Fibrosa Spolka Akcyjna v. Fairbairn Lawson Combe Barbour Ltd.*, [1943] A.C. 32, [1942] 2 All E.R. 122. In the judgment of Lord Wright, which was approved by Mr. Justice Cartwright, for the majority of the Supreme Court of Canada, in *Deglman v. Guar. Trust*, this is said at p. 61:

> It is clear that any civilized system of law is bound to provide remedies for cases of what has been called unjust enrichment or unjust benefit, that is, to prevent a man from retaining the money of or some benefit derived from another which it is against conscience that he should keep. Such remedies in English law are generically different from remedies in contract or in tort, and are now recognized to fall within a third category of the common law which has been called quasi-contract or restitution.

In 66 Am. Jur. 2d at p. 945, unjust enrichment is defined as "the unjust retention of a benefit to the loss of another, or the retention of money or property of another, against the fundamental principles of justice or equity and good conscience." And see *Major-Blakeney Corp. v. Jenkins*, 263 P. 2d 655 (Cal.Dist.C.A.,1953); *B & M Die Co. v. Ford Motor Co.* , 421 N.W. 2d 620 (Mich.C.A.1988); and *Belpar Marine Inc. v. Adams & Porter Inc.* 638 F. Supp. 1001 (Dist.Ct., 1986). Those cases illustrate the continuing insistence in the United States that the enrichment must be against equity and good conscience. In my opinion the concept of the injustice of the enrichment as being against sound commercial conscience must continue to guide the application of the three tests in *Pettkus v. Becker* when they are applied to a commercial relationship.

64 I do not see how it can be said that the enrichment here, if it be such, is "against equity and good conscience" when the funds are in the hands of the Bay as a result of the security it held and the operation of the priority provisions of the ***Bankruptcy Act***. In my opinion, security agreements such as we have here and the priority provisions of the ***Bankruptcy Act*** provide sufficient juristic reason for any "enrichment" to counteract any suggestion of that "enrichment" being unjust.

65 The Crown says this Court should be guided by the decision of the Saskatchewan Court of Appeal in ***Taypotat v. Surgeson***, [1985] 3 W.W.R. 18 and impose a constructive trust to prevent what it describes as a windfall to secured creditors in this bankruptcy. ***Taypotat*** dealt with a series of building contracts between councillors of an Indian band and a construction company which went bankrupt before completion of the houses. The trustee in bankruptcy rejected the claim of the purchasers of those uncompleted houses. The Court found for the purchasers on two grounds. First, on the basis of the building contracts establishing the purchasers' legal proprietary right in the uncompleted houses, and second, on the principle of unjust enrichment impressing a constructive trust over the uncompleted houses. The Court recognized that the imposition of a constructive trust in that situation was disruptive of the scheme of priorities in the ***Bankruptcy Act*** by referring by analogy to

statutory deemed trusts created by parliament and the provincial legislatures. At p. 37 (W.W.R.) the Court said:

> In this particular case we are not required to consider limiting factors to the remedial sweep flowing from a constructive trust. The appellants' claim is limited to the five partly completed houses which are readily identifiable. We accordingly leave the question of limiting factors for future consideration.
>
> We would, however, observe that, in the circumstances of this case, we reject any notion that the relief granted is disruptive of the scheme of priorities in bankruptcies or under the Personal Property Security Act, 1979-80 (Sask.), c. P-6.1. Parliament has had no difficulty in creating statutory deemed trusts with respect to Canada pension contributions or unemployment insurance. The legislature of this province has created and deemed trusts with respect to wages and vacation pay under the Labour Standards Act, R.S.S. 1978, s. L-1, and statutory charges under the Education and Health Tax Act, R.S.S. 1978, c. E-3; see for example *Royal Bank of Can. v. G.M. Homes Inc.* (1984), 52 C.B.R. (N.S.) 224, 26 B.L.R. 297, 4 P.P.S.A.C. 116, 10 D.L.R. (4th) 439, 34 Sask.R. 195 (C.A.).

66 As I read this passage the Saskatchewan Court of Appeal felt at liberty to grant a remedy that would be "disruptive of the scheme of priorities in bankruptcies" because the provincial legislature had created deemed trusts that did just that. With respect, I think that reasoning must fall in the face of the principle enunciated by the Supreme Court of Canada in ***Henfrey Samson*** that provincial legislatures cannot legislate deemed trusts which have the effect of interfering with the priority provisions of the ***Bankruptcy Act***.

67 For these reasons I think the Crown has failed to establish unjust enrichment on the part of the Bay and, that being so, the claim for constructive trust over the sum of $31,017.57 must fail.

68 I would dismiss the appeal.

"The Honourable Mr. Justice Hollinrake"

I AGREE: "The Honourable Chief Justice McEachern"

I AGREE: "The Honourable Mr. Justice Legg"

TAB 7

Caja Paraguaya de Jubilaciones y Pensiones del Personal deltaipu Binacional v. Obregon et al.

[Indexed as: Caja Paraguaya de Jubilaciones y Pensiones del Personal de Itaipu Binacional v. Obregon]

Ontario Reports

Court of Appeal for Ontario

Pepall, Pardu and Paciocco JJ.A.

June 5, 2020

151 O.R. (3d) 529 | 2020 ONCA 412

Case Summary

Corporations — Directors — Liability — Appellant's bankrupt husband defrauding foreign pension fund by diverting moneys into bank account of appellant's company — Trial judge finding liability against appellant based on wilful blindness — Judge erred by applying constructive knowledge standard in finding liability based on knowing assistance — Judge had no evidence to ground such a finding — Appeal allowed.

Trusts and trustees — Breach of trust — Appellant's bankrupt husband defrauding foreign pension fund by diverting moneys into bank account of appellant's company — Trial judge finding liability against appellant based on wilful blindness — Judge erred by applying constructive knowledge standard in finding liability based on knowing assistance — Judge had no evidence to ground such a finding — Appeal allowed.

The appellant was the sole officer, director and shareholder of a Canadian company, C. The respondent was a Paraguayan pension fund. With the complicity of insider officers, the respondent attempted to invest more than $34 million in Canadian investments proposed by one of the defendants, G. The bulk of the money was invested on less favourable terms and at greater risk than the fraudulent documentation disclosed. The balance was used to pay kickbacks to insiders and to enrich G and his associates. G fraudulently diverted $3 million of intended investment funds into a bank account owned by C. The respondent brought an action against multiple defendants in Canada, including the appellant. The trial judge found that, notwithstanding the appellant's legal authority to control C, her bankrupt husband, a former business associate of G, was the de facto controlling mind and will of the company and made virtually all its financial decisions. The judge found liability against both the appellant and her husband. The judge observed that the husband was one of the architects of the fraud perpetrated upon the respondent and he actively and knowingly authorized the dissipation of funds received by C that he knew or ought to have known came subject to a constructive trust in the respondent's favour. With respect to the appellant, the judge found that her passive acquiescence in her husband's schemes went beyond mere trust and faith and crossed into wilful blindness. She knew that her husband had filed for bankruptcy and she knew generally

what reverses had led him there. She continued to sign cheques and authorizations for large amounts of money to transit through her company without due inquiry and in circumstances where she ought to have been on inquiry. Judgment was given against the appellant in the amount of $3 million jointly and severally with her husband and C. The appellant appealed.

Held, the appeal should be allowed.

Per Paciocco and Pardu JJ.A.: The trial judge erred by applying a constructive knowledge standard in finding the appellant liable based on knowing assistance. The doctrine of knowing assistance was a mechanism for imposing [page530] liability on strangers to a fiduciary relationship who participate in a breach of trust by the fiduciary. The preconditions of knowing assistance liability were structured to identify dishonest participation in a dishonest breach of trust. One of the elements was actual knowledge by the stranger of both the fiduciary relationship and the fiduciary's fraudulent and dishonest conduct. Although the trial judge identified certain facts that the appellant knew, he made no finding as to whether she knew or suspected that the money transiting through her company was trust money that was being employed in a dishonest or fraudulent breach of trust. That was a critical omission. Without such findings, a proper determination of wilful blindness could not be made. He spoke instead of how the appellant ought to have been on inquiry, which was the language of objective fault or constructive knowledge, not the language of subjective wilful blindness.

The trial judge made a palpable and overriding error in finding the appellant liable for knowing assistance. The finding that the appellant continued to sign cheques and authorizations for large amounts of money without due inquiry could support liability only if it related to the respondent's funds deposited to C's account. However, the trial judge had no evidence to ground a finding that the appellant signed any cheques or authorizations after such funds were deposited.

The trial judge did not base the appellant's liability alternatively on the doctrine of knowing receipt, so the respondent's contention to the contrary was rejected. Liability for knowing receipt may be imposed based on the kind of constructive knowledge found by the trial judge, but the judge based the appellant's liability on wilful blindness and found that C, and not the appellant, received the $3 million. Nor was it appropriate for the Court of Appeal to impose personal liability on the appellant as a constructive trustee, because the trial judge did not make the necessary factual findings to identify the precise funds that the appellant received personally or for her benefit, and a new trial was appropriate on the knowing receipt issue.

Per Pepall J.A. (dissenting): Although the trial judge used terms such as "without due inquiry", he also mentioned "acquiescence", "facilitating", and "orchestrated", suggesting subjective knowledge. The trial judge outlined some of the numerous benefits received by the appellant and her husband. The judge made a finding that the appellant was wilfully blind, and an independent reading of her cross-examination testimony led to no other reasonable conclusion. The appellant was found liable for knowingly assisting C's breach of trust. Read as a whole within the context of the entire record, it could not be said that the knowledge component needed to anchor a finding of wilful blindness by the appellant was absent from the trial judge's reasons, and his conclusion was supported by the record. Despite the appellant's more limited

role than that of her husband, the trial judge made no palpable and overriding error in stating that the appellant continued to sign cheques and authorizations to transit money through her company. The appeal on knowing assistance would have been dismissed, rendering a new trial on knowing receipt unnecessary.

Cases referred to

1169822 Ontario Ltd. v. Toronto-Dominion Bank, [2018] O.J. No. 1570, 2018 ONSC 1631 (S.C.J.); *Air Canada v. British Columbia*, [1989] 1 S.C.R. 1161, [1989] S.C.J. No. 44, 59 D.L.R. (4th) 161, 95 N.R. 1, [1989] 4 W.W.R. 97, 36 B.C.L.R. (2d) 145, 41 C.R.R. 308, 2 T.C.T. 4178; *Air Canada v. M & L Travel Ltd.* (1993), 15 O.R. (3d) 804, [1993] 3 S.C.R. 787, [1993] S.C.J. No. 118, 108 D.L.R. (4th) 592, 159 N.R. 1, [page531] 67 O.A.C. 1, 50 E.T.R. 225; *B.M.P. Global Distribution Inc. v. Bank of Nova Scotia*, [2009] 1 S.C.R. 504, [2009] S.C.J. No. 15, 2009 SCC 15, [2009] 8 W.W.R. 428, 94 B.C.L.R. (4th) 1, 268 B.C.A.C. 1, 386 N.R. 296, 304 D.L.R. (4th) 292, 58 B.L.R. (4th) 1; *Bikur Cholim Jewish Volunteer Services v. Langston (2009)*, 94 O.R. (3d) 401, [2009] O.J. No. 841, 2009 ONCA 196, 308 D.L.R. (4th) 494, 250 O.A.C. 129, 68 C.P.C. (6th) 209, 48 E.T.R. (3d) 22 (C.A.); *Caja Paraguay de Jubilaciones y Pensiones del Personal de Itaipu Binacional v. Obregon*, [2018] O.J. No. 5570, 2018 ONSC 5379 (S.C.J.); *Caja Paraguaya de Jubilaciones y Pensiones del Personal de Itaipu Binacional v. Obregon*, [2020] O.J. No. 670, 2020 ONCA 124, 96 M.P.L.R. (5th) 1 (C.A.); *Carl-Zeiss-Siftung v. Herbert Smith & Co. (No. 2)*, [1969] 2 All E.R. 367, [1969] 2 Ch 276, [1969] 2 WLR 427, [1969] FSR 40, [1969] RPC 338, 112 Sol Jo 1021 (C.A.); *Christine Dejong Medecine Professional Corp. v. DBDC Spadina Ltd*., [2019] S.C.J. No. 30, 2019 SCC 30, 435 D.L.R. (4th) 379, 48 E.T.R. (4th) 1, 69 C.B.R. (6th) 1, 89 B.L.R. (5th) 1; *Citadel General Assurance Co. v. Lloyds Bank Canada*, [1997] 3 S.C.R. 805, [1997] S.C.J. No. 92, 152 D.L.R. (4th) 411, 219 N.R. 323, 66 Alta. L.R. (3d) 241, 206 A.R. 321, 35 B.L.R. (2d) 153, 47 C.C.L.I. (2d) 153, 19 E.T.R. (2d) 93; *Commercial Union Life Assurance Co. of Canada v. John Ingle Insurance Group Inc.* (2002), 61 O.R. (3d) 296, [2002] O.J. No. 3200, 217 D.L.R. (4th) 178, 162 O.A.C. 203, 50 C.C.L.I. (3d) 6 (C.A.); *DBDC Spadina Ltd. v. Walton*, [2018] O.J. No. 578, 2018 ONCA 60, 33 E.T.R. (4th) 173, 56 C.B.R. (6th) 173, 419 D.L.R. (4th) 409, 78 B.L.R. (5th) 183 (C.A.); *Enbridge Gas v. Marinaccio*, [2012] O.J. No. 4558, 2012 ONCA 650, 355 D.L.R. (4th) 333, 298 O.A.C. 189, 96 C.C.L.T. (3d) 89, 7 B.L.R. (5th) 173 (C.A.); *Gold v. Rosenberg*, [1997] 3 S.C.R. 767, [1997] S.C.J. No. 93, at para. 74; *Harris v. Leikin Group Inc*., [2011] O.J. No. 5714, 2011 ONCA 790 (C.A.); *IWA - Forest Industry Pension Plan (Trustees of) v. Leroy*, [2017] B.C.J. No. 166, 2017 BCSC 158, 44 C.B.R. (6th) 221, 33 C.C.P.B. (2d) 83 (S.C.); *Paton Estate v. Ontario Lottery and Gaming Corp.* (2016), 131 O.R. (3d) 273, [2016] O.J. No. 3031, 2016 ONCA 458, 349 O.A.C. 106, 19 E.T.R. (4th) 171, 403 D.L.R. (4th) 485 (C.A.); *R. v. Briscoe*, [2010] 1 S.C.R. 411, [2010] S.C.J. No. 13, 2010 SCC 13, 400 N.R. 216, 210 C.R.R. (2d) 150, 316 D.L.R. (4th) 577, 253 C.C.C. (3d) 140, 477 A.R. 86, 87 W.C.B. (2d) 293, 73 C.R. (6th) 224, 22 Alta. L.R. (5th) 49, [2010] 6 W.W.R. 1; *R. v. Morrison*, [2019] 2 S.C.R. 3, [2019] S.C.J. No. 15, 2019 SCC 15, 375 C.C.C. (3d) 153, 429 C.R.R. (2d) 228, 432 D.L.R. (4th) 637, 52 C.R. (7th) 273; *R. v. Sansregret*, [1985] 1 S.C.R. 570, [1985] S.C.J. No. 23, 17 D.L.R. (4th) 577, 58 N.R. 123, [1985] 3 W.W.R. 701, J.E. 85-503, 35 Man.R. (2d) 1, 18 C.C.C. (3d) 223, 45 C.R. (3d) 193; *Sorrel 1985 Ltd. Partnership v. Sorrel Resources Ltd.*, [2000] A.J. No. 1140, 2000 ABCA 256, [2001] 1 W.W.R. 93, 85 Alta. L.R. (3d) 27, 277 A.R. 1, 10 B.L.R. (3d) 61 (C.A.); *Transamerica Occidental Life Insurance Co. v. Toronto Dominion*

Bank (1999), 44 O.R. (3d) 97, [1999] O.J. No. 1195, 173 D.L.R. (4th) 468, 118 O.A.C. 149, 28 E.T.R. (2d) 113 (C.A.); *Wescom Solutions Inc. v. Minetto*, [2019] O.J. No. 1584, 2019 ONCA 251 (C.A.)

Statutes referred to

Business Corporations Act, R.S.O. 1990, c. B.16, ss. 92 [as am.], 118(1) [as am.]

Courts of Justice Act, R.S.O. 1990, c. C.43, s. 134(6) [as am.]

Rules and regulations referred to

Rules of Civil Procedure, R.R.O. 1990, Reg. 194, rule 61.08(2)

Authorities referred to

Oosterhoff, A.H., Chambers, Robert & McInnes, Mitchell, *Oosterhoff on Trusts: Text, Commentary and Materials*, 8th ed. (Toronto: Carswell, 2014) [page532]

APPEAL from the judgment of Dunphy J., [2018] O.J. No. 5570, 2018 ONSC 5379 (S.C.J.).

Kevin Sherkin and *Allison Farley*, for appellant.

Jacqueline L. King and *Christopher Gaytan*, for respondent.

The judgment of the court was delivered by
PACIOCCO J.A. (PARDU J.A., concurring):

Overview

[1] With the assistance of insider officers and others, Eduardo Garcia spearheaded a massive fraud against a Paraguayan pension fund, Caja Paraguaya de Jubilaciones y Pensiones del Personal de Itaipu Binacional ("Cajubi"). As a result, Cajubi lost $12,460,930.

[2] One of Mr. Garcia's former business associates, Mr. Antonio Duscio, assisted in rerouting approximately $7.4 million of the money that Cajubi ultimately lost. Mr. Duscio filtered approximately $3 million of this money through a corporation, Catan Canada Inc. ("Catan"). His wife, Ms. Leanne Duscio, testified that she was the sole shareholder of Catan.

[3] When Cajubi brought an action against multiple defendants in Canada, Ms. Duscio was added as a defendant. The trial judge granted judgment against her in the amount of $3 million jointly and severally with her husband and Catan, finding her to have been a knowing assister relating to the Cajubi money that was routed through Catan. She alone appealed that portion of the decision.

[4] For reasons that follow, I would allow her appeal from that decision and order a new trial.

Material Facts

[5] With the complicity of Cajubi insiders (its president, vice-president and treasurer), Cajubi attempted to invest more than $34 million in Canadian investments proposed by Mr. Garcia. The bulk of this money was invested with three third-party Canadian enterprises, but on less favourable terms and at greater risk than the elaborate fraudulent documentation disclosed. The balance of the money was diverted and used to pay kickbacks to Cajubi insiders and to enrich Mr. Garcia and his associates, including his wife, Claudia Patricia De Garcia.

[6] One of those three Canadian enterprises was Union Securities Limited ("Union"). Ostensibly, Cajubi invested $14.099 million through a managed commodities trading account operated [page533] by Union. In fact, just under $11.5 million was placed with Union investments.

[7] Mr. Garcia successfully controlled the flow of material information between Cajubi and Union to hide this fact, and to paint a false picture that enabled him to maintain and increase the contributions Cajubi was making to the falsified Union investments. He did so through a shell corporation he had set up, Managed (Portfolio) Corp. ("Managed Portfolio"), which he used to facilitate the transactions between Cajubi and Union.

[8] This appeal concerns $3 million of the fraudulent Union investment, the only monies linked in any way to the appellant, Leanne Duscio. In simple terms, Mr. Garcia, with the assistance of Mr. Duscio, routed $3 million of the funds that had been invested with Union through a bank account of Catan, a corporation owned by Ms. Duscio.

[9] The complex series of transactions that achieved the routing of money through the Catan account began on August 14, 2008, when Mr. Garcia opened a new bank account in the name of Managed Portfolio, designated as "Managed (Portfolio) Corp. ITF Cajubi". The "ITF" was meant to indicate "in trust for".

[10] The next day, using a power of attorney that he had secured from Cajubi relating to the Union-managed commodities trading account, Mr. Garcia diverted $3 million to the Managed (Portfolio) Corp. ITF Cajubi account. This transaction was not known to the Cajubi insiders complicit in the fraudulent schemes.

[11] Proximate to the transfer, Mr. Garcia created false documentation purporting to show a $3 million "Demand Promissory Note" issued on August 22, 2008, by a corporation called Columbus Capital Corp. ("Columbus Capital"). This documentation represented that the promissory note was connected to Union, which it was not. Indeed, as I will describe shortly, Columbus Capital was not even incorporated until August 25, 2008, three days after Columbus Capital purportedly issued the promissory note.

[12] On August 22, 2008, the date shown on the face of the fraudulent Demand Promissory Note, the $3 million was transferred by Managed Portfolio into a bank account owned by Catan. The deposit note described the money as "due to Columbus". Immediately prior to the deposit, the balance in the Catan account was $292,238.57. Catan also held an American funds account which held an additional $13,469.37 USD at the time of the $3 million deposit into the Canadian account.

[13] Leanne Duscio is the sole officer and director of Catan and its only shareholder. Catan was incorporated in January 2006 as a business vehicle for office rental income generated from a building Catan owns, as well as a dance studio operated out of that building by Ms. Duscio. [page534]

[14] Notwithstanding Ms. Duscio's legal authority to control Catan, the trial judge found that her bankrupt husband, Mr. Antonio Duscio, a former business associate of Mr. Garcia's, was actually "the *de facto* controlling mind and will of Catan", and "made virtually all of the financial decisions in relation to Catan, controlled all of its banking, arranged for the keeping of its books and records, etc.".

[15] On August 25, 2008, three days after the $3 million Catan deposit, Columbus Capital was incorporated, with a business address in the Catan building. The trial judge found that at all material times, Mr. Duscio was also the *de facto* controlling mind and will of this corporation, even though, once again, he held no shares, directorships or corporate offices.

[16] The Corporation Profile for Columbus Capital reveals that Mr. Garcia was the administrator and president of Columbus Capital at the time of its incorporation. A Mr. Greg Baker is registered as the first and sole director. Mr. Baker is an acquaintance of Mr. Duscio. Mr. Baker expected Columbus Capital to be used for a business that he and Mr. Duscio were launching, trading in refurbished computer equipment. He would supply the business contacts and Mr. Duscio, the capital. Accordingly, Mr. Duscio was given signing authority over Columbus Capital's bank account, which enabled him to control Columbus Capital's funds.

[17] Although the $3 million was ostensibly to be placed with Columbus Capital, the funds were not simply transferred from Catan to Columbus Capital once Columbus Capital was incorporated. Instead, the trial judge found that over the next nine months, until June 1, 2009, more than $2.5 million in wire transfers was paid out of the Catan account for purposes linked to Columbus Capital. Without undertaking a close tracing on all funds in the Catan account, the trial judge estimated [at para. 394] that "at least $400,000 of Cajubi's funds were spent by Catan (under Mr. Duscio's direction) that even Mr. Duscio could not find cause to charge to Columbus".[1]

[18] More than half of the Columbus Capital outlays from the Catan account, including the payment of significant sums to Mr. Garcia's Guatemalan uncle, Mr. Nicholas de Leon, occurred within approximately two weeks after the August 22, 2008 deposit. The bulk of the remainder was paid out one month after the deposit, when, on September 22, 2008, USD$700,038.94 was wired in connection with a Columbus Capital expenditure. The final transfer to Columbus Capital of $513,931.92 CDN did not occur until June 1, 2009. [page535]

[19] The trial judge itemized [at para. 394] the "larger of the miscellaneous non-Columbus expenditures identified during the relevant time frame" that he concluded were linked to Cajubi funds. His breakdown of those funds is presented in the reasons for decision as follows:

(a) Advances to Mrs. Duscio's Dance Studio: $19,231;

(b) Tony Duscio lawyers (paid as accounts payable): $76,558;

(c) Tony Duscio lawyers (charged as shareholder advances): $17,000;

(d) Payroll to Ms. Duscio starting in January 2009 ($750/wk x 22 = $8,250);

(e) Leanne Duscio: $20,000:

(f) Cash withdrawals ($12,500);

(g) John Duscio ($8,000);

(h) BMW (shareholder advance): $25,890;

(i) Tony Duscio cheque: $5,000;

(j) Home Improvements: at least $32,000 identified.

[20] In early June 2009, Mr. Baker discovered the CDN$513,931.92 transfer from Catan in the Columbus Capital bank account, an amount far beyond what the computer refurbishing business could account for. He also noted large commission payments that had been made to Mr. Nicholas de Leon, a name he was not familiar with. Concerned about the improper use of the Columbus Capital bank account, he arranged as the sole shareholder and director of Columbus Capital to change the signing officers on Columbus Capital's bank account, shutting Mr. Duscio out.

The Trial Judge's Decision

[21] On October 12, 2018, after a trial that spanned 17 days that included claims related to the transactions described, the trial judge gave judgment. [page536]

[22] The trial judge imposed extensive liability against Mr. Garcia, his wife, and corporations Mr. Garcia used to assist him in his fraudulent activity.[2] The trial judge also found Cajubi to be entitled to judgment against Mr. Duscio, Ms. Duscio, and Catan, in the amount of $3 million arising from the Catan deposit,[3] and to a tracing order permitting Cajubi to trace its funds.

[23] The basis for Mr. Duscio's personal liability arising from the Catan deposit was simple and compelling. Mr. Duscio was the *de facto* directing mind and will of Catan, and he used his control over the financial affairs of the company to assist Mr. Garcia in arranging the transfer of what Mr. Duscio knew to be $3 million in trust money held by Mr. Garcia for Cajubi. When the funds were received by Catan, Mr. Duscio knew that the transfer was occurring under the pretense that it was for a promissory note purportedly issued by a company that had yet to be incorporated. He furnished the banking information to facilitate the deposit, assisted in obtaining forged signatures for the promissory note documentation, and arranged the payment at Mr. Garcia's direction of a secret 10 per cent commission to Mr. de Leon, knowing full well that it had not been approved by Cajubi. He also arranged for other payments having no connection to the promissory note.

[24] It is helpful to set out with more specificity comments made by the trial judge relating to Mr. Duscio's *de facto* control over Catan because they bear on Ms. Duscio's appeal.

[25] When recounting the material transactions in the course of his reasons for decision the trial judge said [at para. 333]:

> Whatever the public record shows regarding ownership and control of Catan, the defendant Mr. Anthony Duscio was at all material times the *de facto* controlling mind and will of Catan.

> Mr. and Mrs. Duscio both agree that Mr. Duscio made virtually all of the financial decisions in relation to Catan, controlled all of its banking, arranged for the keeping of its books and records, etc. Mrs. Duscio was advised by her husband from time to time what needed signing and, when asked, did so with little apparent curiosity. She had little to no direct information about any of the business undertaken by Catan. There is no evidence that she invested anything in it or played anything but a passive role. Catan was for all intents and purposes Mr. Duscio's *alter ego*, an *alter ego* whose usefulness was greatly enhanced following his bankruptcy.

[26] The trial judge reiterated [at para. 468] when finding Mr. Duscio liable that Mr. Duscio was the controlling mind and will of Catan, "even if his wife Leanne was the titular shareholder and signing officer. He arranged for all of the bookkeeping and banking and took care of matters electronically or arranged to have his wife sign what needed signing." [page537]

[27] The trial judge's brief reasons [at paras. 472-74] for imposing liability on Mrs. Duscio warrant complete reproduction:

> As officers and directors -- *de jure* in the case of Ms. Leanne Duscio and *de facto* in the case of Mr. Anthony Duscio -- of Catan, the liability of Catan for breach of constructive trust by which it was bound falls equally upon the shoulders of Leanne Duscio and Anthony Duscio. These two both provided knowing assistance in Catan's breach of trust: *Air Canada*.
>
> The particulars of the knowing assistance in Anthony Duscio needs no elaboration. He was one of the architects of the fraud perpetrated upon Cajubi and he actively and knowingly authorized and directed the dissipation of funds received by Catan that he knew or ought to have known came subject to a constructive trust in Cajubi's favour.
> In Leanne Duscio's case, I find that her passive acquiescence in her husband's schemes went beyond mere trust and faith and crossed the line to wilful blindness. She knew that her husband had filed for bankruptcy earlier that year and she knew generally what reverses had led him there. She continued to sign as needed cheques and authorizations for very large quantities of money to transit through her company without due inquiry and in circumstances where she ought to have been on inquiry. She cannot hide behind her own wilful blindness to avoid the consequences of facilitating her husband's fraud.

[28] Later, when explaining Mr. Duscio's liability relating to three other Columbus promissory note transactions, totalling an additional $4,379,958, the trial judge explained why Ms. Duscio was not similarly liable with respect to these transactions: "There is no evidence that Mrs. Duscio or Catan had any direct role in Columbus Capital or its misappropriation of funds" [at para. 479].

[29] When summarizing his disposition, the trial judge said [para. 501]:

> The liability of Ms. Duscio and her company Catan is restricted to the Cajubi funds that were actually received by Catan ($3 million). Should the plaintiff uncover evidence supporting tracing other amounts found by me to be subject to a constructive trust into the hands of either Catan or Ms. Duscio, further application may be made on the basis of such additional evidence of knowing receipt of funds subject to a constructive trust.

The Grounds of Appeal

[30] Ms. Duscio contends that the doctrine of knowing assistance is the sole basis for the $3 million judgment against her. She urges that the trial judge erred in the identification and application of [page538] the knowing assistance test, including by misapprehending the evidence. Cajubi disagrees but argues that the trial judge also based Ms. Duscio's liability on her knowing receipt of Cajubi funds. The specific issues that arise can be stated as follows:

> A. Did the trial judge err by applying a constructive knowledge standard in finding Ms. Duscio liable based on knowing assistance?
>
> B. Did the trial judge make palpable and overriding errors in finding Ms. Duscio liable for knowing assistance?
>
> C. Did the trial judge base Ms. Duscio's liability alternatively on the doctrine of knowing receipt?

A. *Did the trial judge err by applying a constructive knowledge standard in finding Ms. Duscio liable based on knowing assistance?*

[31] The doctrine of knowing assistance is a mechanism for imposing liability on strangers to a fiduciary relationship who participate in a breach of trust by the fiduciary. Strangers to a fiduciary relationship who are made liable on this basis are held responsible because of their "want of probity", "meaning lack of honesty": *Air Canada v. M & L Travel Ltd.* (1993), 15 O.R. (3d) 804, [1993] 3 S.C.R. 787, [1993] S.C.J. No. 118, at p. 812 S.C.R.; *Bikur Cholim Jewish Volunteer Services v. Langston* (2009), 94 O.R. (3d) 401, [2009] O.J. No. 841, 2009 ONCA 196 (C.A.), at para. 43.

[32] Accordingly, the preconditions of knowing assistance liability have been structured to identify dishonest participation in a dishonest breach of trust. In *DBDC Spadina Ltd. v. Walton*, [2018] O.J. No. 578, 2018 ONCA 60, 419 D.L.R. (4th) 409 (C.A.), at para. 211, van Rensburg J.A., in a dissenting opinion adopted by the Supreme Court of Canada as its reasons on appeal, *Christine Dejong Medecine Professional Corp. v. DBDC Spadina Ltd.*, [2019] S.C.J. No. 30, 2019 SCC 30, 435 D.L.R. (4th) 379, identified the elements of knowing assistance in a fiduciary breach [at para. 211] as

> (1) a fiduciary duty; (2) a fraudulent and dishonest breach of the duty by the fiduciary; (3) actual knowledge by the stranger to the fiduciary relationship of both the fiduciary relationship and the fiduciary's fraudulent and dishonest conduct; and (4) participation by or assistance of the stranger in the fiduciary's fraudulent and dishonest conduct.

[33] Two points relating to the "actual knowledge" requirement warrant elaboration, given the issues in this appeal. The first is that the "actual knowledge" of the "stranger" must include knowledge of a fiduciary relationship and "the fiduciary's fraudulent and [page539] dishonest conduct*": DBDC Spadina,* at para. 211; *Harris v. Leikin Group Inc*., [2011] O.J. No. 5714, 2011 ONCA 790 (C.A.), at para. 8. It is not enough for the stranger to know or suspect in some unspecified way that the fiduciary was up to no good. In this case, Ms. Duscio would be liable as a knowing assister only if she had "actual knowledge" that Catan held funds as trustee, and that

she was participating or assisting Catan in fraudulent and dishonest conduct relating to those funds.

[34] Second, the concept of "actual knowledge" is more expansive than the term "actual knowledge" denotes. Although "actual knowledge" by the stranger of the fiduciary relationship and of the fiduciary's fraudulent and dishonest conduct will satisfy this requirement, so, too, will "recklessness or wilful blindness to the fiduciary relationship and the fiduciary's fraudulent and dishonest conduct": *Air Canada*, at p. 811 S.C.R.; see, also, *Harris*, at para. 8.

[35] I need say nothing more about the concept of recklessness, since the trial judge imposed knowing assistance liability based on wilful blindness. Wilful blindness, the concept of interest in this appeal, is well developed in the criminal law. It has been described as "deliberate ignorance" and exists where the subject suspects the relevant facts but deliberately chooses not to inquire because they do not wish to know the truth: *R. v. Morrison*, [2019] 2 S.C.R. 3, [2019] S.C.J. No. 15, 2019 SCC 15, 375 C.C.C. (3d) 153, at paras. 98, 100. A finding of wilful blindness can therefore be made where an affirmative answer can be provided to the question, "Did the accused shut his eyes because he knew or strongly suspected that looking would fix him with knowledge?": *R. v. Briscoe*, [2010] 1 S.C.R. 411, [2010] S.C.J. No. 13, 2010 SCC 13, at para. 21.

[36] Wilful blindness has similar meaning in knowing assistance cases. In *Air Canada*, at pp. 811-12 S.C.R., quoting from *Carl-Zeiss-Siftung v. Herbert Smith & Co*. *(No. 2)*, [1969] 2 All E.R. 367, [1969] 2 Ch 276 (C.A.), at p. 379 All E.R., Iacobucci J. described the alternative basis for knowing assistance liability where the stranger does not have "both actual knowledge of the trust's existence and actual knowledge that what is being done is improperly in breach of that trust" by saying "of course, in both cases a person wilfully shutting his eyes to the obvious is in no different position than if he kept them open".

[37] To be clear, wilful blindness is a subjective standard of fault that depends on the stranger's actual state of mind. This distinguishes wilful blindness from objective standards of fault based on what the subject ought to have known, such as negligence: *R. v. Sansregret*, [1985] 1 S.C.R. 570, [1985] S.C.J. No. 23, at pp. 581-82, 584 S.C.R. [page540]

[38] This distinction is crucial given the underlying theory of liability. In *Air Canada*, Iacobucci J. commented that "carelessness" involved in constructive knowledge does "not normally amount to a want of probity, and will therefore be insufficient to bind the stranger's conscience", as required in knowing assistance cases: at p. 812 S.C.R. In *Citadel [Citadel General Assurance Co. v. Lloyds Bank Canada*, [1997] 3 S.C.R. 805, [1997] S.C.J. No. 92], La Forest J. described the kind of insufficient, constructive knowledge Iacobucci J. was referring to as "knowledge of facts sufficient to put reasonable people on notice or inquiry": at para. 48. Rosenberg J.A., discussing *Air Canada*, observed that "want of probity" is necessary to capture the notion of being privy or party to a fraud and that "[i]t cannot be enough that the trustee was simply negligent or ought to have known that the co-trustee was committing a fraud or fraudulent breach of trust": *Bikur*, at para. 43.

[39] I am persuaded that the trial judge erred in this case by relying on constructive knowledge based on Ms. Duscio's carelessness to ground his finding that Ms. Duscio "went beyond mere

trust and faith and crossed the line to wilful blindness". He said in material part [at para. 474]:

> She knew that her husband had filed for bankruptcy earlier that year and she knew generally what reverses had led him there. She continued to sign as needed cheques and authorizations for very large quantities of money to transit through her company without due inquiry and in circumstances where she ought to have been on inquiry. She cannot hide behind her own wilful blindness to avoid the consequences of facilitating her husband's fraud.

[40] Although the trial judge identified certain facts that Ms. Duscio knew, he made no finding as to whether she knew or suspected that the money transiting through her company was trust money that was being employed in a dishonest or fraudulent breach of trust. This is a critical omission. Without such findings, a proper determination of wilful blindness cannot be made. He spoke instead of how Ms. Duscio "ought to have been on inquiry" [para. 474]. Describing what someone ought to have known or done is the language of objective fault or constructive knowledge, not the language of subjective wilful blindness.

[41] My conclusion that the trial judge used constructive knowledge to support his knowing assistance finding is reinforced by another passage in his reasons for decision. Specifically, he said [at para. 472]:

> As officers and directors -- *de jure* in the case of Ms. Leanne Duscio and *de facto* in the case of Mr. Anthony Duscio -- of Catan, the liability of Catan for breach of the constructive trust by which it was bound falls equally upon the [page541] shoulders of Leanne Duscio and Anthony Duscio. These two both provided knowing assistance in Catan's breach of trust: *Air Canada*.

[42] With respect, it is an error to construct liability for knowing assistance based on the status of the stranger as an officer in a corporation that has received trust property, when what is required is a finding of actual knowledge, personal recklessness or wilful blindness.

[43] I have had the benefit of reading my colleague's dissenting reasons in which she would find that the trial judge based his wilful blindness finding on Ms. Duscio's subjective knowledge. I agree with my colleague that there was evidence on the record that could have supported a finding of subjective knowledge or subjective suspicion on Ms. Duscio's part. The affidavit of August 2009 that Ms. Duscio swore in a different action attesting that, two months after the money had already been moved, she knew that approximately $500,000 had been loaned from Catan to Columbus Capital, is helpful in that regard. So, too, is the fact that Ms. Duscio benefited from some of the withdrawals that occurred while there was trust money in the account. Even the fact that she and her husband lived well beyond their incomes during the relevant period could point in that direction, notwithstanding that prior to the $3 million deposit, the Catan account already held enough money to cover the withdrawals that the trial judge found to have benefited the Duscios during the relevant period. However, the trial judge did not mention any of this in explaining his wrongful assistance finding, nor did he even allude to what Ms. Duscio knew or suspected. He spoke only of what she ought to have known. I cannot, in the face of the direct and exclusive objective-fault explanation he offered for his wilful blindness finding, read the trial judge's decision as implicitly finding that Ms. Duscio had the requisite

subjective fault. The fact that on isolated occasions in the 107-page decision the trial judge used language, without elaboration or explanation, that might be taken to suggest subjective knowledge on Ms. Duscio's part does not assist me in that regard.

[44] It must be remembered when reading the decision as a whole that the trial judge made numerous factual findings that would work against a finding of subjective knowledge or suspicion on Ms. Duscio's part. Specifically, he found that Mr. Duscio was "at all material times the *de facto* controlling mind and will of Catan"; that he "controlled all of its banking, [and] arranged for the keeping of its books and records"; that he and Mr. Garcia had arranged for the deposit of the Cajubi funds; that he was responsible for the wire transfers paid from the account; that Ms. Duscio "had little to [page542] no direct information about any of the business undertaken by Catan"; and that "[t]here is no evidence that she invested anything in it or played anything but a passive role" [at para. 333]. Nor was there evidence of any event that triggered a need for inquiry into a possible breach of trust that she shut her eyes to; there was no evidence that Ms. Duscio was even made aware that the money had been deposited, or that wire transfers had occurred. This was not a slam-dunk case for subjective wilful blindness. It is not the kind of case, in my view, where it is appropriate to infer that the trial judge applied the appropriate subjective standards of fault, notwithstanding that in his analysis he focused solely on an objective standard of fault.

[45] I would find that the trial judge erred in law by applying a constructive knowledge standard in finding Ms. Duscio liable based on knowing assistance. This alone requires that the judgment against her be set aside.

B. *Did the trial judge make palpable and overriding errors in finding Ms. Duscio liable for knowing assistance?*

[46] Ms. Duscio contends that the trial judge made several palpable and overriding errors in finding her liable for knowing assistance. I will address only one of those alleged errors, as it is the only one that I would find to have occurred. I am satisfied that the trial judge committed a palpable error relating to his finding that Ms. Duscio continued to sign cheques and authorizations for very large quantities of money. Since this is the only finding the trial judge made that could show assistance by Ms. Duscio, a necessary condition to "wrongful assistance" liability, this error was overriding.

[47] Specifically, the trial judge found [at para. 474]:

> She knew that her husband had filed for bankruptcy earlier that year and she knew generally what reverses had led him there. She continued to sign as needed cheques and authorizations for very large quantities of money to transit through her company without due inquiry and in circumstances where she ought to have been on inquiry. She cannot hide behind her own wilful blindness to avoid the consequences of facilitating her husband's fraud.

(Emphasis added)

[48] To support Ms. Duscio's liability, this finding would have to relate to cheques and authorizations that are linked to Cajubi funds deposited into the Catan account. However, the

trial judge had no evidence that could ground a finding that Ms. Duscio signed any of the cheques or authorizations after the Cajubi funds were deposited.

[49] First, the trial judge found that it was Mr. Duscio who arranged for the $3 million deposit and the wire transfers of more [page543] than $2.5 million that the trial judge linked to Columbus Capital. There was no evidence that Ms. Duscio played any role in these wire transfers or had any knowledge that the deposit or wire transfer withdrawals had even occurred.

[50] Second, Ms. Duscio's testimony about signing cheques was not linked to the trust money. She acknowledged in her testimony to signing without due inquiry several documents relating to the acquisition and financing of Catan's 20 Queen St. North property, and the litigation affidavit of August 2009 under her husband's direction. She also agreed more generally that "I'll just sign whatever [my husband] puts in front of me." Despite this, she gave no specific evidence relating to signing any cheques that could be linked to Cajubi funds. No cheques or authorizations executed after the Cajubi deposit were put to Ms. Duscio during her cross-examination, and no other evidence was called to prove her signature on any relevant cheques or authorizations.

[51] Although contemporaneous cheques were filed in the case, no admissions were made relating to their authorship. The trial judge did not proceed during the hearing on the basis that those cheques had been proved, since he advised counsel when cross-examining Ms. Duscio to either have her prove the documents she could or read in admissions on discovery to do so. Neither step was taken, and no other evidence was presented linking Ms. Duscio to any of the contemporaneous cheques or authorizations.

[52] In my view the trial judge committed a palpable error by making the finding underlined in para. 49, above, relating as it must have to Cajubi funds, without evidence or admission.

[53] This error is not only palpable, it is overriding. As indicated, Ms. Duscio's liability for knowing assistance depended upon a finding that she assisted in the breach of trust. Cajubi argued before us that she did so by permitting Mr. Duscio to use Catan's bank account to receive and disburse the Cajubi funds, but the trial judge made no mention of this theory of assistance. The only material finding the trial judge made that could amount to assistance was this: that she "continued to sign as needed cheques and authorizations for very large quantities of money to transit through her company without due inquiry". This palpably erroneous finding had to be a lynchpin to a finding of liability for knowing assistance.

[54] I would therefore allow this ground of appeal, on this basis.

C. *Did the trial judge base Ms. Duscio's liability alternatively on the doctrine of knowing receipt?*

[55] The theory of liability of strangers to the trust for knowing receipt rests in the law of restitution. Liability arises from the fact [page544] that the stranger has received trust property for its own benefit and in doing so, has been enriched at the beneficiary's expense: *Citadel*, at para. 31. The stranger is therefore conscience-bound to restore the property received: *Citadel*, at para. 32.

[56] Since liability rests in restitution and not wrongdoing, a lower level of knowledge will suffice than in knowing assistance cases. In knowing receipt cases, constructive knowledge,

based on knowledge of facts that would put a reasonable person on notice or inquiry, may serve as a basis for restitutionary liability: *Citadel*, at para. 48.

[57] The legal test for knowing receipt therefore requires that (1) the stranger receives trust property, (2) for his or her own benefit or in his or her personal capacity, (3) with actual or constructive knowledge that the trust property is being misapplied. In addition to actual knowledge, including wilful blindness or recklessness, requirement (3) can be met where the recipient, having "knowledge of facts which would put a reasonable person on inquiry, actually fails to inquire as to the possible misapplication of the trust property": *Citadel*, at para. 49; *Gold v. Rosenberg*, [1997] 3 S.C.R. 767, [1997] S.C.J. No. 93, at para. 74; see, also, *Paton Estate v. Ontario Lottery and Gaming Corp.* (2016), 131 O.R. (3d) 273, [2016] O.J. No. 3031, 2016 ONCA 458, at para. 62.

[58] Where liability is imposed, the "measure of the restitutionary recovery is the gain the [defendant] has made at the [plaintiff's] expense": *Citadel*, at para. 30, citing *Air Canada v. British Columbia*, [1989] 1 S.C.R. 1161, [1989] S.C.J. No. 44, at pp. 1202-03 S.C.R.

[59] Since liability for knowing receipt may be imposed based on the kind of constructive knowledge the trial judge found in this case, Cajubi seeks to uphold the trial judge's liability finding by urging that he imposed liability on Ms. Duscio for knowing receipt. I do not accept this contention, for these reasons:

-- Although the trial judge cited the doctrine of knowing receipt in para. 441 of his reasons for judgment he made no reference to knowing receipt when describing the liability of Ms. Duscio. Instead, he described Ms. Duscio's liability as based on "knowing assistance in Catan's breach of trust";

-- The trial judge analyzed Ms. Duscio's liability based on "wilful blindness", a mental state that is not required for knowing receipt;

-- When the trial judge explained the liability of Ms. Duscio, he focused on the $3 million deposit, and Ms. Duscio never [page545] received this $3 million for her own benefit or in her personal capacity, necessary conditions to liability based on knowing receipt. The trial judge found correctly that Catan received this money;

-- Although the trial judge made findings that at least $400,000 of the Catan money was spent by Catan on non-Columbus Capital disbursements, some of which are itemized in para. 19 above as having been paid to Ms. Duscio, or arguably for her benefit, he did not find her liable in the amount that she had gained, the measure of restitutionary recovery for knowing receipt. Instead, the trial judge found her liable for the full $3 million paid into Catan, an amount of recovery appropriate in the circumstances only for knowing assistance; and

-- The trial judge made no effort to identify which of the itemized payments described in para. 19, above, or how much of that money, was received personally by Ms. Duscio or for her benefit, which he would have had to do to impose liability based on knowing receipt.

[60] Cajubi argues that the trial judge found Ms. Duscio to be liable for knowing receipt when he said [at para. 501]:

> The liability of Ms. Duscio and her company Catan is restricted to the Cajubi funds which were actually received by Catan ($3 million). Should the plaintiff uncover evidence supporting tracing other amounts found by me to be subject to a constructive trust into the hands of either Catan or Ms. Duscio, further application may be made on the basis of such additional evidence of knowing receipt of funds subject to a constructive trust.

[61] This is not a finding of liability against Ms. Duscio based on knowing receipt. As para. 11 of the formal order confirms, the trial judge was advising the parties that *should* constructive trust funds be shown in the future by as yet uncovered evidence to be in the hands of Ms. Duscio, a "further" application may be made "on the basis of such additional evidence of knowing receipt of funds subject to a constructive trust".

[62] I have considered whether it is appropriate for this court to impose personal liability on Ms. Duscio as a constructive trustee, based on the constructive knowledge and receipt findings made by the trial judge that could support a finding of liability for knowing receipt (although that was not the trial judge's conclusion). In my view, it is not appropriate to do so. First, the trial judge did not make the necessary factual findings to identify the precise funds, listed in para. 19 above, that Ms. Duscio received personally or for her benefit. Second, it is my view that this is a case where a substantial wrong has occurred, warranting a new trial under *Courts [page546] of Justice Act*, R.S.O. 1990, c. C.43, s. 134(6). Premised on a legal error, Ms. Duscio was ordered to pay $3 million. Meanwhile, Cajubi has not had the benefit of a knowing receipt determination involving Ms. Duscio, despite having pleaded this cause of action. Since I would order a new trial on the knowing receipt issue, a precise determination of liability based on knowing receipt can be made at the retrial, if appropriate.

[63] One final point. None of what I say affects the validity of the contingent tracing order that trial judge made. Not only is the tracing order contingent, a tracing order does not depend upon a finding of liability for knowing receipt. Liability in tracing flows from the fact of receipt, and the extent of liability is dependent on the amount received: *B.M.P. Global Distribution Inc. v. Bank of Nova Scotia*, [2009] 1 S.C.R. 504, [2009] S.C.J. No. 15, 2009 SCC 15, at paras. 78-79. A party holding identifiable property that another has a superior legal or equitable right to possess can be compelled under the rules of legal or equitable tracing to transfer that property to the party with the superior legal or equitable right, without the need for a finding of liability for knowing receipt, and without a finding of that the holder is a constructive trustee of that property. As La Forest J. emphasized in *Citadel,* at para. 57, "[t]he imposition of liability as a constructive trustee on the basis of 'knowing receipt' is a restitutionary remedy and should not be confused with the right to trace assets at common law or in equity." He further said, at para. 58:

> Liability at common law [based on common law or equitable tracing rules] is strict, flowing from the fact of receipt. Liability in "knowing receipt" cases is not strict; it depends not only on the fact of enrichment (i.e. receipt of trust property) but also on the unjust nature of that enrichment (i.e. the stranger's knowledge of the breach of trust).

[64] For this reason, I would therefore respectfully observe that the contingent tracing order made by the trial judge is more demanding than it needs to be. If Cajubi funds are traced into the hands of Ms. Duscio, and are identifiable under the rules of equitable tracing, on further application Ms. Duscio could be required to hand the funds over, or to hand over any lasting

assets that have been acquired with those funds, without the need for a finding of actual or constructive knowledge on her part.

Conclusion

[65] I would allow the appeal and set aside the order made in para. 10 of the judgment that holds Leanne Duscio jointly and severally liable to pay to Cajubi $3 million. I would also order a new trial relating to the personal liability claims made against Leanne Duscio for knowing receipt of trust funds. Catan remains jointly [page547] liable with Mr. Duscio and Columbus Capital for the $3 million to be paid to Cajubi pursuant to para. 10 of the trial judge's order.

[66] I would set aside the costs order made against Leanne Duscio below.

[67] I would order costs in this matter to be payable to Leanne Duscio in the amount of $30,000, inclusive of disbursement and applicable taxes, as agreed between the parties.

PEPALL J.A. (dissenting): --

[68] Knowing assistance and knowing receipt are torts that frequently find themselves in the company of civil fraud. They are torts that have evolved as our legal system has struggled to respond to dishonest dealings in society.

[69] In this appeal, the trial judge presided over a 17-day trial involving Cajubi, a Paraguayan workers' pension fund located in Paraguay, that was defrauded of over $20 million, a fraud that was largely masterminded by Canadians. As mentioned by my colleague, we dismissed the appeal brought by two of the perpetrators, Mr. and Mrs. Garcia, and their associated companies: 2020 ONCA 124, 96 M.P.L.R. (5th) 1. In addition to the judgment of $20,843,888 granted against the Garcias, the trial judge also ordered the appellant, Leanne Duscio, and her wholly owned company, Catan Canada Inc. ("Catan"), to pay Cajubi $3 million. Mrs. Duscio is also the sole officer and director of Catan. Catan did not appeal this $3 million judgment against it. Nor did Anthony Duscio, the bankrupt husband of the appellant, appeal the $7,379,958 judgment granted against him in favour of Cajubi.

[70] My colleague would allow Mrs. Duscio's appeal relating to the $3 million award against her based on knowing assistance and would order a new trial on knowing receipt. His basis for allowing the appeal is that the trial judge erred by applying a constructive knowledge standard to the wilful blindness component of knowing assistance and made a palpable and overriding error relating to his finding that Mrs. Duscio continued to sign as needed cheques and authorizations for very large quantities of money to transit through Catan.

[71] I would dismiss the appeal on knowing assistance, which would also render a new trial on knowing receipt unnecessary. In my view, read as a whole together with the record, I am not persuaded that the judgment awarded was in error.

Trial Judge's Reasons

[72] In extensive reasons for decision, 107 pages in length, the trial judge addressed the case against the Garcia defendants, as he [page548] called them.[4] Along with others, the Garcia defendants orchestrated a massive fraud against the Cajubi pension fund in Paraguay. However, the Duscios were not mere bystanders to this fraud.

[73] Mr. Duscio's then company, Universal Settlements Inc. ("USI"), hired Mr. Garcia as a salesman around 2002. USI was in the viaticals business -- it found investors to purchase life insurance policies from owners. Sadly, for the pension fund, through his work with USI, Mr. Garcia came into contact with Cajubi in 2005.

[74] The trial judge introduced the Duscios in para. 14 of his reasons:

> Mr. Anthony Duscio, his wife Leanne Duscio and her company Catan Canada Inc. -- the "Duscio Defendants" -- stand in a class apart among the other defendants to this action. Their involvement (in the subject-matter of this proceeding at least) is limited to the "Columbus Notes" matter by which Cajubi was defrauded of almost $7.4 million. This was an utterly fraudulent investment scheme Mr. Duscio and Mr. Garcia hastily assembled to avoid sending back to Paraguay the proceeds of liquidation of the Union Securities investment. This scheme enabled Mr. Garcia to secrete more than $1 million of Cajubi's funds out of Canada into the hands of a family member. Some or all of the remaining funds simply vanished in a variety of fraudulent transfers orchestrated by the Duscio Defendants without even a façade of propriety. While Mr. Garcia appears to have been taken by surprise by the extent of Mr. Duscio's fraud, this does not affect the liability of either for the blatant and fraudulent misappropriation of the plaintiff's funds.

[75] At para. 329 and following, the trial judge described how Mr. Garcia caused $7,379,958 of the pension fund's money to be transferred to Columbus Capital Corp. ("Columbus Capital"), discussed in more detail below.

[76] Catan owned a heavily mortgaged property on Queen Street in Kitchener, which it acquired in 2006. This building had no tenants, so Mrs. Duscio moved her dance studio, described by her as a hobby and for which she got paid $1,000 -- $1,500 a month, into the building. Mrs. Duscio testified that the dance studio lost money each year.

[77] Greg Baker's daughter attended the dance studio and, as a result of this connection, Mr. Duscio was introduced to Mr. Baker. Mr. Baker asked Mr. Duscio to assist with start-up funds for a computer refurbishing and leasing business. The two discussed the [page549] venture and Mr. Duscio later discussed the venture with Mr. Garcia as well. In August 2008, Mr. Duscio arranged for Columbus Capital to be incorporated. Mr. Duscio had filed for bankruptcy in early 2008 and Mr. Baker became the sole officer and director of Columbus Capital. Catan's building on Queen Street in Kitchener became Columbus Capital's registered office.

[78] Mr. Baker did not know where the funding came from for the computer leasing business, but transactions ensued, and he thought the venture was taking off. The trial judge found that Mr. Duscio controlled all of Columbus Capital's finances, kept the books, and was the *de facto* controlling mind and will of Columbus Capital from inception. Tensions began to grow, however, and things fell apart when Mr. Baker discovered various banking ledgers with large amounts of money that he did not recognize. Mr. Baker locked Mr. Duscio out of Columbus Capital on June 9, 2009, and the company ceased carrying on business soon after.

[79] The trial judge found that substantially all of the funds that went into Columbus Capital came from the Cajubi pension fund and from customers paying for purchases financed by the

Cajubi pension fund. He also found that nothing had been recovered by Cajubi from Columbus Capital.

[80] The trial judge found at para. 333 of his reasons that Mr. Duscio was the *de facto* controlling mind, will, and alter ego of Catan. Mrs. Duscio was advised by Mr. Duscio what needed signing and, when asked, did so with little apparent curiosity. She had little to no direct information about the business undertaken by Catan. There was no evidence that she invested anything in Catan or played anything but a passive role. However, she was the sole shareholder, officer, and director of Catan.

[81] The trial judge described the Duscios' circumstances, at paras. 335 and 336 of his reasons:

> At the time of trial, Mr. Duscio had very recently obtained employment working in a factory while Mrs. Duscio works as a sales assistant in a retail store at a modest hourly wage. Despite their very modest joint income, the couple continues to maintain a lifestyle well beyond what their income would suggest. They live in a custom-built home outside of Kitchener that can only be described as palatial, have a property in Florida that they visit perhaps two times per year and have luxury cars registered to both addresses.
> Mr. Duscio had originally hoped to house USI in the Queen Street building but when that situation turned into litigation, Catan was left with a building and no tenant. Mrs. Duscio moved her dance studio from her home to the office and began a small-scale business that she described as more of a hobby out of the building. As of mid-2008, Garcia caused $7,379,958 of Cajubi's money to be "invested" in Columbus Capital through the latter's issuance of promissory notes. Duscio had little in the way of concrete plans for the building (it was eventually sold in 2012). [page550]

[82] On August 22, 2008, Mr. Garcia caused $3 million of Cajubi's money to be transferred directly to Catan.[5] By June 9, 2009, very little of the money transferred to Catan or Columbus Capital remained. The trial judge found that all of the funds deposited in Catan's account were impressed with a constructive trust in favour of Cajubi.

[83] Over the intervening ten months, Catan's general ledger identified approximately $2 million being transferred to Columbus Capital. In addition, according to an affidavit sworn by Mrs. Duscio on August 20, 2009, which I will discuss in further detail, and on which she was cross-examined at trial, $513,931.92 was lent by Catan to Columbus Capital in June 2009.

[84] In addition, $400,000 was spent by Catan. Some of the details of these disbursements in favour of the Duscios are described at para. 19 of my colleague's reasons.

[85] As the trial judge observed, at para. 395 of his reasons:

> There is no evidence that Catan had any "business" beyond owning the 20 Queen Street building from which a small amount of rental income was derived. I need not examine or count every nickel to conclude as I do that all or substantially all of the funds spent by Catan from August 22, 2008 until June 1, 2009 went to personal expenditures of either Mr. Duscio or Mrs. Duscio. Cajubi's money, once deposited at Catan, became a piggy bank that was

drawn upon at will. Mrs. Duscio was given a salary she had not previously drawn, home improvements were made and paid for, luxury car payments were made, etc.

[86] Money coming into Columbus Capital followed the same pattern as shown by Catan. The trial judge noted that this included expenditures of a clearly personal nature in favour of Mr. and Mrs. Duscio, having nothing to do with the computer leasing business. Examples given were Mrs. Duscio's dance studio: $20,530; Mrs. Duscio advances: $31,522.81; Credit Nation: $999,936.10; and Home improvements of at least $21,000: at para. 405. [page551]

[87] Having outlined the facts, the trial judge correctly described the elements of fraudulent misrepresentation, breach of fiduciary duty, knowing assistance and knowing receipt. He relied on *Air Canada v. M & L Travel Ltd.*, *supra*, and *DBDC Spadina Ltd. v. Walton*, *supra*, rev'd, *Christine DeJong Medicine Professional Corp. v. DBDC Spadina Ltd.*, *supra*.

[88] He wrote, at paras. 441 and 442:

> The doctrine of knowing receipt requires a finding that the person has received trust property in his or her own *personal capacity* with actual or constructive knowledge of the breach of trust or fiduciary duty: *DBDC* at para. 37. It is thus only applicable as against the recipient of property found to be trust property (including property subject to a constructive trust) upon proof of the requisite level of knowledge. It is a form of liability that arises from the law of restitution and is a tool deployed, among other purposes, to trace trust funds that have been misappropriated and restore them to their rightful owner.
> The doctrine of knowing assistance is fault-based instead of restitution-based. It requires proof that the person, with knowledge, participates in or assists the defaulting trustee or fiduciary in a fraudulent or dishonest scheme: *DBDC* at para. 40. Actual knowledge includes recklessness or wilful blindness: *Air Canada* at para. 39.[6]

[89] The trial judge found that the facts known to Catan established that the pension fund's $3 million was received by Catan as a consequence of fraud and in breach of fiduciary duties owed to Cajubi by Mr. Garcia and his company. Accordingly, Catan's funds were impressed with a constructive trust in favour of Cajubi and Catan breached its obligations as constructive trustee by failing to hold the funds separate and apart and by failing to take immediate steps to return them to the pension fund: at para. 470. He wrote that Catan violated its trust obligations to Cajubi as quickly and as often as possible, including by making expenditures on clearly personal items for the benefit of the Duscio family: at para. 471.

[90] As mentioned, the trial judge granted judgment to Cajubi against Mr. Duscio and Columbus Capital in the amount of $7,379,958 and against Mrs. Duscio and Catan in the amount of $3 million and also made a tracing order. My colleague has already recited some of the trial judge's conclusions, at para. 472 and following, but for ease of reference, I will repeat paras. 472 to 474:

> As officers and directors -- *de jure* in the case of Ms. Leanne Duscio and *de facto* in the case of Mr. Anthony Duscio -- of Catan, the liability of Catan *for breach of the constructive trust* by which it was bound falls equally upon the [page552] shoulders of Leanne Duscio and

> Anthony Duscio. *These two both provided knowing assistance in Catan's breach of trust*: *Air Canada*.
>
> The particulars of the knowing assistance of Anthony Duscio needs no elaboration. He was one of the architects of the fraud perpetrated upon Cajubi and he actively and knowingly authorized and directed the dissipation of the funds received by Catan that he knew or ought to have known came subject to a constructive trust in Cajubi's favour.
> In Leanne Duscio's case, I find that her passive acquiescence in her husband's schemes went beyond mere trust and faith and crossed the line into wilful blindness. She knew that her husband had filed for bankruptcy earlier that year and she knew generally what reverses had led him there. She continued to sign as needed cheques and authorizations for very large quantities of money to transit through her company without due inquiry and in circumstances where she ought to have been on inquiry. She cannot hide behind her own wilful blindness to avoid the consequences of facilitating her husband's fraud.

(Emphasis added)

[91] The trial judge thus first concluded that Catan was liable for breach of constructive trust. He went on to conclude that Mr. and Mrs. Duscio "provided knowing assistance in Catan's breach of trust": at para. 472.

[92] My colleague takes issue with one sentence in para. 474 in two respects. First, he states that the use of the words "without due inquiry" and "in circumstances where she ought to have been on inquiry" establish that the trial judge incorrectly applied an objective test to the knowledge component of wilful blindness. Second, he states that the trial judge made a palpable and overriding error in finding that Mrs. Duscio signed as needed cheques and authorizations for very large quantities of money to transit through her company, Catan. I will delineate why I reject these two arguments that anchor my colleague's allowance of the appeal and the setting aside of the judgment of the trial judge.

Analysis

(1) *Wilful blindness*

[93] In this case, the trial judge found that Mrs. Duscio was wilfully blind in facilitating Catan's breach of trust. My colleague reasoned that there was evidence on the record that could have supported a finding of subjective knowledge on Mrs. Duscio's part. I agree. Indeed, there was ample evidence to support the trial judge's finding of wilful blindness. My colleague takes issue with what he describes as Mrs. Duscio's carelessness to ground the trial judge's finding of wilful blindness and the application of a constructive knowledge standard. I do not agree that the trial judge's finding of wilful blindness was based on a carelessness or constructive knowledge standard. [page553]

(a) *The trial judge's language and Mrs. Duscio's affidavit*

[94] First, although the trial judge did use the terms "without due inquiry" and "in circumstances where she ought to have been on inquiry", this does not preclude a finding of wilful blindness, and in any event, I would not read his reasons so narrowly as my colleague

does. The trial judge used other words to describe Mrs. Duscio that import the requisite knowledge component: "acquiescence" (at para. 474), "facilitating" (at para. 474) and "orchestrated" (at para. 14). All of these words, each of which the trial judge used to describe Mrs. Duscio's participation in the dishonest conduct of Catan, suggest subjective knowledge. He was also of the view that she had constructive knowledge, but this did not preclude his express or implicit finding of subjective knowledge. The evidence of such knowledge supports my conclusion that the trial judge was not limiting his basis for liability to constructive knowledge.

[95] I will start first with Catan. As mentioned, the trial judge gave judgment against Catan for $3 million. The trial judge found that it received the $3 million as a consequence of fraud. At para. 470 of his reasons, the trial judge stated that Catan breached its obligations by, among other things, failing to return those funds to Cajubi. The judgment against Catan has not been appealed. As mentioned, Mrs. Duscio is the sole officer, director and shareholder of Catan. The trial judge did not make a finding that Catan had other signing officers, as he did with Columbus Capital.

[96] On August 20, 2009, Mrs. Duscio swore an affidavit in support of an Application in which Catan was suing Columbus Capital. At the trial of the action under appeal, Mrs. Duscio was cross-examined on her sworn affidavit, which she testified that she recalled. In that affidavit, she makes oath and says that she is the president of Catan "and as such, [has] knowledge of the matters to which I hereinafter depose". She then describes the following: her husband's bankruptcy; the bankruptcy of Mr. Baker, whom she described as the director of Columbus Capital; how Catan, an Ontario corporation, agreed to lend and did lend Columbus Capital $513,931.92; and how she was "genuinely concerned that Mr. Baker has misappropriated the Loan proceeds". She spoke of Mr. Baker having closed Columbus Capital's bank accounts without "our knowledge or consent" and also expressed concern about having made a loan to an undischarged bankrupt. Thus, although she claimed no knowledge of the $3 million, she sought the return of $513,931.92 of that amount.

[97] Our system of justice in the civil arena is largely based on testimony given under oath and sworn affidavits. This is [page554] particularly the case with the increase of a paper record in summary judgment motions. Mrs. Duscio's affidavit was referenced in her cross-examination and was a part of the evidence at trial. It defies reason that, having sworn such an affidavit, subjective knowledge of the fraud and breaches perpetrated by Catan was not imputed by the trial judge to Mrs. Duscio. At a minimum, it would be fair for the trial judge to draw an inference from this and other evidence that Mrs. Duscio was wilfully blind, as that term is legally understood.

(b) *The appellant's receipt of benefits*

[98] Second, receipt of a benefit may also ground an inference that Mrs. Duscio knew of the fraud and the breaches: *Air Canada*, at p. 812 S.C.R. The trial judge found that there was no evidence that Catan had any "business" beyond owning the 20 Queen Street building from which a small amount of rental income was derived and that all or substantially all of the funds spent by Catan from August 22, 2008 until June 1, 2009 went to personal expenditures of either Mr. Duscio or Mrs. Duscio. This of course was Cajubi's money. To use the trial judge's language, Cajubi's money, once deposited at Catan, became "a piggy bank" for the Duscios.

Recall that at this time, Mr. Duscio was bankrupt. At the time of trial, Mr. Duscio had very recently obtained modest employment working in a factory, while Mrs. Duscio worked as a sales assistant in a retail store at a low hourly wage. She reported income of $25,500 and $22,437.08 for the years 2008 and 2009, yet the cheques to her from Catan, which based on the business records, appear to have been deposited into her Bank of Montreal bank account, far exceeded those amounts. In the years 2007, 2008 and 2009, on behalf of Catan, she reported losses of $95,981, $130,266 and $79,211 respectively. Catan's taxable income was noted as zero and she is identified as the Company's president and contact person. The electronic tax filing appears to certify that she has examined the return and that the information is accurate and complete. In her cross-examination, Mrs. Duscio reiterated that Catan didn't have much day-to-day business other than collecting rent. A review of all of the account statements and Catan's general ledger, which were before the trial judge, show that other than the fraudulent funds, no other material amounts were deposited into Catan.

[99] The trial judge outlined some of the numerous benefits received by both of them. Despite their very modest joint income, the couple, who had been together for 35 years, continued to maintain a lifestyle well beyond what their income would suggest. They lived in a custom-built home outside of Kitchener that could only be described as palatial, had a property in Florida [page555] that they visited perhaps two times per year and had luxury cars registered to both addresses. Moreover, Mrs. Duscio received a salary she had not previously drawn, home improvements were made and paid for, and luxury car payments were made, all from Catan and hence Cajubi. She testified that her dance studio had lost money for each of the six years it had been in operation. And, Mr. Duscio was bankrupt. In essence, the pensions of the Paraguayan workers became pensions for the Duscios.

(c) *The trial judge's finding of wilful blindness*

[100] Third, it cannot be ignored that the trial judge did make a finding that Mrs. Duscio was wilfully blind. This is unlike the Supreme Court's decision in *Citadel General Assurance Co. v. Lloyds Bank Canada*, *supra*, where, in concluding that the trial judge had improperly restricted her findings of knowing assistance to constructive knowledge, the court noted that there was no finding of wilful blindness or recklessness: at para. 23. This is not that case.

[101] In essence, my colleague disregards this finding. Rather, relying on one sentence in the trial judge's reasons, he concludes that the trial judge failed to understand the concept of wilful blindness and only applied an objective standard, based on Mrs. Duscio's carelessness, to ground his finding. With respect, this is an overly narrow reading of the trial judge's decision. As mentioned, stating that Mrs. Duscio ought to have been on inquiry does not preclude a finding of wilful blindness. Indeed, the fact that someone ought to have been on inquiry may be a factor to consider in whether they were wilfully blind: *IWA - Forest Industry Pension Plan (Trustees of) v. Leroy*, [2017] B.C.J. No. 166, 2017 BCSC 158, 44 C.B.R. (6th) 221 (S.C.) ("*Trustees of the IWA"*), at paras. 121-22. In *Trustees of the IWA*, the trial judge applied a subjective standard for wilful blindness, but also inferred wilful blindness from a combination of what the personal defendant subjectively knew and what she ought to have known about the corporate defendant's breach of trust.

[102] In the paragraph on Mr. Duscio's liability, the trial judge explained that Mr. Duscio was one of the architects of the fraud who "knowingly authorized and directed the dissipation of the funds received by Catan". The trial judge then went on to say that Mr. Duscio "knew *or ought to have known*" that those funds were subject to a constructive trust in Cajubi's favour (emphasis added). No one in this case suggests that the trial judge applied an objective standard for Mr. Duscio. It is clear that the trial judge considered, correctly, that what someone ought to have [page556] known may be a factor to consider in determining whether they were wilfully blind.

[103] Moreover, in closing argument at trial, the trial judge was specifically referred to a decision that he had authored two months earlier in *1169822 Ontario Ltd. v. Toronto-Dominion Bank*, [2018] O.J. No. 1570, 2018 ONSC 1631 (S.C.J.), involving knowing assistance and wilful blindness. In that decision, the trial judge noted that actual knowledge is required for the equitable tort of knowing assistance and observed that this included wilful blindness and recklessness. He wrote, at paras. 128 and 132-137 of that decision:

> The parameters of the equitable claim for knowing assistance in a breach of trust are quite clear and the required level of knowledge is a high one. Only actual knowledge of the existence and breach of the trust -- or its moral equivalents wilful blindness or recklessness -- will suffice to bind the stranger's conscience in favour of the victim of the breach of trust and give rise to a remedy where the required action was not taken. The bank's liability does not arise where only constructive knowledge of the breach can be shown: *Air Canada* at paras. 39-41.
>
> . . . . .
>
> It has long been held that actual knowledge of fraud also extends to parties who are wilfully blind of the fraud or who are reckless as to its existence. They are each equivalent to each other in terms of the consequences that flow from having such knowledge and failing to act upon it.
>
> Both wilful blindness and recklessness are comparatively high standards of knowledge because they involve a level of knowledge that is considered to be morally equivalent to actual knowledge. They require a consideration of both the degree of actual knowledge and of the culpable attitude or mental state of the person whose knowledge is in question.
>
> They are concepts that are defined in part by contrast to what they are not. While a failure to inquire after being put on notice can be a component of wilful blindness or of recklessness, it can also be a component of constructive knowledge, the latter concept entailing a significantly lower level of knowledge and culpability.
>
> Wilful blindness or recklessness requires proof of culpable conduct that goes beyond "mere" negligence or laziness underlying a failure to inquire. It requires a combination of knowledge and conduct of a level that can fairly be equated to actual knowledge. The additional element I have described as "culpability" was described by Iacobucci J. in *Air Canada* as being "want of probity". He described this as the element that differentiates wilful blindness or recklessness (either of which will bind the stranger's conscience) from constructive knowledge (which normally will not): *Air Canada* at para. 41.

> Wilful blindness arises where a party is aware of the need for inquiry but declines to undertake it "because he does not wish to know the truth"; where "it can almost be said that the defendant actually knew"; where it can be said that the person suspected the fact and realized its probability but refrained from obtaining confirmation deliberately: *R. v. Sansregret*, [1985] 1 S.C.R. 570 at para. 22. It is to be distinguished from mere negligence in [page557] failing to obtain information. The required level of knowledge extends beyond knowledge of some risk of fraud to knowledge of the "clear probability" of it: *Big X Holdings Inc. v. Royal Bank of Canada*, 2015 NSCS 184 at para. 89. In *Bullock v. Key Property Management Inc.*, 1997 CanLII 3440 (ON CA) the Court of Appeal found that wilful blindness is premised on the existence of an actual suspicion that certain facts exist and not on the failure to take steps to inform oneself of those facts.
>
> Each of these definitions of wilful blindness intentionally sets this standard apart from mere negligence and thus attaches to a much narrower, more exceptional and thus more culpable range of conduct. In *Bullock*, it was not sufficient that the bank should have been on inquiry regarding its customer.

[104] I accept that the trial judge's reasons in the case under appeal would have benefitted from elaboration and more precision. It would have been preferable had he repeated the statements of law from *1169822 Ontario Ltd.* in the Cajubi reasons. However, the trial judge in this case applied the same correct standard.

[105] Furthermore, at para. 441, he noted that knowing receipt requires a finding that the stranger had actual *or constructive knowledge* of the breach of trust. In the next paragraph, he explained that knowing assistance requires a finding that the stranger had actual knowledge (which includes wilful blindness or recklessness) of the breach of trust. He specifically left "constructive knowledge" out of the explanation of knowing assistance, after including it in the explanation of knowing receipt the paragraph immediately before. I cannot conclude that the trial judge's finding of wilful blindness was grounded in an objective standard.

(d) *The appellant's testimony at trial*

[106] Fourth, Mrs. Duscio's cross-examination at trial, peppered with "I don't know" and "I can't recall" answers, did not detract from the trial judge's finding of wilful blindness. The following is an example of one of her answers:

Q: Tony Duscio, okay, so you just signed the papers, you had no idea what was happening?

A: Well, I'm not going to say I had no idea. He probably told me what was happening, and I -- I'm not going to dispute him or disagree with anything he's doing. I don't know why I would, so I would have signed the

papers, yes.

Q: Okay.

A: And probably not given it a lot of thought either.

[page558]

[107] Mrs. Duscio also testified that even though she signed whatever was put in front of her, she recognized that she had responsibility for the things she signed.

[108] My colleague suggests that the excerpt above is restricted to the purchase of the office building, but again, with respect, he ignores the other possible global interpretation that treats her evidence as the summing up or culmination of her prior testimony. It is the trial judge who has the opportunity to see and hear the witnesses in the context of the trial as a whole, not this court.

[109] Again, although it would have been preferable for the trial judge to elaborate, faced with the constellation of facts before him, it was open to him to find wilful blindness and to conclude that Mrs. Duscio was wilfully shutting her eyes to Catan's dishonest dealings. Indeed, Mrs. Duscio is the very definition of someone who is wilfully blind. Frankly, an independent reading of her cross-examination testimony leads to no other reasonable conclusion.

(e) *The test for knowing assistance of breach of trust*

[110] Lastly, I reiterate that Mrs. Duscio was found liable for knowingly assisting Catan's breach of trust. At paras. 31-33 of his reasons, my colleague repeatedly references fiduciary relationships and breach of fiduciary duty. However, this case raises the issue of how the doctrine of knowing assistance applies in circumstances of breach of constructive trust.[7]

[111] The relevant test for knowing assistance of breach of trust is from *Air Canada*: (1) there must be a trust;[8] (2) a fraudulent and dishonest breach of that trust; (3) actual knowledge by the [page559] stranger of the fraudulent and dishonest breach of trust (wilful blindness or recklessness will also suffice); and (4) participation by or assistance of the stranger in the fraudulent and dishonest breach of trust. In *Air Canada*, the Supreme Court explained that the method by which a trust is created has an impact on the question of the stranger's knowledge of the trust. The decision in *Air Canada* concerned a trust created by contract, so the Supreme Court stated that "whether the stranger knew of the trust will depend on his or her familiarity or involvement with the contract": *Air Canada*, at p. 812 S.C.R. There was no mention in *Air Canada* of fiduciaries or fiduciary relationships. In circumstances of breach of constructive trust, the trustee does not necessarily owe fiduciary obligations: Oosterhoff, at p. 1132. Fiduciary relationships therefore do not always play a role in a case of knowing assistance of breach of constructive trust.

[112] From *Air Canada*, it follows that, in cases of breach of constructive trust, whether the stranger knew of the trust will depend on his or her familiarity or involvement with the

circumstances leading to the imposition of the constructive trust. As mentioned, Catan was impressed with a constructive trust because the funds were received in circumstances of dishonesty and fraud. Constructive trusts are imposed by law, so it is unhelpful to speak of strangers to a constructive trust "knowing" of, or even being wilfully blind to, the trust's existence, as my colleague suggests.

[113] Again, based on how the *Air Canada* test would apply in circumstances of breach of constructive trust, Mrs. Duscio was required to (1) know, or be wilfully blind to, the circumstances leading to the imposition of a constructive trust on Catan; (2) know, or be wilfully blind to, Catan's fraudulent activity;[9] and (3) participate or assist in Catan's fraudulent activity. In cases of knowing assistance of breach of constructive trust, a finding of liability will depend on the particular circumstances of each individual case. Hence a case-by-case analysis is required.

[114] Against this backdrop, the trial judge found Mrs. Duscio wilfully blind to the fraudulent means by which Catan received the funds. Her passivity did not preclude a finding of wilful blindness. A wide range of factors can be taken into account in inferring wilful blindness. In *Sorrel 1985 Ltd. Partnership v. Sorrel [page560] Resources Ltd.*, [2000] A.J. No. 1140, 2000 ABCA 256 (C.A.), for example, the Alberta Court of Appeal considered the respondents' subjective knowledge of a "depressed market" to be relevant in determining whether they were wilfully blind. The issue was whether the personal respondents were liable for knowingly assisting a breach by Sorrel Resources Ltd. ("Sorrel") of a trust relationship it had with the appellant, Sorrel 1985 Limited Partnership (the "Sorrel Partnership"). This turned, in part, on whether the personal respondents knew that Sorrel Partnership funds were at risk of being seized by creditors because of Sorrel's vulnerability. The Alberta Court of Appeal held that they were wilfully blind or reckless of the fact even if they did not have actual knowledge. This was because "[t]hey had subjective knowledge that Sorrel had a serious working overdraft, the market was depressed and they were refinancing": *Sorrel*, at para. 72. Knowledge of general facts like a "depressed market", and of certain surrounding circumstances reflecting the financial health of a company, may be relevant to a wilful blindness assessment.

[115] In this case, the trial judge focused, as he should have, on the fact that Mrs. Duscio knew about her husband's bankruptcy and the circumstances that led him to his bankruptcy; that the Duscios had modest incomes but lived extravagant lives; and that Mrs. Duscio was Catan's sole officer, director, and shareholder. The trial judge found that, given Mrs. Duscio's subjective knowledge of these things, she was wilfully blind to the fraudulent means by which Catan received and disbursed funds, and Catan's obvious breach of trust. She swore an affidavit referencing what she described as a loan to Columbus Capital in circumstances where, apart from a small amount of rental income, her company, as found by the trial judge, had no business. From all of these facts, the trial judge was entitled to find that she was wilfully blind and that these funds did not belong to Catan or to her. Mrs. Duscio's conscience was sufficiently affected to justify the trial judge's imposition of liability upon her.

[116] Even if it were the case that the trial judge grounded his wilful blindness finding on an objective standard, which I do not accept, this court is permitted to review the record in order to determine if the finding of wilful blindness was open to the trial judge. In *Wescom Solutions Inc. v. Minetto*, [2019] O.J. No. 1584, 2019 ONCA 251 (C.A.), for example, the trial judge mistakenly applied an objective standard for wilful blindness, but this court nevertheless held that the trial

judge's error "in law in his articulation of the concept of wilful blindness" did not mean that the trial judge was wrong to conclude that the appellant was wilfully blind: *Wescom*, at para. 10. The trial judge's mischaracterization of wilful [page561] blindness was not fatal because he had made findings of fact that established that the appellant was wilfully blind on a subjective standard. Again, my colleague agrees that there was evidence on the record that could have supported a finding of subjective knowledge on Mrs. Duscio's part.

(f) *Conclusion on wilful blindness*

[117] Contrary to my colleague's determination, I conclude that, read as a whole within the context of the entire record before him, it cannot be said that the knowledge component needed to anchor a finding of wilful blindness by Mrs. Duscio is absent from the trial judge's reasons. Moreover, the trial judge's conclusion was supported by the record. He was fully conversant with the detailed record, having presided over the trial for over three weeks and having trial managed the case beforehand. It was open to the trial judge to conclude that Mrs. Duscio was wilfully blind, particularly given her affidavit sworn on behalf of Catan that detailed its activities. This included Catan's alleged entitlement to the $513,931.92 she stated that Catan had lent to Columbus Capital and her knowledge of her husband's bankruptcy. Moreover, she had a modest income, she received extensive benefits from the company of which she was the sole officer, director and shareholder, and maintained an opulent lifestyle. She permitted her company to be used, signed Catan's documents, and accepted the substantial fruits of her efforts. The trial judge understood the requirements of wilful blindness, determined that they were met, and did not simply apply a constructive knowledge standard to Mrs. Duscio's conduct. Carelessness this was not.

(2) *Cheques and authorizations*

[118] Dealing with the second argument, my colleague writes that the trial judge had no evidence that could ground a finding of liability relating to cheques and authorizations that were linked to Cajubi's funds. He states that there is no evidence that Mrs. Duscio played any role in wire transfers. My colleague also states that no evidence was presented that linked Mrs. Duscio to the cheques or authorizations relevant to Cajubi funds. For the following reasons, I would not allow the appeal on this basis.

[119] First, I do not see this as a ground of appeal in the appellant's notice of appeal. There is no mention of a palpable and overriding error relating to the cheques and authorizations. Rather, the grounds enumerate inconsistent factual findings, Mrs. Duscio's liability for knowing receipt, and the misapprehension of the law in *Air Canada*. See Rules of Civil Procedure, R.R.O. 1990, Reg. 194, rule 61.08(2). [page562]

[120] Second, I have already addressed the linkage between Mrs. Duscio's knowledge and the fraud and breach of trust by Catan. With respect, my colleague's analysis appears to subtract Catan from the equation. All the trial judge had to conclude was that Mrs. Duscio was wilfully blind to Catan's receipt and disbursement of fraudulent funds and its breach of constructive trust, and that she participated in that breach.

[121] Recall that Mrs. Duscio was the sole officer, director, and shareholder of Catan; her husband was an undischarged bankrupt;[10] and Catan carried on virtually no business.

Furthermore, there is no suggestion that Catan's cheques were improperly admitted into evidence,[11] nor any argument that the numerous cheques that were filed in evidence before the trial judge were not signed by Mrs. Duscio. (This helps explain why the cheques were not the subject matter of the notice of appeal.) Moreover, Mrs. Duscio was also the recipient of many of them. Based on the business records, the cheques appear to have been deposited into her bank account. There can be no question that she knowingly permitted her company to be used for improper purposes. In spite of Mrs. Duscio's more limited role than that of her husband, I do not see the trial judge's statements that she continued to sign as needed cheques and authorizations to transit money through Catan as a palpable and overriding error. I would not allow the appeal on this basis.

Conclusion

[122] Lastly, in closing, I would also observe that knowing assistance is an equitable remedy. While I do not ground my dissent on equity, with respect, my colleague's reasons ignore the equitable underpinning of the tort of knowing assistance. This case presented the trial judge with a Paraguayan pension fund that was defrauded of millions of dollars with the benefits accruing to the appellant and her husband along with the Garcias. The trial judge did his job, applied the correct legal principles, and reached a decision that was both equitable and legally sound. I would not disturb his decision. Given my decision, nor would I compel the parties to [page563] expend the time and expense on a new trial on the issue of knowing receipt.

Disposition

[123] I would dismiss the appeal with costs of $30,000, as agreed by the parties, inclusive of disbursements and applicable tax, to be paid by the appellant to the respondent.

Appeal allowed; new trial ordered.

Notes

1 The trial judge identified the amounts as $2,079,136 paid before June 1, 2009, plus $513,931.92 transferred to Columbus Capital on that date. The actual amounts paid on Columbus Capital's behalf may in fact have been nearly $100,000 higher than this. The trial judge achieved his figures by simply adding together disbursements from Catan's Canadian and US accounts, apparently without accounting for exchange differences. Two transfers totalling $1,874,430 CDN were made from Catan's Canadian account to its US account that can be linked to funding the $1,779,140.94 USD that was paid on Columbus Capital's behalf out of the US account, producing an exchange differential of slightly less than $100,000 CDN. On this basis, the breakdown may, in fact, be over $2.6 million attributable to Columbus, and slightly over $300,000 remaining with Catan.

2 This panel recently denied the appeal from these decisions: Caja Paraguaya de Jubilaciones y Pensiones del Personal de Itaipu Binacional v. Obregon, [2020] O.J. No. 670, 2020 ONCA 124.

3 Mr. Duscio was also found liable, along with Columbus Capital, to pay an additional $4,379,958 relating to other fraudulent Columbus notes.

4 The trial judge used the term "Garcia defendants" to refer to Mr. Eduardo Garcia Obregon, his wife Mrs. Claudia Patricia Garcia (and all names used by each) as well as certain companies that played a role in the scheme against Cajubi: Managed (Portfolio), Corp., Genesis (LA), Corp. (Ontario), Genesis (LA), Corp. (Alberta), FC Int, Corp. and First Canadian Int. Corp. The trial judge also used the term "individual Garcia Defendants" to refer to Mr. and Mrs. Garcia. I will adopt the same terminology in my dissenting reasons.

5 As my colleague notes, the trial judge found that Catan's Canadian dollar account had a balance of $292,238 prior to its receipt of Cajubi funds, and Catan's US dollar account had a balance of $13,469.37 prior to its receipt of Cajubi funds: see para. 391. These amounts were used by the trial judge as benchmarks to determine how much of Cajubi's money was funnelled through Catan to Columbus Capital, and how much of Cajubi's money was spent by Catan itself: see paras. 392-94. In her cross-examination, Mrs. Duscio was not asked about these sums. She was asked about the mortgages registered on title of the 20 Queen Street building, to which she testified that she knew nothing. My colleague now attempts to infer either that Mrs. Duscio knew of this balance or that the trial judge did not take these amounts into account when making a finding of wilful blindness against Mrs. Duscio. None of the parties gave these amounts any significance during Mrs. Duscio's cross-examination.

6 Though the majority decision of the Court of Appeal for Ontario in DBDC Spadina was reversed by the Supreme Court on appeal, the legal proposition the majority cited in para. 40, relied upon by the trial judge, is unassailable.

7 See, for example, A.H. Oosterhoff, Robert Chambers and Mitchell McInnes, Oosterhoff on Trusts: Text, Commentary and Materials, 8th ed. (Toronto: Carswell, 2014), at p. 1128, note 2, and p. 1132, note 23.

8 In Commercial Union Life Assurance Co. of Canada v. John Ingle Insurance Group Inc. (2002), 61 O.R. (3d) 296, [2002] O.J. No. 3200 (C.A.), Weiler J.A. suggested, in obiter, that a constructive trust is not sufficient for knowing assistance. In Transamerica Occidental Life Insurance Co. v. Toronto Dominion Bank (1999), 44 O.R. (3d) 97, [1999] O.J. No. 1195 (C.A.), however, this court specifically sent the issue of whether "TD can, in law, assist in the breach of a constructive trust on the basis of actions that took place before the constructive trust was declared to exist" to trial. The decision in Transamerica Occidental was a summary judgment motion so the court could have decided that a constructive trust is not sufficient for knowing assistance. In my view, there is no principled basis why, in appropriate circumstances, the doctrine of knowing assistance cannot be extended to cases of breach of constructive trust. See, also, Oosterhoff, supra note 7.

9 In this context, "dishonest and fraudulent conduct [signifies] a level of misconduct or impropriety that is morally reprehensible but does not necessarily amount to criminal behaviour": Enbridge Gas v. Marinaccio, [2012] O.J. No. 4558, 2012 ONCA 650, 355 D.L.R. (4th) 333 (C.A.), at para. 27.

10 Under the Business Corporations Act, R.S.O. 1990, c. B.16, s. 92, an undischarged bankrupt cannot be a director of a corporation: s. 118(1).

11 This trial proceeded as a hybrid trial, as is now common in civil actions. As such, there were trial management conferences regarding procedure and evidence and much of the evidence-in-chief was adduced by affidavit. Cross-examinations then ensued, followed by evidence given in reply.

End of Document

TAB 8

Court of Queen's Bench of Alberta

Citation: Carevest Capital Inc. v. 1262459 Alberta Ltd., 2011 ABQB 148

Date: 20110307
Docket: 1003 01050
Registry: Edmonton

Between:

Carevest Captial Inc.

Plaintiff

- and -

1262459 Alberta Ltd., 1281388 Alberta Ltd., 1256462 Alberta Ltd., Jagjit Dhami, Baljinder Dhot, Aqbal Gill and Ravinder Khandal

Defendants

Reasons for Decision
of
L. A. Smart, Master in Chambers

Background

[1] 126245 Alberta Ltd. ("126") is a property development company that was carrying on business in the County of Leduc ("the County"). On April 17, 2007, the County issued conditional subdivision approval to 126 for development of lands within the County. 126 obtained a mortgage loan from CareVest Capital Inc. ("CareVest"), secured in part by land mortgages, and a General Security Agreement over all present and after acquired personal property ("the GSA"). On December 19, 2007, the County and 126 entered into a development agreement ("the Development Agreement"). Schedule "E" of the Development Agreement set out 126's responsibilities regarding the levies payable to the County, which were subject to future adjustments based on the anticipated passage of a new proposed off-site levy bylaw (the

"Off-site Levy Bylaw"). On April 15, 2008, Mr. Thind, counsel for 126, received an advance of $801,350.00 (the "First Advance") from CareVest, with the following condition:

> These funds are forwarded to you on the trust condition that you immediately pay the balance of the Leduc County Offsite Levy to the Leduc County in the amount of $801,350.00 and thereafter provide our office with proof of payment that the entire Offsite Levy has been paid in full.

[2] Two other advances were also made, on June 27, 2008 and August 19, 2008, which brought the total sum of the advances to $3,341,902.40. Both of these advances were made with the following condition:

> These funds are forwarded to you on the trust condition that you immediately provide our office with confirmation that the Leduc Country [sic] Offsite Levy has been paid in full.

[3] On April 15, 2008, the same date as the First Advance, Mr. Thind sent two cheques to the County for an amount totaling $900,433.12 (one cheque was for $801,350.00, and the other for $99,083.12). Before the cheques were cashed, 126 applied for a reduced levy rate under the Off-site Levy Bylaw. As a result, the County did not immediately deposit those cheques. The County eventually rejected 126's reduced rate request, and proceeded to review the calculation of the levies. At some point in this process, the cheques became stale-dated.

[4] On December 31, 2008, the County advised 126 that the amount owing for the levies was $1,089,932.80 rather than $900,433.12. Shortly thereafter, 126 wrote back to the County and identified an error in the County's calculations. The County reviewed the calculations, and replied on January 12, 2009 that the correct amount was $900,309.26.

[5] Mr. Thind e-mailed the County several times between November 13, 2008 and March 6, 2009 reminding the County that the cheques were stale-dated and uncashed, and that the County could request replacement cheques. Mr. Thind did not receive a response until October 9, 2009, at which point the County requested new cheques. 126 instructed Mr. Thind to refrain from sending new cheques. The funds remained in Mr. Thind's trust account, until they were deposited into Court pursuant to a consent order granted by Master Laycock on January 13, 2010. Entitlement to the approximately $900,000 deposit (the "Subject Funds") is the issue in the current dispute. The County claims that it has entitlement to the Subject Funds by virtue of a *Quistclose* trust. CareVest claims entitlement on the basis of a security interest in the assets of 126 under its GSA, or alternatively, if a *Quistclose* trust exists, it is the rightful "beneficiary".

Positions of the Parties

The County

[6] The County takes the position that the Subject Funds were impressed with a *Quistclose* trust. CareVest advanced the funds specifically for the purpose of paying the off-site levies. That purpose still remains capable of being carried out, as the levies remain unpaid and outstanding. Additionally, the formal requirements of a trust were met, as there was certainty of intention, subject-matter and object. Since the County is the beneficial owner of the Subject Funds, the *Personal Property Security Act* ("*PPSA*") does not apply and the funds should be awarded to the County.

CareVest

[7] CareVest takes the position that a *Quistclose* trust was not created, or alternatively, that as the lender, CareVest is the beneficial owner of the Subject Funds. In support of its first argument, CareVest submits that the trust conditions do not expressly or impliedly state that the monies were to be used exclusively to pay the off-site levies. The total amount of all three advances was $3,341,902.40, a substantially larger amount than the off-site levies. Therefore, clearly not all of these funds were intended to be paid to the County. Additionally, there is no evidence showing a distinction between the funds held by Mr. Thind for the payment of the off-site levies, and the funds held by Mr. Thind for the benefit of 126. CareVest also argues that the requirement for the certainty of subject-matter is absent in this instance, as the final amount of the off-site levies was not determined until January 12, 2009. Since the requirements of a trust relationship are not present, the relationship is actually one of debtor-creditor, to which the *PPSA* applies.

[8] In the alternative, CareVest submits that if a *Quistclose* trust has been created, then it should nonetheless receive the Subject Funds. The primary purpose of the trust, which was to pay the off-site levies immediately, failed when the County did not cash the original trust cheques. The original mandate of the trust, which was to help 126 complete the development, would have been frustrated when 126 defaulted under the loan. If a *Quistclose* trust existed, CareVest would be entitled to a return of the Subject Funds as the beneficial owner of those funds.

Law

[9] In ***Barclays Bank Ltd. v. Quistclose Investments Ltd.***, [1970] A.C. 567; [1968] 3 All E.R. 651; [1958] 3 W.L.R. 1097 (H.L.) Rolls Razor Ltd. borrowed money from Quistclose Investments for the specific purpose of paying a declared dividend. However, before the dividend was paid, Rolls Razor entered voluntary liquidation. Barclay's Bank applied the money earmarked for the dividend account against Rolls Razor's outstanding loan. Quistclose sued for a return of its funds on the basis that they had been impressed with a trust.

[10] The Lord Wilberforce stated, at page 579:

> Two questions arise, both of which must be answered favourably to the respondents if they are to recover the money from the bank. The first is whether

> as between the respondents and Rolls Razor Limited, the terms upon which the loan was made were such as to impress upon the sum of £209,719 8s. 6d. a trust in their favour in the event of the dividend not being paid. The second is whether, in that event, the bank had such notice of the trust or of the circumstances giving rise to it as to make the trust binding upon them.

[11] The House of Lords found that both of these conditions had been met. The "mutual intention" of the parties was that the money should be used exclusively for the payment of the dividend. Barclay's Bank also had sufficient notice, by way of a letter from Rolls Razor to the bank. Therefore, the arrangement gave rise to a "primary trust", the terms of which required the money to be paid out as a dividend. Where the primary trust failed, as in this instance, the "secondary purpose" of the trust operated to return the dividend monies to the lender, Quistclose. If the dividend monies had been distributed, thereby fulfilling the primary purpose of the trust, then Quistclose would only have had a remedy against Rolls Razor through a debt action. This case is the origin of the term *Quistclose* trust, although the principles underlying the trust can be traced back to much older cases: ***Tooley v. Milne*** (1819) 2 B. & A. 683, ***Edwards v. Glynn*** (1859) 2 E. & E. 29.

[12] In ***Ling v. Chinavision Canada Corp.*** (1992), 10 O.R. (3d) 79 (Ont. Gen. Div.) the plaintiff ("Ling") advanced $500,000.00 loan to the defendant corporation ("Chinavision"). The loan agreement contained a term that, in the event of a default, Ling could convert his debt to shares of Chinavision. The loan was guaranteed by Mr. Francis Cheung ("Cheung"), who was also a co-defendant in this matter. Both Cheung and Chinavision became insolvent, and Chinavision defaulted on the loan. Ling attempted to convert his debt into shares of Chinavision.

[13] A third party, North America Television Production Corporation ("North America T.V."), advanced funds to Chinavision and Cheung for the purpose of paying off the loan. Ling refused to accept the loan repayment because he was concerned that the funds would be "attacked by creditors of Mr. Cheung." Chinavision then applied for summary judgment, seeking a declaration that Ling was obliged to accept the repayment. The Court found that the "principle contained in the *Quistclose* trust case has been recognized consistently in this jurisdiction." He concluded that the funds tendered by North America T.V. were "for the sole purpose of paying the indebtedness of [Cheung]" and therefore did not become part of the estate of either of the defendants. Ling must accept the repayment.

[14] In ***Del Grande v. McCleery*** (1998), 40 B.L.R. (2d) 202; 24 E.T.R. (2d) 30 (Ont. Ct. J. (Gen. Div.)), aff'd (2000) 127 O.A.C. 394 (C.A.) after reviewing ***Barclays Bank Ltd. v. Quistclose Investments Ltd.***, the Court restated the criteria for finding a *Quistclose* trust at p. 206:

1. Whether the terms of the loan were such as to impress upon the loan sum a trust in favour of the lender if the specific purpose of the loan was not achieved or fulfilled;

2. Whether the party receiving the loan proceeds had notice of the trust or of the circumstances giving rise to the trust so as to bind such a party.

[15] In ***Twinsectra Ltd. v. Yardley***, [2002] UKHL 12; [2002] 2 A.C. 164; [2002] 2 W.L.R. 802 a purchaser ("Yardley") sought financing to purchase property. He obtained financing from Twinsectra Ltd. ("Twinsectra"), on the condition that the loan money will be "utilized solely for the acquisition of property". The money was released to the client account of Yardley's solicitor ("Sims"). Yardley assured Sims that the money would be used to fund the acquisition of property, and was therefore disbursed to another of Yardley's solicitors ("Leach"). Leach was unaware of the previous undertaking, and the money was subsequently used for purposes other than the acquisition of property. Yardley went bankrupt, and Twinsectra commenced proceedings against all parties involved in the transaction.

[16] The House of Lords found that the parties had created a *Quistclose* trust. Lord Millet discussed the nature of the *Quistclose* trust. He considered where the beneficial interest of the trust was located and rejected Lord Wilberforce's characterization of there being two trusts, a primary trust and a secondary trust. Instead, Lord Millet determined that there are four theoretical possibilities for the location of the beneficial interest in a *Quistclose* trust: (i) the lender, (ii) the borrower, (iii) the contemplated beneficiary, (iv) in suspense. After examining all the possibilities, Lord Millet concluded that the beneficial interest remains with the lender. When a *Quistclose* trust is established, the lender "does not part with the entire beneficial interest in the money, and in so far as he does not it is held on a resulting trust for the lender from the outset."

[17] ***Re Cliffs Over Maple Bay Investments Ltd.***, 2010 BCSC 389, a real estate company, The Cliffs Over Maple Bay Investments Ltd. (The "Cliffs"), commenced proceedings under the *Companies' Creditors Arrangement Act* in May, 2008. Pursuant to those proceedings, the Court issued a debtor in possession order (the "DIP Order"), which authorized The Cliffs to borrow funds from Century Services Inc. The DIP Order provided that the terms and conditions of the loan were to be subject to a commitment letter dated June 13, 2008. The DIP Order also imposed certain conditions on the use of the DIP funds. The Cliffs borrowed $500,000.00 from Century, which was deposited into the trust account of The Cliff's solicitors, Lawson Lundell LLP. The Cliffs made expenditures pursuant to the terms of the DIP Order. However, pursuant to an appeal to the British Columbia Court of Appeal, the DIP Order was set aside on August 15, 2008 (***Cliffs Over Maple Bay Investments Ltd. v. Fisgard Capital Corp.***, 2008 BCCA 327). At that point, $162,276.33 of the loan ("the Funds") remained in the trust account. The setting aside of the DIP Order left no way for expenditures to be made from the Funds.

[18] This case concerned entitlement to the Funds. Three parties claimed exclusive entitlement: Century argued that it retained both legal and equitable ownership of the Funds pursuant to a *Quistclose* trust; Fisgard Capital Corp. and Liberty Excell Holdings Ltd. ("Fisgard"), the secured creditors to The Cliffs, claimed that they had priority and ownership of the Funds; and Lawson Lundell claimed that it had a solictor's lien over the Funds. The Court ultimately concluded that Century was entitled to the Funds, as they had been impressed with a *Quistclose* trust.

[19] At para. 78, the Court stated that:

> Where funds have been released by a lender to a borrower's solicitor with trust conditions governing their use, they do not become the property of the borrower until the trust conditions are satisfied. If the trust conditions are not satisfied, unspent funds must be returned to the lender.

[20] Since the trust condition "has not and now never will be satisfied", the Court concluded at para. 89 that The Cliffs never had possession or control over the Funds. This finding defeated both the claims of Fisgard and Lawson Lundell.

Analysis

A.) Were the terms of the loan capable of impressing the funds with a *Quistclose* trust?

[21] The first issue before the Court is whether a valid *Quistclose* trust was created. The terms of the loan must have been capable of impressing the funds with a trust in favour of the lender. The three certainties of a trust must still be present to create a *Quistclose* trust and ascertainable on an objective basis. The party who seeks to apply the trust bears the onus of proving its existence on a balance of probabilities.

i.) Certainty of Intention

[22] The County submits that, in this case, the terms of the advance were sufficiently clear to impress the Subject Funds with a *Quistclose* trust. The fax accompanying the First Advance by CareVest was on the trust condition that 126 "immediately pay the balance of the Leduc County Offiste Levy to the Leduc County in the amount of $801,350.00." This first condition was clear the trust property was to be used for no other purpose than for payment of the offsite levy. Subsequent advances were made on the trust condition that required 126 to provide proof that the levies had been paid in full. If a *Quistclose* trust was created, there must have been the mutual intention to create a trust where the beneficial interest remained with the lender, CareVest. Here, there is insufficient evidence to establish a mutual intention that the subsequent advances were to be restricted solely for the purpose of paying the Offsite Levies. The mutual intention to create a *Quistclose* trust was not present for the subsequent advances so the claim that the funds were impressed with a *Quistclose* trust must fail for those advances. Arguably the *Quistclose* trust could exist for the First Advance although the subsequent co-mingling of funds arguably puts that in question.

ii.) Certainty of Subject Matter

[23] CareVest argues that the certainty of subject-matter is not present in the circumstances of the case because the exact amount of the off-site levies had not been finally determined until well after the advance was made. However, whether the First Advance represented all or a

portion of the off-site levies is irrelevant to whether they are considered to be held in trust. To establish the certainty of subject-matter, the trust property has to be clearly identifiable.

[24] The County has not argued that the second and third advances were impressed with a *Quistclose* trust. Therefore, if a *Quistclose* trust is to be found, the subject-matter of the trust is limited to the First Advance, and $801,350.00 of the Subject Funds is all that could be considered trust property. The remainder of the funds advanced would be the property of 126, and are subject to the claim of CareVest under its GSA.

*iii.) Certainty of Object*s

[25] The object of the trust is easily ascertainable in this case. Assuming that a trust had been created, the funds were to be forwarded to the County for payment of the off-site levies. In its reply brief, CareVest did not dispute the certainty of objects.

B.) Notice requirement

[26] It is the intended recipient of the funds, the County, rather than the lender, CareVest, who is seeking to apply a *Quistclose* trust. The policy rationale behind the notification requirement is to provide certainty to the party receiving the funds. In other words, the notice requirement exists for the protection of the recipients of the trust funds, who are entitled to know if funds must be returned to the lender when they are not applied towards a specific purpose. The notice requirement has no application to these circumstances.

C.) If a trust has attached to the First Advance, then which party is the rightful beneficiary of the trust?

[27] Prior to 2002, there had been some debate regarding the location of the beneficial interest in a *Quistclose* trust. In ***Twinsectra v. Yardley,*** Lord Millet directly answered this debate. He rejected the notion that there was a primary trust and a secondary trust, and concluded that the beneficial interest of a *Quistclose* trust remains with the lender until the primary purpose of the trust is achieved.

> The lender pays the money to the borrower by way of loan, but he does not part with the entire beneficial interest in the money, and in so far as he does not it is held on a resulting trust for the lender from the outset. Contrary to the opinion of the Court of Appeal, it is the borrower who has a very limited use of the money, being obliged to apply it for the stated purpose or return it. He has no beneficial interest in the money, which remains throughout in the lender subject only to the borrower's power or duty to apply the money in accordance with the lender's instructions. When the purpose fails, the money is returnable to the lender, not under some new trust in his favour which only comes into being on the failure of the purpose, but because the resulting trust in his favour is no longer subject to any power on the part of the borrower to make use of the money.

> Whether the borrower is obliged to apply the money for the stated purpose or merely at liberty to do so, and whether the lender can countermand the borrower's mandate while it is still capable of being carried out, must depend on the circumstances of the particular case.

[28] As noted above the Ontario Court of Justice (affirmed by the Court of Appeal) restated the criteria for finding a Quistclose trust in part as follows:

> "Whether the terms of the loan were such as to impress upon the loan sum a trust in favor of the lender **if the specific purpose of the loan was not achieved or fulfilled**;" (emphasis added).

[29] The County argues that the cheques forwarded to them support the intention of Carevest and 126 to use the funds for payment to the County for off-site levies. Although the cheques were allowed to staledate the purpose of the trust is still capable of being carried out, that is, it is not impossible to carry out.

[30] I agree with the County, the funds when advanced did not become the property of the Developer (126) but equally they did not become the property of the County. 126 is not proceeding to complete the development and will not instruct Mr. Thind to send new cheques to the County for the levies. In my view the purpose of the loan was not achieved or fulfilled and in these circumstances can be said to be impossible to carry out.

Conclusion

[31] In a *Quistclose trust* the beneficial interest remains with the lender until the purpose of the trust is carried out. Therefore in the circumstances, Carevest is entitled to the Subject Funds. Failing the existence of the *Quistclose trust* it is not disputed that Carevest would have priority to the Subject Fund pursuant to its security, particularly the GSA. In either case Mr. Thind and 126 must return the funds to Carevest. Accordingly, the Clerk shall release the funds held pursuant to the Order of Master Laycock including any interest accrued thereon to Carevest. Carevest shall have their costs.

Heard on the 29th day of June, 2010.

Dated at Edmonton, Alberta this 7th day of March, 2011.

L. A. Smart
M.C.C.Q.B.A.

Appearances:

David Madsen
Borden Ladner Gervais LLP
for the Plaintiff

Emmanuel Alade
City Law Office - Fort Saskatchewan
for the Defendant

Daniel Peskett
Brownlee LLP
for theCounty of Leduc

TAB 9

Citadel General Assurance Co. v. Lloyds Bank Canada

Supreme Court Reports

Supreme Court of Canada

Present: La Forest, Sopinka, Gonthier, Cory, McLachlin, Iacobucci and Major JJ.

1997: May 20 / 1997: October 30.

File No.: 25189.

[1997] 3 S.C.R. 805 | [1997] 3 R.C.S. 805 | [1997] S.C.J. No. 92 | [1997] A.C.S. no 92

The Citadel General Assurance Company and the Citadel Life Assurance Company, appellants; v. Lloyds Bank Canada and Hongkong Bank of Canada, respondents.

ON APPEAL FROM THE COURT OF APPEAL FOR ALBERTA

Case Summary

Trusts and trustees — Breach of trust — Liability of strangers to trust — Knowing assistance — Knowing receipt — Insurance agent depositing premiums collected on insurer's behalf into bank account — Bank transferring funds to account of insurance agent's parent company to reduce overdraft — Whether bank liable for breach of trust on basis of knowing assistance or knowing receipt.

D sold insurance to auto dealers. After collecting the premiums, D paid commissions and settled any current claims under the policies. The balance of the premiums was remitted on a monthly basis to the appellant insurance companies, the underwriters of the policies. In December 1986, D and its parent company started banking with the respondents (the "bank"). D used one bank account for all its transactions. Through its senior officers, the bank was aware that insurance premiums were being deposited into that account. In May 1987, a "trip report" by one of the appellants' employees indicated that D was reluctant to establish a trust account for the premiums but would do so if necessary. From June 1, D no longer settled claims under the insurance policies, with the result that the monthly premiums payable to the appellants increased significantly. In June the bank received instructions from the parent company's signing officers, who were identical to D's signing officers, to transfer all funds in D's account to the parent company's account at the end of each business day. In July and August, the transfer of funds between the accounts resulted in an overall reduction in the parent company's overdraft. In late August D advised the appellants that the July and August premiums could not be remitted. It agreed to pay these outstanding receipts by way of promissory note. After D and its parent company ceased carrying on business, the appellants brought an action against the bank for the outstanding insurance premiums. They were successful at trial and judgment was entered against the bank. The Court of Appeal allowed the bank's appeal and dismissed the appellants' claim.

Held: The appeal should be allowed.

Per La Forest, Gonthier, Cory, McLachlin, Iacobucci and Major JJ.: The relationship between the appellant insurers and D was clearly one of trust. Under s. 124(1) of the Alberta Insurance Act, an agent who receives any money as a premium for an insurance contract from the insured is deemed to hold the premium in trust for the insurer. The promissory note was merely confirmation of the amount owed by D to the appellants and did not amount to a revocation of the trust. As well, the arrangement between them meets the three characteristics of a trust, namely certainty of intent, certainty of subject-matter, and certainty of object. The fact that the trust funds in D's account were commingled with other funds does not undermine the relationship of trust between the parties. Also, D's actions in failing to remit to the appellants the insurance premiums collected on their behalf in July and August 1987 were clearly in breach of trust. Moreover, the appellants did not acquiesce in the breach of trust by asking for and receiving the promissory note from D.

There are three ways in which a stranger to a trust can be held liable as a constructive trustee for breach of trust: as a trustee de son tort; for "knowing assistance"; and for "knowing receipt". The first type of liability is inapplicable to the present case since the bank never assumed the office or function of trustee. A stranger to a trust can be liable for breach of trust by knowingly assisting in a fraudulent and dishonest design on the part of the trustees. Assuming the present case falls under this "knowing assistance" category, it is clear that only actual knowledge, recklessness, or wilful blindness will render the bank liable for participating in the breach of trust. Since the bank had only constructive knowledge, it cannot be liable under the "knowing assistance" category of constructive trusteeship.

Liability on the basis of "knowing receipt" requires that strangers to the trust receive or apply trust property for their own use and benefit. By applying the deposit of insurance premiums as a set-off against the parent company's overdraft, the bank received a benefit and thus received the trust funds for its own use and benefit. The bank cannot avoid the "property" issue by characterizing the deposit of trust monies in D's account as a debt obligation. A debt obligation is a chose in action and, therefore, property over which one can impose a trust. The receipt requirement in "knowing receipt" cases is best characterized in restitutionary terms. In this case the bank has been enriched at the appellants' expense and thus, in restitutionary terms, there can be no doubt that the bank received trust property for its own use and benefit.

The second requirement for establishing liability on the basis of "knowing receipt" relates to the degree of knowledge required of the bank in relation to the breach of trust. While constructive knowledge is excluded as the basis for liability in "knowing assistance" cases, in "knowing receipt" cases, which are concerned with the receipt of trust property for one's own benefit, there should be a lower threshold of knowledge required of the stranger to the trust. More is expected of the recipient, who, unlike the accessory, is necessarily enriched at the plaintiff's expense. Because the recipient is held to this higher standard, constructive knowledge (that is, knowledge of facts sufficient to put a reasonable person on notice or inquiry) will suffice as the basis for restitutionary liability. This lower threshold of knowledge is sufficient to establish the "unjust" or "unjustified" nature of the recipient's enrichment, thereby entitling the plaintiff to a restitutionary remedy. More specifically, relief will be granted where a stranger to the trust, having received trust property for his or her own benefit and having knowledge of facts which would put a reasonable person on inquiry, actually fails to inquire as to the possible misapplication of trust property.

On the issue of knowledge, it is clear from the trial judge's findings that the bank was aware of the nature of the funds being deposited into, and transferred out of, D's account. The bank knew that D's sole source of revenue was the sale of insurance policies and that premiums collected by D were payable to the appellants. In light of the bank's knowledge of the nature of the funds, the daily emptying of D's account was in the trial judge's view "very suspicious". In these circumstances, a reasonable person would have been put on inquiry as to the possible misapplication of the trust funds. The bank should have inquired whether the use of the premiums to reduce the account overdrafts constituted a breach of trust. By failing to make the appropriate inquiries, the bank had constructive knowledge of D's breach of trust. The bank's enrichment was thus clearly unjust, rendering it liable to the appellants as a constructive trustee.

Per Sopinka J.: Subject to what was said in Gold, issued concurrently, La Forest J.'s reasons were agreed with.

Cases Cited

By La Forest J.

Referred to: Air Canada v. M & L Travel Ltd., [1993] 3 S.C.R. 787; Gold v. Rosenberg, [1997] 3 S.C.R. 767; Canadian Pacific Air Lines, Ltd. v. Canadian Imperial Bank of Commerce (1987), 61 O.R. (2d) 233; R. v. Lowden (1981), 27 A.R. 91; Bank of N.S. v. Soc. Gen. (Can.), [1988] 4 W.W.R. 232; Fletcher v. Collis, [1905] 2 Ch. 24; Selangor United Rubber Estates, Ltd. v. Cradock (No. 3), [1968] 2 All E.R. 1073; Agip (Africa) Ltd. v. Jackson, [1990] 1 Ch. 265, aff'd [1992] 4 All E.R. 451; Foley v. Hill (1848), [1843-60] All E.R. Rep. 16; Fonthill Lumber Ltd. v. Bank of Montreal (1959), 19 D.L.R. (2d) 618; Lipkin Gorman v. Karpnale Ltd., [1991] 3 W.L.R. 10; Lac Minerals Ltd. v. International Corona Resources Ltd., [1989] 2 S.C.R. 574; Air Canada v. British Columbia, [1989] 1 S.C.R. 1161;

In re Montagu's Settlement Trusts, [1987] 1 Ch. 264; Polly Peck International plc v. Nadir (No. 2), [1992] 4 All E.R. 769; C.I.B.C. v. Valley Credit Union Ltd., [1990] 1 W.W.R. 736; Bullock v. Key Property Management Inc. (1997), 33 O.R. (3d) 1; Groves-Raffin Construction Ltd. v. Bank of Nova Scotia (1975), 64 D.L.R. (3d) 78; Carl B. Potter Ltd. v. Mercantile Bank of Canada, [1980] 2 S.C.R. 343; Arthur Andersen Inc. v. Toronto-Dominion Bank (1994), 17 O.R. (3d) 363, leave to appeal refused, [1994] 3 S.C.R. v; Glenko Enterprises Ltd. v. Ernie Keller Contractors Ltd. (1996), 134 D.L.R. (4th) 161; Cowan de Groot Properties Ltd. v. Eagle Trust plc, [1992] 4 All E.R. 700; El Ajou v. Dollar Land Holdings plc, [1993] 3 All E.R. 717; Royal Brunei Airlines Sdn. Bhd. v. Tan, [1995] 3 W.L.R. 64.

By Sopinka J.

Referred to: Gold v. Rosenberg, [1997] 3 S.C.R. 767.

Statutes and Regulations Cited

Bank Act, R.S.C., 1985, c. B-1 [now repealed], s. 206(1). Insurance Act, R.S.A. 1980, c. I-5, s. 124(1).

Authors Cited

Birks, Peter. "Misdirected Funds: Restitution from the Recipient", [1989] L.M.C.L.Q. 296. Birks, Peter. "Overview: Tracing, Claiming and Defences". In Peter Birks, ed., Laundering and Tracing. Oxford: Clarendon Press, 1995, 289. Gardner, Simon. "Knowing Assistance and Knowing Receipt: Taking Stock" (1996), 112 L.Q.R. 56. Halsbury's Laws of England, vol. 48, 4th ed. London: Butterworths, 1995 (reissue). Harpum, Charles. "The Stranger as Constructive Trustee" (1986), 102 L.Q.R. 114. Millett, Sir Peter. "Tracing the Proceeds of Fraud" (1991), 107 L.Q.R. 71. Pettit, Philip H. Equity and the Law of Trusts, 7th ed. London: Butterworths, 1993. Underhill and Hayton, Law Relating to Trusts and Trustees, 14th ed. By David J. Hayton. London: Butterworths, 1987.

APPEAL from a judgment of the Alberta Court of Appeal (1996), 181 A.R. 76, 116 W.A.C. 76, 37 Alta. L.R. (3d) 293, [1996] 5 W.W.R. 9, 33 C.C.L.I. (2d) 241, [1996] A.J. No. 59 (QL), reversing a judgment of the Court of Queen's Bench, [1993] A.J. No. 680 (QL), imposing a constructive trust on the defendant banks. Appeal allowed.
Eric F. Macklin, Q.C., and W. Scott Schlosser, for the appellants. Donald R. Cranston and Stacy M. Neufeld, for the respondents.

Solicitors for the appellants: Duncan & Craig, Edmonton. Solicitors for the respondents: Cruickshank Karvellas, Edmonton.

The judgment of La Forest, Gonthier, Cory, McLachlin, Iacobucci and Major JJ. was delivered by

LA FOREST J.

1 This appeal concerns the liability of a bank for its customer's breach of trust. The appellants, as beneficiaries of the trust, seek recovery for unpaid insurance premiums collected by the trustee and deposited with the respondent banks. The principal question in this appeal is this: Are the respondent banks liable as constructive trustees for the breach of trust committed by one of their clients? This question deals with the liability of strangers who participate in a breach of trust and, in particular, the degree of knowledge required for the imposition of liability as a constructive trustee.

I. Factual Background

2 The Citadel General Assurance Company and the Citadel Life Assurance Company ("Citadel") are insurance companies which carried on business in Alberta. Beginning in 1979, Citadel's business operations involved another Alberta corporation, Drive On Guaranteed Vehicle Payment Plan (1982) Limited ("Drive On"). As a wholly owned subsidiary of International Warranty Company Limited ("International Warranty"), Drive On sold consumer life, casualty, and unemployment insurance to auto dealers. The insurance premiums were collected by auto dealers at

the time vehicles were sold and then remitted to Drive On. After collecting the premiums, Drive On paid commissions and settled any current claims under the policies. The balance of the premiums was remitted on a monthly basis to Citadel, the underwriter of the insurance policies. In early 1987, the premiums received during a calendar month were normally forwarded to Citadel at the end of the following month. This arrangement continued satisfactorily until August 1987 when Drive On defaulted on its payments to Citadel. As well, from 1979 until late August 1987, there was no written agreement between Citadel and Drive On.

3 In December 1986, the International Warranty Group of Companies, including Drive On and International Warranty, started banking with the now-amalgamated Lloyds Bank Canada and Hongkong Bank of Canada (hereinafter collectively called "the Bank"). During 1987, the only banker of Drive On was the Bank. Drive On used one bank account for all its transactions. The only deposits to that account were either insurance premiums collected from auto dealers or transfers of funds from International Warranty. Through its senior officers, the Bank was aware that insurance premiums were being deposited into Drive On's account. During the period after April 1, 1987, Drive On's account was usually in an overdraft position. On April 8, the Bank received instructions from International Warranty's signing officers (who were identical to Drive On's signing officers) to transfer funds between the International Warranty and Drive On accounts to cover overdrafts on either account.

4 Also in April 1987, the Presidents of Drive On and Citadel met to discuss their business relationship. As a result of the meeting, Citadel and Drive On agreed that a written agreement would be prepared to formalize their business relationship. It was also agreed that Drive On would no longer settle claims under the insurance policies. From June 1, 1987, Citadel assumed the adjudication and payment of all claims. As a result, the monthly premiums payable to Citadel were increased significantly. Also as a result of the presidents' meeting, Citadel ordered a detailed examination of Drive On's current procedures. A "trip report" was delivered by one of Citadel's employees on May 14. The report found that Drive On was depositing insurance premiums in a general bank account which was not set up as a trust account. The report also indicated that Drive On was somewhat reluctant to establish a trust account but would do so if necessary.

5 On June 5, 1987, the Bank received instructions from International Warranty's signing officers to transfer all funds in the Drive On account to the International Warranty account at the end of each business day. In July and August, the transfer of funds between the International Warranty and Drive On accounts resulted in an overall reduction in International Warranty's overdraft.

6 On August 7, 1987, Drive On forwarded the June premiums to Citadel. In late August, Citadel first learned of Drive On's financial difficulties. The President of Drive On advised Citadel that the July and August premiums could not be remitted. A new arrangement, effective September 1, was set in place whereby all premium monies would be forwarded directly to Citadel. With regard to the outstanding July and August receipts, Drive On agreed to pay Citadel by way of promissory note dated September 21, 1987. The note provided for monthly payments of $100,000. Drive On made a number of payments until it, and the other members of the International Warranty Group of Companies, ceased carrying on business in December. Citadel sued Drive On and the guarantor on the promissory note but has been unsuccessful in collecting anything. The parties agree that the outstanding amount payable to Citadel is $633,622.84.

7 Citadel brought an action against the Bank for the outstanding insurance premiums. At trial, Citadel was successful and judgment was entered against the Bank for $633,622.84: [1993] A.J. No. 680 (QL). The Court of Appeal allowed the Bank's appeal and dismissed Citadel's claim: (1996), 181 A.R. 76, 116 W.A.C. 76, 37 Alta. L.R. (3d) 293, [1996] 5 W.W.R. 9, 33 C.C.L.I. (2d) 241, [1996] A.J. No. 59 (QL).

II. Decisions Below

A. Court of Queen's Bench of Alberta

8 The trial judge, Marshall J., found that a relationship of trust existed between Citadel and Drive On. This finding was based in part on s. 124(1) of the Insurance Act, R.S.A. 1980, c. I-5, which provides that an agent or broker who negotiates a contract of insurance with an insurer and receives insurance premiums for that contract is deemed to

hold the premiums in trust for the insurer. As well, the trial judge found that the arrangement between Citadel and Drive On had the three certainties of a trust, namely, certainty of subject-matter, certainty of intent, and certainty of object. Further, the trial judge held that a breach of trust occurred when Drive On failed to remit the insurance premiums collected on Citadel's behalf.

9 The trial judge stated that in order for the Bank to be liable as a stranger to the trust, the Bank must have had knowledge that the funds were trust monies or the circumstances must have required it to inquire before dealing with the money. In scrutinizing the evidence, the trial judge found that Drive On's instructions to empty its account daily were "very suspicious" (para. 26), given the Bank's knowledge that insurance premiums were being deposited in the account. As well, the trial judge concluded that the Bank, having received a benefit from Drive On's breach of trust, was under a greater duty to explain its actions. Liability was imposed on the following basis (at para. 33):

> The Bank had actual knowledge of the nature of the funds in the Drive On account and had an obligation to inquire about their position in the circumstances. The Bank shut its eyes in circumstances which should have caused it to inquire of its customer at least. It did not do so. The Bank had constructive knowledge and is a constructive trustee within the cases . . . .

The plaintiffs received judgment for $633,622.84.

B. Alberta Court of Appeal (1996), 181 A.R. 76

10 On appeal to the Alberta Court of Appeal, Kerans J.A., speaking for the court, began by noting, at p. 77, that there was "no serious difficulty with the finding of creation of the trust made by the trial judge". As such, Kerans J.A. was willing to assume that a trust existed between Citadel and Drive On and that a breach of trust occurred.

11 In Kerans J.A.'s view, the real difficulty with the case was the imposition of liability on the Bank. More specifically, he disagreed with the trial judge's conclusion that constructive knowledge was sufficient to render the Bank liable as a constructive trustee. Relying on this Court's decision in Air Canada v. M & L Travel Ltd., [1993] 3 S.C.R. 787, Kerans J.A. concluded that only actual knowledge, recklessness, or wilful blindness could render the Bank liable for a breach of trust from which it received a benefit. This test was not met in the present case because, although the Bank had "shut its eyes" in the circumstances, the trial judge refused to find that the Bank was actually aware it was taking money in breach of trust. However, since Air Canada v. M & L Travel Ltd. was decided after the trial judge rendered judgment in the present case, the parties were invited to re-argue the facts before the Court of Appeal. Nonetheless, even after reconsidering the facts, Kerans J.A. concluded for the court at p. 78:

> . . . we have come to the conclusion that we cannot say on the balance of probabilities that this bank, when it honoured the direction to pay, was aware that it was moving out money in breach of any trust between the defaulting company and the insurance company. We do not have any difficulty with the trial finding that the bank had some warning that this was the case. But that is not enough. Nor do we think this is an appropriate case in which to rely on wilful blindness.

The Court of Appeal accordingly allowed the Bank's appeal and dismissed the claim.

III. Issues

12 As mentioned, one main question is raised on this appeal: Under what circumstances can the respondent banks be held liable as constructive trustees for the breach of trust committed by one of their customers?

IV. Analysis

A. The Nature of the Relationship between Citadel and Drive On

13 Before beginning my analysis regarding the liability of the Bank as a constructive trustee, I note that I have read the reasons of Iacobucci J. in Gold v. Rosenberg, [1997] 3 S.C.R. 767, a case also dealing with the liability of a bank for a breach of trust committed by one of its customers. I generally agree with Iacobucci J.'s approach in Gold and, indeed, consider it similar to my own in the present appeal.

14 There can be no doubt that the relationship between Citadel and Drive On was one of trust. In this Court, the parties did not dispute the existence of a trust relationship. Relevant to the arrangement between Citadel and Drive On is s. 124(1) of the Insurance Act, which provides:

> 124(1) An agent or broker who acts in negotiating, renewing or continuing a contract of insurance with an insurer licensed under this Act, and who receives any money or substitute for money as a premium for such a contract from the insured, shall be deemed to hold the premium in trust for the insurer.

From 1979 to 1987, Drive On, the insurance agent, was in the business of selling insurance policies underwritten by Citadel, the insurer. In negotiating insurance policies on Citadel's behalf, Drive On collected insurance premiums from auto dealers, paid commissions, and settled current claims under the policies. However, on June 1, 1987, the arrangement was changed and the premiums collected by Drive On were to be forwarded without deductions for policy claims. However, even when Citadel assumed the adjudication of all claims, Drive On still acted as agent or trustee and Citadel remained the principal or beneficiary of the insurance premiums. Moreover, I agree with the trial judge that the repayment arrangements between Citadel and Drive On did not amount to a revocation of the trust. The promissory note dated September 21, 1987, was merely confirmation of the amount owed by Drive On to Citadel. By agreeing to have the promissory note prepared in its favour, Citadel did not revoke its beneficial interest in the insurance premiums.

15 As well, the arrangement between Citadel and Drive On meets the three characteristics of a trust, namely certainty of intent, certainty of subject-matter, and certainty of object; see Air Canada v. M & L Travel Ltd., supra, at pp. 803-4; Canadian Pacific Air Lines, Ltd. v. Canadian Imperial Bank of Commerce (1987), 61 O.R. (2d) 233 (H.C.), at p. 237. The arrangement in the present case was based on the collection of insurance premiums by the insurance agent, Drive On, and the remittance of these premiums, subject to adjustments, to the insurer, Citadel. The intent to create a trust clearly follows from this principal-agent relationship. The object of the trust is the insurer, Citadel. Finally, the insurance premiums constitute the subject-matter of the trust.

16 The fact that the trust funds in Drive On's account were commingled with other funds does not undermine the relationship of trust between the parties. As Iacobucci J. wrote for the majority of this Court in Air Canada v. M & L Travel Ltd., supra, at p. 804, "[w]hile the presence or absence of a prohibition on the commingling of funds is a factor to be considered in favour of a debt relationship, it is not necessarily determinative"; see also R. v. Lowden (1981), 27 A.R. 91 (C.A.), at pp. 101-2; Bank of N.S. v. Soc. Gen. (Can.), [1988] 4 W.W.R. 232 (Alta. C.A.), at p. 238.

17 The intention of the parties in the present case was to create a trust relationship. That Drive On deposited the funds in a general bank account, as opposed to a special trust account, does not alter this intention. In May 1987, Citadel prepared a report of Drive On's procedures. This report found that a trust account had not been set up by Drive On. However, the report also noted that Drive On would establish a trust account if required by Citadel. The report indicates, therefore, that the parties had turned their minds to the possibility of setting up a trust account to prohibit the commingling of funds. Even though the trust account was never established, the fact that the parties considered this possibility confirms that the relationship was viewed by Citadel and Drive On as one of trust.

B. The Liability of the Bank as a Stranger to the Trust

1. General Principles

18 Having found that the relationship between Citadel and Drive On was one of trust, it is clear that Drive On's actions were in breach of trust. Quite simply, Drive On failed to remit to Citadel the insurance premiums collected on Citadel's behalf in July and August 1987. Moreover, I agree with the trial judge that Citadel did not acquiesce in the breach of trust by asking for and receiving the promissory note from Drive On. By accepting the note, Citadel did not represent that it was acquiescing in the use of the funds by the Bank. Consequently, Citadel is not barred from bringing an action against the bank for breach of trust; see Fletcher v. Collis, [1905] 2 Ch. 24 (C.A.); P. H. Pettit, Equity and the Law of Trusts (7th ed. 1993), at p. 491. The question remains whether the Bank, as a stranger to the trust between Citadel and Drive On, can be liable as a constructive trustee.

19 There are three ways in which a stranger to a trust can be held liable as a constructive trustee for breach of trust. First, a stranger to the trust can be liable as a trustee de son tort. Secondly, a stranger to the trust can be liable for breach of trust by knowingly assisting in a fraudulent and dishonest design on the part of the trustees ("knowing assistance"). Thirdly, liability may be imposed on a stranger to the trust who is in receipt and chargeable with trust property ("knowing receipt"; see Air Canada v. M & L Travel Ltd., supra, at pp. 809-11).

20 To be liable as trustees de son tort, strangers to the trust must commit a breach of trust while acting as trustees. Such persons are not appointed trustees but "take on themselves to act as such and to possess and administer trust property"; see Selangor United Rubber Estates, Ltd. v. Cradock (No. 3), [1968] 2 All E.R. 1073 (Ch.), at p. 1095. This type of liability is inapplicable to the present case. The Bank never assumed the office or function of trustee; nor did it administer the trust funds on behalf of the beneficiary Citadel.

21 The two remaining categories of liability, namely "knowing assistance" and "knowing receipt", relate to strangers to the trust who knowingly participate in a breach of trust. In Air Canada v. M & L Travel Ltd., supra, this Court considered the requirements for bringing a case within the "knowing assistance" category. In that case, the defendant travel agency collected funds from the sale of Air Canada tickets and held them in trust to be remitted to Air Canada. The funds were kept in the agency's general bank account. The individual directors of the travel agency, who had personally guaranteed a demand loan, authorized the bank to withdraw funds from the general account to cover monies owing on the loan. A dispute arose between the directors with regard to misappropriation of funds. The bank sent demand notices to the directors and withdrew the full amount owing under the loan from the agency's general account. As a result, Air Canada did not receive monies owed to it for ticket sales. The issue arose whether the appellant director, as stranger to the trust, was liable to Air Canada for the travel agency's breach of trust.

22 This Court found the director liable for knowingly assisting in a breach of trust. The liability of the director was based on his knowledge of, and assistance in, a fraudulent and dishonest breach of trust on the part of the trustees. With regard to the knowledge requirement, Iacobucci J. wrote for the majority, at p. 811: "The knowledge requirement for this type of liability is actual knowledge; recklessness or wilful blindness will also suffice." He expressly excluded constructive knowledge from this test. Iacobucci J. defined constructive knowledge, at p. 812, as "knowledge of circumstances which would indicate the facts to an honest person, or knowledge of facts which would put an honest person on inquiry".

23 The Court of Appeal in the present case relied on the knowledge requirement set out in Air Canada v. M & L Travel Ltd., supra. Assuming the present case falls under the "knowing assistance" category, it is clear that only actual knowledge, recklessness, or wilful blindness will render the Bank liable for participating in the breach of trust. Constructive knowledge will not suffice. The trial judge's conclusions regarding the knowledge of the Bank were as follows (at para. 33):

> The Bank had actual knowledge of the nature of the funds in the Drive On account and had an obligation to inquire about their position in the circumstances. The Bank shut its eyes in circumstances which should have caused it to inquire of its customer at least. It did not do so. The Bank had constructive knowledge and is a constructive trustee. . . .

Kerans J.A. considered this passage from the trial judge's reasons and concluded, at p. 77:

> It is true that the judge used the words "shut its eyes", but reading the passage in its entirety, it seems clear that the judge is refusing to say that the bank was actually aware that it was taking money in breach of trust, as opposed to what it should have known or what its duty was.

I agree with Kerans J.A. that the trial judge refused to make a finding of actual knowledge by the Bank. Rather, the trial judge restricted his findings to constructive knowledge, based on the Bank's duty to inquire of its customer in the circumstances. Moreover, there was no finding of recklessness or wilful blindness as such. It follows from the trial judge's findings that the Bank does not meet the knowledge requirement set out in Air Canada v. M & L Travel

Ltd., supra. Since the Bank had only constructive knowledge, it cannot be liable under the "knowing assistance" category of constructive trusteeship.

24 The only basis upon which the Bank may be held liable as a constructive trustee is under the "knowing receipt" or "knowing receipt and dealing" head of liability. Under this category of constructive trusteeship it is generally recognized that there are two types of cases. First, although inapplicable to the present case, there are strangers to the trust, usually agents of the trustees, who receive trust property lawfully and not for their own benefit but then deal with the property in a manner inconsistent with the trust. These cases may be grouped under the heading "knowing dealing". Secondly, there are strangers to the trust who receive trust property for their own benefit and with knowledge that the property was transferred to them in breach of trust. In all cases it is immaterial whether the breach of trust was fraudulent; see Halsbury's Laws of England (4th ed. 1995), vol. 48, at para. 595; Pettit, supra, at p. 168; Underhill and Hayton, Law Relating to Trusts and Trustees (14th ed. 1987), at p. 357. The second type of case, which is relevant to the present appeal, raises two main issues: the nature of the receipt of trust property and the degree of knowledge required of the stranger to the trust.

2. Liability for Knowing Receipt

(a) The Receipt Requirement

25 Liability on the basis of "knowing receipt" requires that strangers to the trust receive or apply trust property for their own use and benefit; see Agip (Africa) Ltd. v. Jackson, [1990] 1 Ch. 265, aff'd [1992] 4 All E.R. 451 (C.A.); Halsbury's Laws of England, supra, at paras. 595-96; Pettit, supra, at p. 168. As Iacobucci J. wrote in Air Canada v. M & L Travel Ltd., supra, at pp. 810-11, the "knowing receipt" category of liability "requires the stranger to the trust to have received trust property in his or her personal capacity, rather than as an agent of the trustees". In the banking context, which is directly applicable to the present case, the definition of receipt has been applied as follows:

> The essential characteristic of a recipient . . . is that he should have received the property for his own use and benefit. That is why neither the paying nor the collecting bank can normally be made liable as recipient. In paying or collecting money for a customer the bank acts only as his agent. It sets up no title of its own. It is otherwise, however, if the collecting bank uses the money to reduce or discharge the customer's overdraft. In doing so it receives the money for its own benefit. . . . [Footnotes omitted.]
>
> P. J. Millett, "Tracing the Proceeds of Fraud" (1991), 107 L.Q.R. 71, at pp. 82-83.

26 Thus, a distinction is traditionally made between a bank receiving trust funds for its own benefit, in order to pay off a bank overdraft ("knowing receipt"), and a bank receiving and paying out trust funds merely as agent of the trustee ("knowing assistance"); see Underhill and Hayton, supra, at p. 361.

27 In the present case, we saw, Drive On deposited trust funds, namely insurance premiums collected on Citadel's behalf, in an operating account at the Bank. Drive On's parent company, International Warranty, also had an account at the Bank. In April 1987, the Bank transferred funds between the Drive On and International Warranty accounts to cover overdrafts in either account. As well, in June, the Bank transferred the balance of any funds in the Drive On account to the International Warranty account on a regular basis. As a result of the transfers between the accounts in July and August, a net amount was transferred to the International Warranty account. This amount, which was in excess of the July and August premiums deposited by Drive On, was used to reduce International Warranty's overdraft. Although the Bank was instructed by Drive On's signing officers to make the transfers, the Bank did not act as mere agent in the circumstances. The Bank's actions went beyond the mere collection of funds and payment of bills on Drive On's behalf. The Bank, by applying the deposit of insurance premiums as a set-off against International Warranty's overdraft, received a benefit. This benefit, of course, was the reduction in the amount owed to the Bank by one of its customers. It follows that the Bank received the trust funds for its own use and benefit.

28 In this Court, the respondents argued that they could not be liable on the basis of "knowing receipt" because they had not received the trust property. The respondents took the position, accepted by the authorities, that a bank deposit is simply a loan to the bank; see Foley v. Hill (1848), [1843-60] All E.R. Rep. 16 (H.L.); Fonthill Lumber Ltd.

v. Bank of Montreal (1959), 19 D.L.R. (2d) 618 (Ont. C.A.), at p. 628. Accordingly, the deposit of money in Drive On's account was characterized as a debt obligation owed by the Bank to Drive On. This debt obligation gave rise to a credit in Drive On's favour. On instruction from its customer, the Bank simply transferred "credits" from Drive On's account to International Warranty's account. The transfer of credits had the incidental effect of reducing an overdraft in the International Warranty account. In other words, the transfers between the accounts in July and August simply amounted to an off-setting of debt obligations. In the respondents' view, the Bank was not receiving trust property but simply transferring credits from one account to another.

29 The respondents' arguments are not convincing. A debt obligation is a chose in action and, therefore, property over which one can impose a trust. This conclusion is supported by the House of Lords' decision in Lipkin Gorman v. Karpnale Ltd., [1991] 3 W.L.R. 10. In that case, a firm of solicitors was authorized to operate a client's bank account. One of the firm's partners subsequently stole funds from the account and used them for casino gambling. Considering whether the solicitors could trace their client's funds at common law, Lord Goff of Chieveley wrote, at pp. 28-29:

> The relationship of the bank with the solicitors was essentially that of debtor and creditor; and since the client account was at all material times in credit, the bank was the debtor and the solicitors were its creditors. Such a debt constitutes a chose in action, which is a species of property; and since the debt was enforceable at common law, the chose in action was legal property belonging to the solicitors at common law.

The respondents cannot avoid the "property" issue by characterizing the deposit of trust monies in Drive On's account as a debt obligation. The chose in action, constituted by the indebtedness of the Bank to Drive On, was subject to a statutory trust in Citadel's favour. That same chose in action can also be the subject of a constructive trust in Citadel's favour.

30 Nonetheless, the respondents' arguments reflect a difficulty with the traditional conception of "receipt" in "knowing receipt" cases. In my view, the receipt requirement for this type of liability is best characterized in restitutionary terms. In Lac Minerals Ltd. v. International Corona Resources Ltd., [1989] 2 S.C.R. 574, at p. 669, I stated that a restitutionary claim, or a claim for unjust enrichment, is concerned with giving back to someone something that has been taken from them (a restitutionary proprietary award) or its equivalent value (a personal restitutionary award). As well, in Air Canada v. British Columbia, [1989] 1 S.C.R. 1161, at pp. 1202-3, I stated that the function of the law of restitution "is to ensure that where a plaintiff has been deprived of wealth that is either in his possession or would have accrued for his benefit, it is restored to him. The measure of restitutionary recovery is the gain the [defendant] made at the [plaintiff's] expense." In the present case, the Bank was clearly enriched by the off-setting of debt obligations, or transferring of credits between the Drive On and International Warranty accounts. That is, the amount due to the Bank was reduced. As well, the Bank's enrichment deprived Citadel of the insurance premiums collected on its behalf. Moreover, the fact that the insurance premiums were never in Citadel's possession does not preclude Citadel from pursuing a restitutionary claim. After all, the insurance premiums would have accrued to Citadel's benefit. The Bank has been enriched at Citadel's expense. Thus, in restitutionary terms, there can be no doubt that the Bank received trust property for its own use and benefit.

(b) The Knowledge Requirement

31 The first requirement for establishing liability on the basis of "knowing receipt" has been satisfied. The Bank received the trust property for its own benefit and, in doing so, was enriched at the beneficiary's expense. The second requirement relates to the degree of knowledge required of the Bank in relation to the breach of trust. With regard to this knowledge requirement, there are two lines of authorities. According to one line of jurisprudence, the knowledge requirement for both "knowing assistance" and "knowing receipt" cases should be the same. More specifically, constructive knowledge should not be the basis for liability in either type of case. A second line of authority suggests that a different standard should apply in "knowing assistance" and "knowing receipt" cases. More specifically, the authorities favour a lower threshold of knowledge in "knowing receipt" cases.

32 A leading case in relation to the first line of authority is In re Montagu's Settlement Trusts, [1987] 1 Ch. 264.

That case involved a dispute arising out of a 1923 settlement in which the future tenth Duke of Manchester had made an assignment of certain chattels to a number of trustees. The trustees were under a fiduciary duty to select and make an inventory of the chattels after the ninth Duke of Manchester died. The selection and inventory did not occur and the tenth Duke took absolutely whatever chattels he wanted. Megarry V.-C. held that the Duke was not liable as a constructive trustee because he did not know that the chattels were subject to a trust. In discussing the degree of knowledge required of the Duke, Megarry V.-C. emphasized that liability in "knowing receipt" cases is personal in nature and arises only if the stranger's conscience is sufficiently affected to justify imposing a constructive trust. Although cases involving actual knowledge, recklessness, and wilful blindness justify imposing a constructive trust, Megarry V.-C. doubted, at p. 285, whether the carelessness associated with constructive knowledge cases could sufficiently bind the stranger's conscience.

33 In re Montagu's Settlement Trusts was followed in Polly Peck International plc v. Nadir (No. 2), [1992] 4 All E.R. 769 (C.A.). There, the plaintiff company sought to impose liability on a bank for assisting in the misapplication of trust funds and for receiving and dealing in some way with trust property. The bank had been instructed by the trustee to transfer substantial trust funds into offshore accounts. Scott L.J. dealt with the case on the basis of both "knowing assistance" and "knowing receipt" because some of the transfers were made by the banker as agent while others were received for the bank's own benefit. With regard to the "knowing receipt" claim, the plaintiff beneficiary argued that, in the circumstances, the bank should have been put on inquiry as to whether there were improprieties in the transfers. Addressing the "knowing receipt" claim, Scott L.J. commented, at p. 777:

> Liability as constructive trustee in a 'knowing receipt' case does not require that the misapplication of the trust funds should be fraudulent. It does require that the defendant should have knowledge that the funds were trust funds and that they were being misapplied. Actual knowledge obviously will suffice. Mr. Potts [lawyer for the plaintiff] has submitted that it will suffice if the defendant can be shown to have had knowledge of facts which would have put an honest and reasonable man on inquiry, or, at least, if the defendant can be shown to have wilfully and recklessly failed to make such inquiries as an honest and reasonable man would have made. . . . I do not think there is any doubt that, if the latter of the two criteria can be established against the Central Bank, that will suffice. I have some doubts about the sufficiency of the former criterion but do not think that the present appeal is the right occasion for settling the issue.

It should be noted that Scott L.J. went on to apply the test for constructive knowledge, but found that the bank was not liable because it did not have cause to suspect improprieties and was not put on inquiry.

34 The English approach favouring exclusion of constructive knowledge received the approval of the Manitoba Court of Appeal in C.I.B.C. v. Valley Credit Union Ltd., [1990] 1 W.W.R. 736. In that case, a business obtained a line of credit from the plaintiff bank. Under the bank's general security agreement, the customer became trustee of monies paid to it with respect to accounts receivable or sales of inventory. The customer subsequently opened an account with the defendant credit union and used this account to deposit trust monies. The bank became aware of the other account, eventually called the customer's loans, and brought an action against the credit union to recover the funds in the customer's account. Philp J.A. refused to find the credit union liable as a constructive trustee. Without distinguishing between the categories of "knowing assistance" and "knowing receipt", Philp J.A. doubted whether the carelessness associated with constructive knowledge was sufficient to impose liability on the bank as a constructive trustee. Relying in part on In re Montagu's Settlement Trusts, supra, he stated, at p. 747:

> I do not think that it can be said that it has been authoritatively decided in Canada that carelessness or negligence is sufficient to impute constructive knowledge to a stranger, and to impose upon him liability as a constructive trustee. I think that it is a doubtful test, particularly in the case of a bank. The relationship between a bank and its customer is contractual and a principal obligation of the bank is to pay out as directed the moneys its customer has deposited. It seems to me that that obligation should be a paramount one, save in special factual circumstances sufficient to hold the bank privy to its customer's breach.

It should be noted, however, that later in his reasons Philp J.A. applied the test for constructive knowledge, but found that it had not been met in the circumstances.

35 That constructive knowledge should be excluded as a basis for liability in "knowing receipt" cases is also

supported by the Ontario Court of Appeal's decision in Bullock v. Key Property Management Inc. (1997), 33 O.R. (3d) 1. There, a trustee had deposited trust funds in a bank account. The funds were then used to service the trustee's own interests, including the reduction of the trustee's indebtedness to the bank. The court dismissed the action against the bank on the grounds that it did not have the requisite degree of knowledge of the breach of trust. The court did not deal with the categories of "knowing assistance" and "knowing receipt" and apparently found it unnecessary to distinguish between the various heads of liability. Apparently assuming that there was only one category of liability, the court concluded, at p. 4:

> As the law presently stands, a stranger to a trust will be held liable for a breach of that trust by the trustee only where the stranger has actual knowledge or is reckless or wilfully blind as to both the existence of the trust and the dishonest conduct of the trustee in connection with the trust. The inquiry must be directed to what the stranger to the trust actually knew or suspected and not to what the stranger would have known had reasonable inquiries been made. Failure to make reasonable inquiries may have evidentiary value in determining what the stranger to the trust in fact knew or suspected, but it is not a basis for the imposition of liability as a constructive trustee.

36 As well, the Court of Appeal in the present case concluded, without restricting its comments to any particular head of liability, that constructive knowledge should be excluded as a basis for imposing liability on a stranger to the trust. Relying on Iacobucci J.'s reasons in Air Canada v. M & L Travel Ltd., supra, Kerans J.A. wrote, at p. 77, that "[a] stranger to a trust is not liable for a breach of trust from which it received a benefit unless it had both actual knowledge of the trust and participated in the breach".

37 According to a second line of authority, however, constructive knowledge is sufficient to find a stranger to the trust liable on the basis of "knowing receipt". A leading English authority, in terms of formulating the test for constructive knowledge in breach of trust cases, is Selangor, supra. There, a company director carried out a fraudulent takeover bid by using the company's funds to purchase its own shares. Two banks were involved in the takeover. One bank acted on behalf of the director by paying, for a fee, those shareholders who had agreed to sell. The bank's fee was paid for by way of an advance from a second bank, where the company's account had been transferred. The second bank was repaid with trust funds drawn from the company's account. In addressing the banks' liability, Ungoed-Thomas J. did not distinguish between receipt and assistance cases. He presumed, at p. 1095, that there was only one category of liability for strangers to the trust who, unlike trustees de son tort, "act in their own right and not for beneficiaries". Relying on this single category of liability, Ungoed-Thomas J. held, at p. 1104:

> The knowledge required to hold a stranger liable as constructive trustee in a dishonest and fraudulent design, is knowledge of circumstances which would indicate to an honest, reasonable man that such a design was being committed or would put him on enquiry, which the stranger failed to make, whether it was being committed.

Ungoed-Thomas J. found both banks liable as constructive trustees.

38 The Selangor decision was followed by the British Columbia Court of Appeal in Groves-Raffin Construction Ltd. v. Bank of Nova Scotia (1975), 64 D.L.R. (3d) 78. There, a construction company deposited trust funds collected from building contracts with the defendant bank. These trust funds were then used to repay the company's indebtedness to the bank and to reduce personal overdrafts belonging to a director of the company. As well, the director stole trust monies from the company's account and transferred them to a personal account at a second bank. Addressing the liability of the second bank as a constructive trustee, Robertson J.A. wrote, at p. 136, that he was dealing with a "collecting bank" and not a "paying bank", thereby suggesting that the case fell under the "knowing receipt" category. Relying in part on Selangor, supra, Robertson J.A. found, at p. 138:

> Under what I think is the proper test no necessity to take care arises until either it is clear that a breach of trust is being, or is intended to be, committed, or until there has come to the attention of the person something that should arouse suspicion in an honest, reasonable man and put him on inquiry. The person, for his own protection, in the first event should have nothing to do with the improper transaction, and in the second event should not continue to be involved in the suspected transaction until his inquiry shows him - or, more correctly, would show a reasonable man - that the suspicion is unfounded.

39 The Selangor decision was also applied by this Court in Carl B. Potter Ltd. v. Mercantile Bank of Canada, [1980] 2 S.C.R. 343. In that case, the plaintiff bid for the construction of a waste treatment plant. The bid was accompanied by a tender deposit cheque, to be held in trust by the owner of the project. The proceeds of the tender cheque eventually found their way into the owner's collateral account where they were drawn upon to meet the owner's obligations to the defendant bank. In these circumstances, it appears that the trust funds were received by the bank for its own use and benefit, thereby meeting the first requirement under the "knowing receipt" head of liability. Ritchie J., at p. 347, approved of the following test regarding the bank's knowledge of the breach of trust:

> The position of a banker who has been placed "on inquiry" in the manner aforesaid is summarized in the following brief paragraph from Halsbury's Laws of England (4th ed.) vol. III, para. 60:
>
> > A banker may be a constructive trustee of money in his customer's account and in breach of that trust if he pays the money away, even on the customer's mandate, in circumstances which put him upon inquiry.

The footnote references for this passage, although not referred to by Ritchie J., included Selangor, supra. Ritchie J. went on to apply this test to the facts and found the bank liable for breach of trust.

40 A similar test of constructive knowledge was applied by the Ontario Court of Appeal in Arthur Andersen Inc. v. Toronto-Dominion Bank (1994), 17 O.R. (3d) 363, leave to appeal refused, [1994] 3 S.C.R. v. In that case, the defendant bank was sued by a trustee appointed under the Construction Lien Act, R.S.O. 1990, c. C.30. The bank had agreed to administer the accounts of a number of associated construction companies, in accordance with a "mirror accounting system". Among other things, this system eliminated the need to monitor overdrafts in individual accounts and permitted the informal transfer of debits and credits between all of the operating companies' accounts. The trial judge's findings implied that the funds in the accounts were transferred in breach of the trust requirements under the Construction Lien Act. Considering the liability of the bank as a constructive trustee, Grange and McKinlay JJ.A. thus wrote in their joint reasons, at pp. 381-82:

> We consider that the law on this point can be summarized thus: in the absence of sufficient facts or circumstances indicating that there is a good possibility of trust beneficiaries being unpaid there is no duty of inquiry on a bank to determine whether the trades have been paid or will be able to be paid.
>
> . . .
>
> Only if a bank is aware of facts which would indicate that trades would not be paid in the normal course of business should it be charged with a duty of special inquiry.

It should be noted that Grange and McKinlay JJ.A. formulated this test without distinguishing between receipt and assistance cases. However, their comment, at p. 385, that the "Bank can only be liable for a breach of trust, and that breach would have to involve making use for its own benefit of money held on a trust for trade creditors", suggests that the case fell under the "knowing receipt" head of liability.

41 This analysis was endorsed by the Manitoba Court of Appeal in Glenko Enterprises Ltd. v. Ernie Keller Contractors Ltd. (1996), 134 D.L.R. (4th) 161. On facts similar to Arthur Andersen, supra, the court, at pp. 164-65, considered "whether a bank which has applied trust funds received from a building contractor to reduce an account overdraft has participated in a breach of trust and must therefore account to the beneficiaries of that trust for those funds". The funds in question, which were misappropriated by the defendant contractor, were subject to trust requirements under the Builders' Liens Act, R.S.M. 1987, c. B91. Considering whether the bank was a party to a breach of trust by its customer, Scott C.J.M. held, at p. 167:

> . . . the Bank is not liable for the builder's breach of trust if the Bank, in the ordinary course of business, accepted deposits and allowed cheques to be written thereon - or for that matter if it applied the funds on the overdraft - unless it had or clearly should have had knowledge of the breach of trust by the contractor or of facts to put it on notice.

The court went on to agree with the trial judge, at p. 176, that the bank, although it apparently received the trust

funds for its own benefit, was not liable because "the inquiries and arrangements for further information which were made by the bank . . . were reasonable in all the circumstances".

42 There are also a number of recent English authorities supporting the view that constructive knowledge is sufficient to impose liability on the basis of "knowing receipt". In Agip (Africa) Ltd. (Ch.), supra, Millett J. made a number of comments regarding "knowing receipt" cases, even though the case before him was of the "knowing assistance" category. With regard to the degree of knowledge required in "knowing receipt" cases, he wrote, at p. 291:

> The first [category of "knowing receipt" cases] is concerned with the person who receives for his own benefit trust property transferred to him in breach of trust. He is liable as a constructive trustee if he received it with notice, actual or constructive, that it was trust property and that the transfer to him was a breach of trust; or if he received it without such notice but subsequently discovered the facts.

However, Millett J.'s comments must be read in light of a later passage, at p. 293, where he refused to express an opinion as to whether constructive knowledge sufficed in "knowing receipt" cases.

43 Millett J.'s comments were subsequently referred to by Knox J. in Cowan de Groot Properties Ltd. v. Eagle Trust plc, [1992] 4 All E.R. 700 (Ch.). In this "knowing receipt" case the issue arose whether a purchaser company had knowledge of a breach of duty arising out of the sale of another company's property. The purchaser's liability as a constructive trustee turned on whether or not it had knowledge that the directors of the vendor company were deliberately selling at a gross undervalue. Knox J. noted, at p. 758, that there was a "substantial body of authority in favour of the proposition that constructive notice based on what a reasonable man would have concluded though falling short of want of probity on the part of the person charged as a constructive trustee may suffice in a knowing receipt case". Despite this body of authority, Knox J. preferred a test based on actual knowledge, wilful blindness, or recklessness. However, he added that if, contrary to his view, constructive knowledge was sufficient, there would still have been no liability on the facts before him. As well, at p. 761, he suggested "that the underlying broad principle which runs through the authorities regarding commercial transactions is that the court will impute knowledge, on the basis of what a reasonable person would have learnt, to a person who is guilty of commercially unacceptable conduct in the particular context involved".

44 Millett J. reiterated the views he expressed in Agip (Africa) Ltd., supra, in El Ajou v. Dollar Land Holdings plc, [1993] 3 All E.R. 717 (Ch.). That case involved a massive share fraud carried out by three Canadians in Amsterdam between 1984 and 1985. The plaintiff, the largest single victim of the fraud, claimed to be able to trace some of the proceeds of the fraud from Amsterdam through locations in Geneva, Gibraltar, Panama, back to Geneva, and then to London, where they were invested in a joint venture to carry out a property development project. In this "knowing receipt" case, Millett J. was prepared to assume that constructive knowledge was a sufficient basis for liability. At p. 739, he stated:

> In the absence of full argument I am content to assume, without deciding, that dishonesty or want of probity involving actual knowledge (whether proved or inferred) is not a precondition of liability; but that a recipient is not expected to be unduly suspicious and is not to be held liable unless he went ahead without further inquiry in circumstances in which an honest and reasonable man would have realised that the money was probably trust money and was being misapplied.

45 According to the second line of authority, then, the degree of knowledge required of strangers to the trust should be different in assistance and receipt cases. Generally, there are good reasons for requiring different thresholds of knowledge under the two heads of liability. As Millett J. wrote in Agip (Africa) Ltd., supra, at pp. 292-93:

> The basis of liability in the two types of cases is quite different; there is no reason why the degree of knowledge required should be the same, and good reason why it should not. Tracing claims and cases of "knowing receipt" are both concerned with rights of priority in relation to property taken by a legal owner for his own benefit; cases of "knowing assistance" are concerned with the furtherance of fraud.

46 In other words, the distinction between the two categories of liability is fundamental: whereas the accessory's

liability is "fault-based", the recipient's liability is "receipt-based". In an extrajudicial opinion, Millett J. described the distinction as follows:

> . . . the liability of the accessory is limited to the case where the breach of trust in question was fraudulent and dishonest; the liability of the recipient is not so limited. In truth, however, the distinction is fundamental; there is no similarity between the two categories. The accessory is a person who either never received the property at all, or who received it in circumstances where his receipt was irrelevant. His liability cannot be receipt-based. It is necessarily fault-based, and is imposed on him not in the context of the law of competing priorities to property, but in the application of the law which is concerned with the furtherance of fraud. [Footnotes omitted.]
>
> "Tracing the Proceeds of Fraud", supra, at p. 83.

47 S. Gardner makes a similar point in "Knowing Assistance and Knowing Receipt: Taking Stock" (1996), 112 L.Q.R. 56, at p. 85:

> . . . it is questionable whether knowing receipt is about wrongfully causing loss at all. There may be more than one other thing that it could be about, but most modern opinion takes it to be a restitutionary liability, based on the fact that the defendant has acquired the plaintiff's property.

The same view was expressed by the Privy Council in Royal Brunei Airlines Sdn. Bhd. v. Tan, [1995] 3 W.L.R. 64, at p. 70: "Different considerations apply to the two heads of liability. Recipient liability is restitution-based; accessory liability is not." These comments are also cited with approval by Iacobucci J. in Gold, supra, at para. 41.

48 Given the fundamental distinction between the nature of liability in assistance and receipt cases, it makes sense to require a different threshold of knowledge for each category of liability. In "knowing assistance" cases, which are concerned with the furtherance of fraud, there is a higher threshold of knowledge required of the stranger to the trust. Constructive knowledge is excluded as the basis for liability in "knowing assistance" cases; see Air Canada v. M & L Travel Ltd., supra, at pp. 811-13. However, in "knowing receipt" cases, which are concerned with the receipt of trust property for one's own benefit, there should be a lower threshold of knowledge required of the stranger to the trust. More is expected of the recipient, who, unlike the accessory, is necessarily enriched at the plaintiff's expense. Because the recipient is held to this higher standard, constructive knowledge (that is, knowledge of facts sufficient to put a reasonable person on notice or inquiry) will suffice as the basis for restitutionary liability. Iacobucci J. reaches the same conclusion in Gold, supra, where he finds, at para. 46, that a stranger in receipt of trust property "need not have actual knowledge of the equity [in favour of the plaintiff]; notice will suffice".

49 This lower threshold of knowledge is sufficient to establish the "unjust" or "unjustified" nature of the recipient's enrichment, thereby entitling the plaintiff to a restitutionary remedy. As I wrote in Lac Minerals, supra, at p. 670, "[t]he determination that the enrichment is 'unjust' does not refer to abstract notions of morality and justice, but flows directly from the finding that there was a breach of a legally recognized duty for which the courts will grant relief". In "knowing receipt" cases, relief flows from the breach of a legally recognized duty of inquiry. More specifically, relief will be granted where a stranger to the trust, having received trust property for his or her own benefit and having knowledge of facts which would put a reasonable person on inquiry, actually fails to inquire as to the possible misapplication of trust property. It is this lack of inquiry that renders the recipient's enrichment unjust.

50 Some commentators go further and argue that a recipient may be unjustly enriched regardless of either a duty of inquiry or constructive knowledge of a breach of trust. According to Professor Birks, a recipient of misdirected funds should be liable on a strict, restitutionary basis. In his article "Misdirected Funds: Restitution from the Recipient", [1989] L.M.C.L.Q. 296, he argues that a recipient's enrichment is unjust because the plaintiff did not consent to it, not because the defendant knew that the funds were being misdirected. In particular, he writes, at p. 341, that "[t]he 'unjust' factor can be named 'ignorance', signifying that the plaintiff, at the time of the enrichment, was absolutely unaware of the transfer from himself to the defendant". Birks, however, lessens the strictness of his approach by allowing a defendant to take advantage of special defences, including a defence arising out of a bona fide purchase for value. (See also P. Birks, "Overview: Tracing, Claiming and Defences", in P. Birks, ed., Laundering and Tracing (1995), 289, at pp. 322 et seq.)

51 In my view, the test formulated by Professor Birks, while not entirely incompatible with my own, may establish an unjust deprivation, but not an unjust enrichment. It is recalled that a plaintiff is entitled to a restitutionary remedy not because he or she has been unjustly deprived but, rather, because the defendant has been unjustly enriched, at the plaintiff's expense. To show that the defendant's enrichment is unjustified, one must necessarily focus on the defendant's state of mind not the plaintiff's knowledge, or lack thereof. Indeed, without constructive or actual knowledge of the breach of trust, the recipient may very well have a lawful claim to the trust property. It would be unfair to require a recipient to disgorge a benefit that has been lawfully received. In those circumstances, the recipient will not be unjustly enriched and the plaintiff will not be entitled to a restitutionary remedy.

52 In the banking context of the present case, it is true that s. 206(1) of the Bank Act, R.S.C., 1985, c. B-1, negates any duty on the part of a bank to see to the execution of any trust, whether express, implied or constructive, to which a deposit is subject. In accordance with this provision, a bank is not under a duty to regularly monitor the activities of its clients simply because the funds deposited by those clients are impressed with a statutory trust. Nonetheless, this provision does not render a bank immune from liability as a constructive trustee or prevent the recognition of a duty of inquiry on the part of a bank. Indeed, in certain circumstances, a bank's knowledge of its customer's affairs will require the bank to make inquiries as to possible misapplication of trust funds. As discussed earlier, the degree of knowledge required is constructive knowledge of a possible breach of trust. It follows that a bank which is enriched by the receipt of trust property and has knowledge of facts that would put a reasonable person on inquiry is under a duty to make inquiries of its customer regarding a possible breach of trust. If the bank fails to make the appropriate inquiries, it will have constructive knowledge of the breach of trust. In these circumstances, the bank will be unjustly enriched and, therefore, required to disgorge the benefit it received at the plaintiff's expense.

53 The respondents argued that imposing liability on a banker who merely has constructive notice of a breach of trust will place too great a burden on banks, thereby interfering with the proper functioning of the banking system. While this may be true in assistance cases where a banker merely pays out and transfers funds as the trustee's agent, the same argument does not apply to receipt cases where a banker receives the trust funds for his or her own benefit. Professor Harpum addresses this point in "The Stranger as Constructive Trustee" (1986), 102 L.Q.R. 114, at p. 138:

> Although there should be a reluctance to allow the unnecessary intrusion of "the intricacies and doctrines connected with trusts" into ordinary commercial transactions, considerations of speed and the importance of possession which normally justify the exclusion of these doctrines, are less applicable to a banker who chooses to exercise his right of set-off than they are to other commercial dealings. Where a banker combines accounts, he alone stands to gain from the transaction. Because of that benefit, more should be expected of him than if he gained nothing. [Footnotes omitted.]

In "knowing receipt" cases, therefore, it is justifiable to impose liability on a banker who only has constructive knowledge of a breach of trust.

54 In the present case, it has already been established that the Bank was enriched at Citadel's expense by the receipt of insurance premiums collected by Drive On and subject to a statutory trust in favour of Citadel. The only remaining question is whether the Bank had the requisite degree of knowledge to render the enrichment unjust, thereby entitling the plaintiff insurer to a remedy.

55 On this issue, it is clear from the trial judge's findings that the Bank was aware of the nature of the funds being deposited into, and transferred out of, Drive On's account. On discovery, two of the Bank's employees stated that they knew Drive On's sole source of revenue was the sale of insurance policies. The Bank also knew that premiums collected by Drive On were payable to the plaintiff insurer. The Bank's knowledge of the nature of Drive On's deposits must also be considered in conjunction with the activities in Drive On's account. It is recalled that in April 1987 the Bank began transferring funds between the Drive On and International Warranty accounts to cover overdrafts in either account. As well, in June 1987, the Bank was directed to empty the Drive On account on a daily basis, again to facilitate the transfer of funds to the International Warranty account.

56 In light of the Bank's knowledge of the nature of the funds, the daily emptying of the account was in the trial judge's view "very suspicious". In these circumstances, a reasonable person would have been put on inquiry as to the possible misapplication of the trust funds. Notwithstanding the fact that the exact terms of the trust relationship between Citadel and Drive On may have been unknown to the Bank, the Bank should have taken steps, in the form of reasonable inquiries, to determine whether the insurance premiums were being misapplied. More specifically, the Bank should have inquired whether the use of the premiums to reduce the account overdrafts constituted a breach of trust. By failing to make the appropriate inquiries, the Bank had constructive knowledge of Drive On's breach of trust. In these circumstances, the Bank's enrichment was clearly unjust, thereby rendering it liable to Citadel as a constructive trustee.

57 I make one additional point regarding the nature of the Bank's liability in the present case. As already established, recipient liability is restitution-based. The imposition of liability as a constructive trustee on the basis of "knowing receipt" is a restitutionary remedy and should not be confused with the right to trace assets at common law or in equity. The principles relating to tracing at law and in equity were thus set out by the English Court of Appeal in Agip (Africa) Ltd., supra, at pp. 463-64 and 466:

> Tracing at law does not depend upon the establishment of an initial fiduciary relationship. Liability depends upon receipt by the defendant of the plaintiff's money and the extent of the liability depends on the amount received. Since liability depends upon receipt the fact that a recipient has not retained the asset is irrelevant. For the same reason dishonesty or lack of inquiry on the part of the recipient are irrelevant. Identification in the defendant's hands of the plaintiff's asset is, however, necessary. It must be shown that the money received by the defendant was the money of the plaintiff. Further, the very limited common law remedies make it difficult to follow at law into mixed funds.
>
> . . .
>
> Both common law and equity accepted the right of the true owner to trace his property into the hands of others while it was in an identifiable form. The common law treated property as identified if it had not been mixed with other property. Equity, on the other hand, will follow money into a mixed fund and charge the fund.

58 In my view, a distinction should be made between the imposition of liability in "knowing receipt" cases and the availability of tracing orders at common law and in equity. Liability at common law is strict, flowing from the fact of receipt. Liability in "knowing receipt" cases is not strict; it depends not only on the fact of enrichment (i.e. receipt of trust property) but also on the unjust nature of that enrichment (i.e. the stranger's knowledge of the breach of trust). A tracing order at common law, unlike a restitutionary remedy, is only available in respect of funds which have not lost their identity by becoming part of a mixed fund. Further, the imposition of liability as a constructive trustee is wider than a tracing order in equity. The former is not limited to the defence of purchaser without notice and "does not depend upon the recipient still having the property or its traceable proceeds"; see In re Montagu's Settlement Trusts, supra, at p. 276.

59 Despite these distinctions, there appears to be a common thread running through both "knowing receipt" and tracing cases. That is, constructive knowledge will suffice as the basis for imposing liability on the recipient of misdirected trust funds. Notwithstanding this, it is neither necessary nor desirable to confuse the traditional rules of tracing with the restitutionary principles now applicable to "knowing receipt" cases. This does not mean, however, that a restitutionary remedy and a tracing order are mutually exclusive. Where more than one remedy is available on the facts, the plaintiff should be able to choose the one that is most advantageous. In the present case, the plaintiff did not seek a tracing order. It is therefore unnecessary for me to decide whether such a remedy would have been available on the facts of the present appeal, and I have not explored the issue.

V. Disposition

60 For these reasons, I would allow Citadel's appeal with costs and restore the judgment rendered at trial.

The following are the reasons delivered by

SOPINKA J.

61 Subject to my reasons in Gold v. Rosenberg, [1997] 3 S.C.R. 767, I agree with Justice La Forest.

TAB 10

COURT FILE NO.: 06-CL-6566
DATE: 20080326

SUPERIOR COURT OF JUSTICE - ONTARIO

IN THE MATTER OF an Application pursuant to s. 47(1) of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended

AND IN THE MATTER OF s. 101 of the *Courts of Justice Act*, R.S.O. 1990, c. C.43, as amended

RE: **CITIZENS BANK OF RHODE ISLAND**

Applicant

- and -

PARAMOUNT HOLDINGS CANADA COMPANY, PARAMOUNT HOLDINGS CANADA COMPANY II and IMAGE CRAFT INC.

Respondents

BEFORE: **Justice A. Hoy**

COUNSEL: **Harvey G. Chaiton and Maria Konyukhova**, for RSM Richter Inc.

Alan J. Butcher, for Transcorp Distribution Inc.

DATE HEARD: **March 19, 2008**

E N D O R S E M E N T

[1] The issue in this motion by RSM Richter Inc. in its capacity as the court appointed Interim Receiver and Receiver of the assets of Image Craft Inc. ("IC") and its Canadian affiliates, and cross-motion of Transcorp Distribution Inc. ("Transcorp"), is whether accounts receivable in the amount of $243,177.95 collected by the Receiver constitute property of IC or are subject to an implied or constructive trust in favour of Transcorp. It is conceded by Transcorp that there is not an express trust.

[2] If the accounts receivable are the property of IC, they will be paid to IC's first ranking secured creditor, Citizen's Bank of Rhode Island (the "Bank"), which has a security interest over the accounts receivable of IC. The Bank will suffer a substantial deficiency on its secured claim; no funds will be available for distribution to unsecured creditors.

[3] For the reasons that follow, I have concluded that the accounts receivable in issue are not impressed with an implied or constructive trust in favour of Transcorp.

[4] In its cross-motion, Transcorp, in the alternative, sought an order directing a trial of the issue as to the existence of a trust. This relief was not pursued at the hearing, and it was acknowledged at the hearing that there was no dispute at to the material facts. I have assumed that this alternative was abandoned by Transcorp; if not abandoned, the relief would not have been granted, given the absence of dispute as to material facts.

The Facts

[5] IC and its affiliates designed, manufactured and distributed greeting cards, gift wrap and complementary products. It had a number of distributors.

[6] Transcorp has acted as a distributor of IC's products since at least 1995. Transcorp purchased inventory from IC, in bulk, and sold it to outlets of national retail customers located in Quebec and parts of New Brunswick, and to its own local (as opposed to national) customers.

[7] Transcorp billed and collected from its local customers. Those accounts receivable are not at issue on these motions.

[8] In the case of sales to outlets of national retail customers, Transcorp delivered the product to the outlet and provided proof of delivery to IC, and IC invoiced the head office of the national customer and was responsible for collection from the national customer.

[9] With few exceptions, Transcorp did not pay cash for the inventory it acquired from IC. When the inventory was sold to Transcorp, IC would record an account receivable from Transcorp in its books and records. When IC invoiced the national customer, it issued a credit note to Transcorp for the amount invoiced to the national customer, and applied the credit note against the account receivable. In turn, on receipt f the credit note, Transcorp recorded a payment in the amount of the credit note. This system was referred to as the credit and rebill program or procedure.

[10] The documentary evidence establishes that IC offered volume discounts and early payment discounts to national customers. The invoices it sent to national customers (and the amount of the credit notes it issued to Transcorp) were for the sales price, before reduction on account of volume and early payment discounts. The national customers paid an amount, net of these discounts. IC recorded the amounts it invoiced national customers, net of the applicable discounts, as receivables of IC and included them on the accounts receivable information provided to the Bank to support its borrowings. IC deposited the monies it collected from national customers into its general bank account and did not segregate the payments, or account to Transcorp with respect to the collection of those amounts.

[11] The spread between the price at which Transcorp acquired inventory from IC, and the amount invoiced to the national customer, was Transcorp's distribution fee, or gross profit arising from the transaction.

[12] While the credit notes for the invoiced price to the customer were greater than the related accounts receivable for the price of the inventory to Transcorp, until December 2005 Transcorp nonetheless consistently constituted a debtor, in relation to IC, because it bought increasing levels of inventory, thereby creating new and ever increasing accounts receivable on the books of IC.

[13] In 2005, Transcorp began to reduce the inventory levels it maintained. It returned some of its inventory for a credit from IC. At the same time, its sales to national customers increased. As a result, in December of 2005, Transcorp became a creditor of IC and by January of 2006 Transcorp had a receivable from IC of over $700,000.

[14] The evidence of Ms. Miller, IC's Credit Manager during the seven years prior to the bankruptcy, is that arrangements were put into place to reduce the amount that IC owed Transcorp, which evolved into an agreement to pay $40,000 per week, which continued until IC's bankruptcy in July 21, 2006. Her further, undisputed evidence is that the payments were funded from receipts from sales to all customers, and not specifically from the collection of accounts receivable that arose out of sales through Transcorp.

[15] The evidence of Mr. Desjardins, Transcorp's principal, is that the amount of payments agreed to was arbitrary, and designed to bring the account balance down to zero within a certain period of time. An April 14, 2006 e-mail to Mr. Desjardins proposes adjusting the $40,000 amount upwards or downwards given the purchases and collections under credit and rebill program, and asks if this is satisfactory.

[16] At the time of bankruptcy, IC owed Transcorp $283,327.00.

[17] Since that time, the Receiver has collected $243,177.95 from accounts receivable arising out of sales through Transcorp.

[18] The parties entered into two written agreements: a Distribution Agreement among IC, Transcorp and Mr. Desjardins dated April 24, 1995 and a letter agreement dated February 21, 2003 among IC, Transcorp and S. Rossy Inc, one of the national customers. The Distribution Agreement contains an "entire agreement" clause. Neither of the two written agreements provides that amounts receivable collected by IC arising out of sales through Transcorp would be held in trust for Transcorp, or requires that such amounts be segregated from other amounts received by IC. Nor was there any evidence of an oral agreement or discussions to such effect.

The Law

Implied Trust

[19] A trust, express or implied, has three essential characteristics: (1) certainty of the intention to create the trust; (2) certainty of the subject matter or trust property; and (3) certainty of the objects of the trust. If any one of these does not exist, the trust fails to come into existence.

[20] In the absence of formal trust documentation, the Court must consider the circumstances and evidence as to what the parties intended, what was actually agreed to and how the parties conducted themselves to determine if the requisite clear intention to create a trust is present.

[21] Factors the Court will consider include the content of any agreements between the parties, whether the alleged trust property is held in a separate account, whether the alleged trustee is permitted to commingle the alleged trust funds with his or her own funds or use the funds for his or her own general business purposes and, past events and conduct that may suggest that the parties treated the funds as trust funds.

[22] The presence or absence of a prohibition on the commingling of funds is not necessarily determinative. *Commercial Union Life Assurance Co. of Canada v. John Ingle Insurance Group Inc.*, [2001] O.J. No. 3289 (S.C.J.), paras. 300-305 (affirmed [2002] O.J. No. 3200).

Constructive Trust

[23] Constructive trust is an equitable remedy that may be granted in order to prevent an unjust enrichment of a person. In order to impose a constructive trust based on unjust enrichment there must be (1) enrichment; (2) a corresponding deprivation; and (3) no juristic reason for the deprivation.

[24] A "juristic reason" means some underlying justification, grounded in a legal or equitable basis, for the circumstances that have arisen. The juristic reason may arise out of a relationship between the person enriched and some other person, and need not by tied to the person who asserts the unjust enrichment. *Canada (Attorney General) v. Confederation Life Insurance Co.*, [1995] O.J. No. 1959 (Gen. Div.) (affirmed (1997), 32 O.R. (3d) 102, paras. 176, 193-194 (C.A.)).

Analysis

[25] As indicated above, Transcorp concedes that there is no agreement, written or oral, that the receivables from national customers arising through the efforts of Transcorp would be held in trust for Transcorp.

[26] It argues that from the circumstances, namely that Transcorp had become a creditor of IC, and the conduct of the parties, particularly the payments made by IC in 2006, it should be implied that once Transcorp became a creditor of IC those receivables would be held in trust for Transcorp. Counsel for Transcorp unequivocally indicated that Transcorp no longer takes the position that there was a trust arrangement when Transcorp was a debtor, as opposed to a creditor.

[27] The payments in 2006 are not sufficient to imply a trust. Mr. Desjardin's own evidence is that they were arbitrary in amount, and designed to reduce the amounts owing to Transcorp. The April 14, 2006 e-mail, referred to above, that counsel for Transcorp points to as supporting a trust, in my view is consistent with the evidence that the payments were

designed to eliminate the indebtedness over a certain time. As also noted above, the payments were made out of IC's general funds; an arrangement whereby the amounts receivable were "passed through" to Transcorp was not put in place, and there was no requirement that a separate account be established and maintained until the credit imbalance was rectified. There was no evidence that the word "trust" was used in the parties' discussions regarding repayment. The payments are in my view consistent with a debtor-creditor relationship.

[28] Nor does the fact that Transcorp had, after many years as a debtor, become a creditor provide the requisite clear intention to create a trust.

[29] Throughout the arrangement, IC bore the risk of non-payment by national customers. The fact that IC accorded volume and early payment discounts in relation to the receivables is consistent with the accounts receivable constituting IC's property.

[30] As the requisite intention to create a trust is not present, there can be no implied trust.

[31] Counsel for Transcorp also argued that the Receiver is obligated to continue to pay down the outstanding balance owing to Transcorp, in priority, because the receiving order contains the customary provision restraining suppliers of services from terminating the supply of those services, provided that the normal prices or charges for services received after the date of the order are paid by the receiver in accordance with normal payment practices of the debtor. I understand Transcorp to argue that the normal payment practice of IC was that the accounts receivable were held in trust and paid to Transcorp pending rectification of the credit imbalance, that the Receiver did not do so and is therefore in breach of the receiving order and, by analogy to *GMAC Commercial Credit Corporation v. TCT Logistics Inc.*, [2005] O.J. No. 589 (C.A.), the fact that the accounts receivable were commingled with IC's general funds should not defeat Transcorp's trust claim. This argument is disposed of by my conclusion that there was no intention that the accounts receivable be held in trust and applied to repay the indebtedness.

[32] While IC can be seen as having been enriched by the receipt of the accounts receivable at issue, and Transcorp having suffered a corresponding deprivation because it did not receive the benefit of those accounts receivable, there is in my view juristic reason for the deprivation.

[33] Transcorp is an unsecured creditor of IC. The indebtedness arose out of a contractual business relationship. There was no dishonest or underhanded conduct on the part of IC.

[34] Moreover, as noted in *Confederation Life,* a juristic reason may arise out of a relationship between the person enriched and some other person and (para. 208), in the context of a constructive trust claim against the assets of an insolvent person who is allegedly a constructive trustee, it is important to be aware of the interests of the insolvent's other creditors as well as those of the constructive trust claimant. The security interest of the Bank is a further juristic reason for the deprivation.

[35] This case can be distinguished from *Brown & Collett, Ltd. (Re),* [1996] O.J. No. 625 (Gen. Div.) on which Transcorp relies. In that case, Winkler J. (as he then was) found that there was no implied trust but there was an agreement that funds would be forwarded by the defendant to the plaintiff as soon as they had been received, and the accounts were reconciled, and that the defendant had breached that agreement. He accordingly concluded that the debtor-creditor relationship arising out of the agreement did not amount to juristic reason because the enrichment was in clear breach of the agreement. He did not determine whether or not a constructive trust was an appropriate remedy in the circumstances. In this case, the enrichment did not arise out of the breach of an agreement between the parties.

Hoy J.

DATE: March 26, 2008

TAB 11

Gold v. Rosenberg

Supreme Court Reports

Supreme Court of Canada

Present: La Forest, Sopinka, Gonthier, Cory, McLachlin, Iacobucci and Major JJ.

1997: May 21 / 1997: October 30.

File No.: 25064.

[1997] 3 S.C.R. 767 | [1997] 3 R.C.S. 767 | [1997] S.C.J. No. 93 | [1997] A.C.S. no 93

Jeffrey Lorne Gold, appellant; v. Primary Developments Limited and The Toronto-Dominion Bank, respondents.

ON APPEAL FROM THE COURT OF APPEAL FOR ONTARIO

Case Summary

Trusts and trustees — Breach of trust — Liability of strangers to trust — Knowing assistance — Knowing receipt — Customer giving bank loan guarantee supported by collateral mortgage on trust property — Whether bank knowingly assisted in breach of trust — Whether bank liable for knowing receipt of trust property — Whether bank received trust property for its own use and benefit — Whether bank in breach of its duty to inquire.

A testator died in 1985 and named his son, R, and his grandson, the appellant G, as executors and equal beneficiaries of the residue of his estate. The assets of the estate consisted primarily of commercial real estate held by two companies. Shortly after the testator's death, G signed a general power of attorney permitting R to continue his management of the estate companies, in which he was closely involved. The testator, the estate companies, R and a storage company owned by R all banked at the respondent bank. Overseeing all of these accounts was a single account manager, who was familiar with the details of the testator's will and had a copy of the power of attorney. In 1989 the bank agreed to make a loan to the storage company on condition that it received a guarantee from P, one of the estate companies, supported by a second collateral mortgage over property owned by P and a postponement of a mortgage held by the other estate company in favour of a new mortgage to the bank. The law firm which acted for the estate, the estate companies, R, the storage company and, on certain matters, the bank prepared a resolution of the directors of P and also drew up the form for a guarantee. R signed both documents. The law firm sent an opinion letter to the bank stating that the guarantee complied with all legal requirements. The bank advanced its loan to the storage company, and G's signature was subsequently obtained on the directors' resolution. G later revoked the power of attorney and issued a statement of claim against R, P, the bank and the law firm seeking a declaration that the guarantee given to the bank by P was invalid and unenforceable. The bank cross-claimed against P, seeking enforcement of the guarantee. The trial judge imposed a constructive trust on the bank in favour of G and declared that the guarantee, the collateral mortgage and the postponement of the mortgage were unenforceable. The Court of Appeal allowed the bank's appeal and dismissed G's claim against the bank.

Held (La Forest, Cory and Iacobucci JJ. dissenting): The appeal should be dismissed.

Per Sopinka, McLachlin and Major JJ.: Assuming the theory of knowing receipt liability should be entertained even though the case was presented and dealt with in both the trial court and the court of appeal as a knowing assistance case, when a bank receives a guarantee supported by a collateral mortgage on trust property, it has not received the trust property to its own use and benefit. In the context of knowing receipt cases, to receive trust property means, at a minimum, to take the trust property into one's possession. A guarantee is a contract whose performance is contingent on the default of the principal debtor. If the guarantor supports the guarantee with a mortgage on real property, the creditor only enjoys, at best, a contingent interest in that property.

Moreover, even if this is properly viewed as a knowing receipt case, the bank, knowing what it knew, acted reasonably in the circumstances and therefore cannot be found liable. An honest person with knowledge of the facts of this case would not have made further inquiries. Presumably the lawyers and the accountants who acted on the transaction would have affirmed its fairness if asked. If G had been asked about the guarantee, he would hardly have questioned it in view of the fact that he signed the resolution.

In certain circumstances, a third party in the position of the bank will not have discharged its duty to inquire unless the guarantor has been advised to obtain independent legal advice. When the transaction is clearly detrimental to the person offering security and the relationship between that person and the principal debtor is particularly close, the law presumes undue influence on the part of the principal debtor. A relationship that is more distant will raise less suspicion of undue influence, however, even if the transaction is apparently unfavourable to the guarantor. Consequently, less may be required to satisfy an honest and reasonable person that the surety or guarantor is aware of the legal implications of the proposed transaction. At the time G signed the resolution he had three years of university education in which he had taken courses in business, economics and accounting. The purpose of the guarantee was explained to him by R. In the circumstances, advising G to obtain independent legal advice goes beyond what is expected of an honest and reasonable banker.

Per Gonthier J.: While this case is one of knowing receipt of trust property, as found by Iacobucci J., the bank, knowing what it knew, acted reasonably in the circumstances, for the reasons given by Sopinka J.

Per La Forest, Cory and Iacobucci JJ. (dissenting): A breach of trust may give rise to liability in a person who is a stranger to the trust under the doctrine of "knowing assistance". As the name implies, the plaintiff must prove not only that the breach of trust was fraudulent and dishonest, but also that the defendant participated knowingly in that breach of trust. The knowledge requirement for this type of liability is actual knowledge. Assuming without deciding that R committed a dishonest and fraudulent breach of trust and that the bank participated in that breach of trust, G's claim in knowing assistance fails because of the failure to prove that the bank had actual knowledge of R's fraud. The opinion letter undoubtedly provided comfort to the bank that the guarantee was not tainted by fraud, and it therefore cannot be said that the bank had actual knowledge that the guarantee was obtained in breach of trust.

Depending upon considerations of notice, equity may also impose liability if the defendant received, in his or her own right, property obtained through breach of trust. The essence of such a "knowing receipt" claim is that, by receiving the trust property, the defendant has been enriched at the plaintiff's expense. The claim, accordingly, falls within the law of restitution. A court may impose liability for knowing receipt even if the defendant acted with something less than actual knowledge of the breach of trust. The defendant cannot retain the property in question if it was acquired in circumstances which would have alerted a reasonable person to the possibility of a breach of trust. The claim in knowing receipt is essentially a proprietary one and a recipient of trust property may be liable as a constructive trustee if, having notice of a possible breach of trust, he failed to make the appropriate inquiries.

Even if one takes the position that the guarantee provided by P, supported by a collateral mortgage over property owned by P, does not constitute trust property, the benefit conferred on the bank and the resulting loss in value suffered by the estate are sufficient to bring the guarantee within the knowing receipt category of liability. Furthermore, in the present action, the bank has attempted to enforce the guarantee against P. If the guarantee is enforced, then the bank will clearly receive property.

The guarantee was subject to a trust in favour of G, and the bank took possession of it in its own right in breach of trust. The first two elements of knowing receipt have thus been made out. Finally, the bank did not acquire the property as a bona fide purchaser for value without notice as the circumstances were sufficiently suspicious to put it on inquiry. The opinion letter stating that the guarantee complied with all legal requirements does not satisfy the bank's obligation to make reasonable inquiry. Since the bank knew that the law firm was acting on behalf of all parties, it knew that the firm could not have given G independent legal advice with regard to signing the directors' resolution which authorized the guarantee. Accordingly, the bank is fixed with notice of the breach of trust and

therefore takes the guarantee subject to G's equity. For these reasons, the bank cannot enforce the guarantee against P.

Cases Cited

By Sopinka J.

Distinguished: Bertolo v. Bank of Montreal (1986), 57 O.R. (2d) 577; referred to: Citadel General Assurance Co. v. Lloyds Bank Canada, [1997] 3 S.C.R. 805; Baden v. Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France SA, [1992] 4 All E.R. 161; Barclays Bank plc v. O'Brien, [1993] 4 All E.R. 417.

By Iacobucci J. (dissenting)

MacDonald v. Hauer, [1977] 1 W.W.R. 51; Air Canada v. M & L Travel Ltd., [1993] 3 S.C.R. 787; Citadel General Assurance Co. v. Lloyds Bank Canada, [1997] 3 S.C.R. 805; Barnes v. Addy (1874), L.R. 9 Ch. App. 244; Agip (Africa) Ltd. v. Jackson, [1990] 1 Ch. 265; Nelson v. Larholt, [1948] 1 K.B. 339; Royal Brunei Airlines Sdn. Bhd. v. Tan, [1995] 3 W.L.R. 64; Carl Zeiss Stiftung v. Herbert Smith & Co., [1969] 2 Ch. 276; In re Montagu's Settlement Trusts, [1987] 1 Ch. 264; Carl B. Potter Ltd. v. Mercantile Bank of Canada, [1980] 2 S.C.R. 343; Cartwright v. Lyster, [1934] 2 D.L.R. 166; Canadian Pacific Air Lines Ltd. v. Canadian Imperial Bank of Commerce (1987), 27 E.T.R. 281; Barclays Bank plc v. O'Brien, [1993] 4 All E.R. 417; Credit Lyonnais Bank Nederland NV v. Burch, [1997] 1 All E.R. 144; Bertolo v. Bank of Montreal (1986), 57 O.R. (2d) 577.

Authors Cited

Halsbury's Laws of England, vol. 20, 4th ed. London: Butterworths, 1993 (reissue). Harpum, Charles. "The Stranger as Constructive Trustee" (1986), 102 L.Q.R. 114 and 267. McGuinness, Kevin Patrick. The Law of Guarantee: A Treatise on Guarantee, Indemnity and the Standby Letter of Credit, 2nd ed. Scarborough, Ont.: Carswell, 1996. Oxford English Dictionary, 2nd ed. Oxford: Clarendon Press, 1989, "receive".

APPEAL from a judgment of the Ontario Court of Appeal (1995), 25 O.R. (3d) 601, 129 D.L.R. (4th) 152, 86 O.A.C. 116, 9 E.T.R. (2d) 93, [1995] O.J. No. 3156 (QL), reversing a decision of the Ontario Court (General Division), [1993] O.J. No. 2994 (QL), imposing a constructive trust on the defendant bank. Appeal dismissed, La Forest, Cory and Iacobucci JJ. dissenting.
John D. Brownlie, Q.C., and John J. Lucki, for the appellant. No one appeared for the respondent Primary Developments Limited. R. Ross Wells and Sherry A. Currie, for the respondent The Toronto-Dominion Bank.

Solicitors for the appellant: Blake, Cassels & Graydon, Toronto. Solicitors for the respondent The Toronto-Dominion Bank: Gowling, Strathy & Henderson, Kitchener, Ont.

The reasons of La Forest, Cory and Iacobucci JJ. were delivered by

IACOBUCCI J. (dissenting)

1 This appeal involves the question of when a person will be liable for the knowing receipt of trust property.

1. Facts

2 Abraham Rosenberg ("the testator") died on March 30, 1985. He named his son, Maurice Rosenberg ("Rosenberg"), and his grandson, the appellant Jeffrey Gold, as executors and equal beneficiaries of the residue of his estate. The assets of the estate consisted primarily of commercial real estate held by two companies: Primary Developments Ltd. and Existing Enterprises Ltd. (the "estate companies").

3 Both during the testator's life and after his death, Rosenberg was closely involved in the running of the estate companies. Gold, however, has had no involvement in the estate's business.

4 In 1985, shortly after the testator's death, Rosenberg asked Gold to sign a general power of attorney which would permit Rosenberg to continue his management of the estate companies. Gold agreed.

5 Rosenberg had other commercial interests besides the estate companies. Together with his wife, he owned all of the shares of Trojan Self-Storage Mini-Warehouse Ltd. ("Trojan").

6 The testator, the estate companies, Rosenberg and Trojan all banked at the respondent Toronto-Dominion Bank. Overseeing all of these accounts was a single account manager, Kenneth Slack. Mr. Slack was familiar with the details of the testator's will and had a copy of Gold's power of attorney.

7 In July of 1989, the Bank was trying to obtain repayment of a $300,000 loan made to Rosenberg personally and of a US $130,000 loan made to one of Rosenberg's companies. At the same time, Rosenberg wanted to secure substantial new loans, totaling approximately $3.9 million. He and Mr. Slack eventually settled upon a mutually satisfactory arrangement which would use the assets of the two estate companies to repay Rosenberg's personal indebtedness and to secure the new loan. The agreement included the following particulars, relevant to the present appeal:

> The Bank agreed to make the $3.9 million loan to Trojan on the condition that the Bank receive a $1.2 million guarantee from one of the estate companies. This guarantee would be supported by the following:
>
> (i) a $1.2 million second collateral mortgage over property owned by Primary, at 156 Columbia Street, Waterloo; and
>
> (ii) a postponement of a $200,000 mortgage held by Existing over a property owned by Trojan, in favour of a new $4 million mortgage to be given by Trojan to the Bank.

8 A Kitchener law firm, Sills, Madorin, which was a defendant at trial (and which did not appeal the judgment against it), provided legal counsel to the following persons: the estate; Primary; Existing; Rosenberg; Trojan; and, on certain matters, the respondent Bank.

9 Putting the loan agreement into effect required Gold's signature on certain documents, most notably on a Primary directors' resolution, authorizing the guarantee. On July 28, 1989, the law firm prepared a Resolution of the Directors of Primary and also drew up the form for a $1.2 million guarantee. Rosenberg signed both documents on July 28, 1989. Gold signed the Directors' resolution sometime between September 13, 1989 and October 20, 1989.

10 In connection with the guarantee, the law firm sent an opinion letter, dated August 1, 1989, to the Bank. The letter said:

> The authorization, execution, issuance and delivery of the said Guarantee by the Corporation does not conflict with or contravene any terms, conditions or provisions of any law or agreement to which the Corporation is subject or to which the Corporation is a party.

In a cover letter to the opinion letter the law firm indicated that the Directors' resolution had to be signed by both Gold and Rosenberg and that Gold had not yet signed it.

11 Nonetheless, the Bank proceeded to advance its new loans to Trojan. Gold's signature was subsequently obtained on the Directors' resolution.

12 In November 1989, Gold revoked the power of attorney executed in favour of Rosenberg. On January 14, 1993, Gold issued a statement of claim against Rosenberg, Primary, the Bank and the law firm of Sills, Madorin. Gold sought a declaration that the $1.2 million guarantee given to the Bank by Primary was invalid and unenforceable. In

the alternative, Gold claimed indemnity for any loss which he might suffer if the guarantee were enforced. The Bank cross-claimed against Primary, seeking enforcement of the guarantee.

2. Judgments Below

A. Ontario Court of Justice (General Division), [1993] O.J. No. 2994 (QL)

13 In the view of Haley J., the Bank's liability turned on whether or not it had knowingly assisted in a breach of trust. Citing MacDonald v. Hauer, [1977] 1 W.W.R. 51 (Sask. C.A.), the trial judge said that, in order to recover damages for knowing assistance, the plaintiff must prove the following:

(1) assistance by the defendant of a nominated trustee;

(2) with knowledge;

(3) in a dishonest and fraudulent design on the part of the nominated trustee.

With regard to the third element above, Haley J. explained that the "dishonest and fraudulent design" need not amount to a crime. Rather, the test is whether equity would regard the plan as "morally reprehensible" (para. 12).

14 Turning to the facts of the case, Haley J. found that the testator's will created a trust and that Rosenberg was one of the trustees. She also found that the relationship between Rosenberg and Gold was such as to impose upon Rosenberg fiduciary duties (at para. 13):

> Rosenberg, acting under a Power of Attorney given to him by Gold for his executorship, owed a fiduciary duty to Gold under the Power of Attorney and also to him as a 50% beneficiary of the estate.

15 The trial judge went on to hold that Rosenberg had breached his fiduciary duty in three ways:

(1) By causing Primary to give a $1.2 million guarantee in favour of the Bank;

(2) By causing Primary to secure its guarantee by a second collateral mortgage against its property at 156 Columbia Street, Waterloo; and

(3) By causing Existing Developments to postpone its mortgage, in the amount of $200,000, on a Trojan property, in favour of a collateral second mortgage held by the Bank.

In the opinion of the trial judge, these transactions were "fraudulent and dishonest" and, therefore, the case fell within the law of knowing assistance.

16 Turning next to the issue of the Bank's liability, Haley J. held that, by making the necessary arrangements for the guarantee-related transactions, the Bank assisted Rosenberg in his fraudulent and dishonest scheme. Thus, all that remained to be determined was whether the Bank had offered this assistance with the requisite degree of knowledge so as to give rise to liability. The trial judge said (at para. 14):

> The crucial element to be considered is whether the bank at the time it assisted had knowledge, either actual or imputed that:
>
> (a) the scheme was dishonest and fraudulent;
>
> (b) it was assisting Rosenberg in perpetrating the dishonest and fraudulent scheme.

17 In carrying out this inquiry, the trial judge focused on Kenneth Slack, the Toronto-Dominion account manager. In particular, Haley J. highlighted the following evidence:

(1) Slack was familiar with the details of the testator's will.

(2) He knew that Gold played no role in the management of the estate.

(3) He knew that Gold had executed a Power of Attorney in favour of Rosenberg.

(4) He knew that the guarantee and its related transactions could not possibly benefit Gold.

Based on all of the above, the trial judge concluded that the Bank had actual knowledge of Rosenberg's fraudulent and dishonest breach of trust. She said (at para. 66):

> On the basis of all of the knowledge that Slack had in July 1989, when the guarantee was given, and hence that the bank had, I find that the bank knew that what Rosenberg as Trustee was doing, was dishonest and fraudulent. . . .

18 Accordingly, Haley J. imposed a constructive trust on the Bank in favour of Gold, saying (at para. 75):

> . . . I find that equity should fix the bank with a constructive trust in favour of Jeffrey Gold of those assets of the estate representing his 50% beneficial interest by declaring that the $1.2 million guarantee given to the Bank by Primary is unenforceable as are the collateral mortgage on 156 Columbia Street in favour of the bank and the postponement of the Existing third collateral mortgage on 555 Fairway Drive which were given as part of the guarantee transaction.

B. Ontario Court of Appeal (1995), 25 O.R. (3d) 601

19 Like the trial judge, the Court of Appeal proceeded on the basis that liability turned solely on whether or not the defendant Bank had knowingly assisted Rosenberg in a fraudulent and dishonest breach of trust. Writing for a unanimous court, Laskin J.A. applied the test for knowing assistance laid down in Air Canada v. M & L Travel Ltd., [1993] 3 S.C.R. 787. According to Air Canada, in order to impose liability on the Toronto-Dominion Bank for knowing assistance, the plaintiff would have to prove the following:

(1) That Rosenberg was a trustee of the property of Primary;

(2) That, in causing Primary to give the guarantee, Rosenberg committed a fraudulent and dishonest breach of trust;

(3) That the Bank participated in the giving of the guarantee; and

(4) That the Bank knew of or was wilfully blind to Rosenberg's fraud and dishonesty.

20 Laskin J.A. agreed with the trial judge that the plaintiff had proved the first and third elements of its case. However, with regard to whether or not Rosenberg had committed a fraudulent and dishonest breach of trust, the Court of Appeal disagreed with the holding of the trial judge. In reaching this conclusion, the Court of Appeal relied on the fact that Gold had eventually signed the directors' resolution which authorized the guarantee. By signing the resolution, Gold effectively agreed to give the guarantee, thereby consenting to the breach of trust. This consent, if validly given, would negate any finding of a dishonest breach of trust. Laskin J.A. wrote (at p. 606):

> If a beneficiary validly consents to a breach of trust before it is carried out, the beneficiary cannot claim compensation from the trustee for any subsequent loss. . . . This principle logically implies that a beneficiary's consent will negate a finding of a dishonest breach of trust.

The Court of Appeal examined the facts surrounding the signing of the directors' resolution and concluded that Gold understood the nature of the guarantee and was aware of the risk it posed to his share of the estate. Laskin J.A. said (at pp. 607-8):

> [T]he record demonstrates that Gold knew what a guarantee was, he knew the reason for this guarantee and he knew the possible consequences of authorizing it. He was not misled about the purpose, the effect or the risk of giving his approval. Therefore Gold's consent was valid.

Gold's consent, since valid, precluded a finding that Rosenberg had committed a fraudulent and dishonest breach of trust. Therefore, the case did not fall within the scope of knowing assistance.

21 The above holding (i.e. that Rosenberg had not committed a fraudulent and dishonest breach of trust) was sufficient to dispose of Gold's claim against the Bank. Nevertheless, Laskin J.A. proceeded to address the issue of whether or not the Bank had knowledge of the breach of trust.

22 In the opinion of the Court of Appeal, the trial judge had manifestly erred in concluding that the Bank had actual

knowledge of the breach of trust. Specifically, Laskin J.A. held that the trial judge had failed to give sufficient weight to the Sills, Madorin opinion letter, which stated that the guarantee was valid. Laskin J.A. said (at p. 610):

> [The opinion letter] undoubtedly provided comfort to the bank that the guarantee was not tainted by fraud. However, the trial judge did not refer to the opinion letter.

Given the content of the opinion letter, the Court of Appeal concluded that, contrary to the finding of the trial judge, the Bank neither knew of nor was wilfully blind to Rosenberg's fraudulent and dishonest breach of trust. Laskin J.A. said (at p. 610):

> Even if Rosenberg had misled Gold about the effect of the guarantee, the bank was not privy to their discussion and there is no other evidence that the bank knew Gold had been misled. Absent such knowledge the bank can divorce itself from Rosenberg's dishonesty.

23 Accordingly, the Court of Appeal allowed the appeal and dismissed Gold's claim against the Bank with costs.

3. Issues

24

(1) Is the respondent Bank liable under the doctrine of knowing assistance?

(2) Is the respondent Bank liable under the doctrine of knowing receipt?

4. Analysis

25 At the outset, I should note that I have read the reasons of my colleague La Forest J. in Citadel General Assurance Co. v. Lloyds Bank Canada, [1997] 3 S.C.R. 805, and I agree generally with his approach regarding liability for knowing receipt. Like him, I believe our reasons take a similar approach.

26 A person who has not been appointed as a trustee may, under certain circumstances, attract the liabilities of trusteeship. In Barnes v. Addy (1874), L.R. 9 Ch. App. 244, Lord Selborne L.C. explained that there are three situations in which a breach of trust may give rise to liability in a person who is a stranger to the trust. First, a person may be liable as a trustee de son tort. The facts of this case do not require consideration of this category of liability. Second, a person will be liable if he or she knowingly assisted in a fraudulent and dishonest breach of trust. This type of liability is referred to as "knowing assistance". And third, depending upon considerations of notice, equity may impose liability if the defendant received, in his or her own right, property obtained through breach of trust. This last category of liability is referred to as "knowing receipt".

27 This Court has expressed its approval of the Barnes v. Addy classification system, most recently in Air Canada, supra (at p. 810):

> In addition to a trustee de son tort, there were traditionally therefore two ways in which a stranger to the trust could be held personally liable to the beneficiaries as a participant in a breach of trust: as one in receipt and chargeable with trust property and as one who knowingly assisted in a dishonest and fraudulent design on the part of the trustees. The former category of constructive trusteeship has been termed "knowing receipt" or "knowing receipt and dealing", while the latter category has been termed "knowing assistance".

28 Knowing assistance and knowing receipt share certain factual similarities; however, they are distinct heads of liability. Confusion has developed in the case law on account of a failure to distinguish between these separate forms of liability. The main source of confusion stems from disagreement over the degree of "knowledge" required for liability in each category. As Charles Harpum writes in his article "The Stranger as Constructive Trustee" (1986), 102 L.Q.R. 114, at p. 120, although a degree of knowledge is required for liability under both heads of liability:

> [t]he cases reveal a sharp difference of opinion as to the degree of cognisance that is required before a person may be held liable as a constructive trustee and as to whether the degree of knowledge required under one head is necessarily applicable to another.

29 In the present case, the appellant argues that the respondent is liable under both knowing assistance and knowing receipt. I will consider each head of liability in turn. I will pay particular attention to the degree of knowledge required to justify liability in each category.

Is the respondent Bank liable under the doctrine of knowing assistance?

30 This Court reviewed the law of knowing assistance in Air Canada. In that case, we adopted the definition of "knowing assistance" given in Barnes v. Addy, where Lord Selborne L.C. stated that a stranger to the trust will be liable if he or she "assist[s] with knowledge in a dishonest and fraudulent design on the part of the trustees" (p. 252).

31 A "dishonest and fraudulent design" includes "the taking of a knowingly wrongful risk resulting in prejudice to the beneficiary". As was said in Air Canada (at p. 826):

> I would therefore "take as a relevant description of fraud 'the taking of a risk to the prejudice of another's rights, which risk is known to be one which there is no right to take'."

32 As the name "knowing assistance" implies, the plaintiff must prove not only that the breach of trust was fraudulent and dishonest, but also that the defendant participated knowingly in that breach of trust. As stated in Air Canada (at p. 811):

> The knowledge requirement for this type of liability is actual knowledge; recklessness or wilful blindness will also suffice.

33 As Millett J. explained in Agip (Africa) Ltd. v. Jackson, [1990] 1 Ch. 265, at p. 292, liability is imposed, in cases of knowing assistance, on the basis that the defendant has participated in a fraud and "participation", in its relevant sense, implies actual knowledge of the fraud being perpetrated by the rogue trustee. La Forest J. reached a similar conclusion in Citadel where he described liability in knowing assistance as "fault-based" liability (at para. 46). Thus, the basis of liability, participation in a fraud, supports the test for liability which I set out in Air Canada, actual knowledge of the trust and its fraudulent breach.

34 In the present case, in order to recover damages for knowing assistance, the appellant must demonstrate the following:

(1) That there was a trust;

(2) That the named trustee, Rosenberg, perpetrated a dishonest and fraudulent breach of trust; and

(3) That the respondent Bank participated in and had actual knowledge of Rosenberg's dishonest and fraudulent breach of trust.

35 I should note at the outset that both parties agree that there was, indeed, a trust.

36 Assuming without deciding that Rosenberg committed a dishonest and fraudulent breach of trust and assuming without deciding that the Bank participated in that breach of trust, in my opinion, the appellant's claim in knowing assistance fails because of the failure to prove that the Bank had actual knowledge of Rosenberg's fraud. As mentioned above, the Bank received an opinion letter from the law firm of Sills, Madorin. The closing paragraph of the letter stated:

> The authorization, execution, issuance and delivery of the said Guarantee by the Corporation does not conflict with or contravene any terms, conditions or provisions of any law or agreement to which the Corporation is subject or to which the Corporation is a party.

37 In light of this letter, in my view, it cannot be said that the Bank had actual knowledge that the guarantee was obtained in breach of trust. As Laskin J.A. said (at p. 610), this letter "undoubtedly provided comfort to the bank that the guarantee was not tainted by fraud" and I agree with the Court of Appeal that the trial judge made a manifest error in holding to the contrary.

38 For this reason, in my opinion, the appellant's claim in knowing assistance should be dismissed.

39 I will next consider whether the respondent is liable for the knowing receipt of trust property.

Is the respondent Bank liable under the doctrine of knowing receipt?

40 In a knowing receipt case, the plaintiff sues to recover his or her property which has come into the possession of the defendant, as a result of a breach of trust. As Lord Selborne L.C. said in Barnes v. Addy, the defendant has "receive[d] and become chargeable with some part of the trust property" (at pp. 251-52). However, the mere fact of receipt, of possession, is not a sufficient condition for liability. To be "chargeable" with trust property, a defendant must have received it in his or her own right, must have enjoyed the property beneficially. There is, thus, no cause of action in knowing receipt against a person who holds trust property merely as an agent for a third party. This was the rationale for dismissing the plaintiff's knowing receipt claim in Air Canada. As mentioned therein (at pp. 810-11):

> The . . . category of "knowing receipt" of trust property is inapplicable to the present case because it requires the stranger to the trust to have received trust property in his or her personal capacity, rather than as an agent of the trustees.

See also Agip (Africa) Ltd., at p. 288.

41 The essence of a knowing receipt claim is that, by receiving the trust property, the defendant has been enriched. Because the property was subject to a trust in favour of the plaintiff, the defendant's enrichment was at the plaintiff's expense. The claim, accordingly, falls within the law of restitution. As Denning J. said in Nelson v. Larholt, [1948] 1 K.B. 339, at p. 343:

> The right here is not peculiar to equity or contract or tort, but falls naturally within the important category of cases where the court orders restitution....

Similarly, in Royal Brunei Airlines Sdn. Bhd. v. Tan, [1995] 3 W.L.R. 64 (P.C.), at p. 70, Lord Nicholls of Birkenhead stated, "Recipient liability is restitution-based". I note that La Forest J. reached a similar conclusion in Citadel, where he described liability in knowing receipt as "receipt-based" liability (at para. 46). Therein lies a fundamental difference between the categories of knowing assistance and knowing receipt. Participation in a fraud underlies liability in cases of knowing assistance; unjust enrichment is the essence of a claim in knowing receipt. In Agip (Africa) Ltd., Millett J. distinguished between the two heads of liability (at pp. 292-93):

> Tracing claims and cases of "knowing receipt" are both concerned with rights of priority in relation to property taken by a legal owner for his own benefit; cases of "knowing assistance" are concerned with the furtherance of fraud.

42 As with knowing assistance, the plaintiff must prove a certain degree of knowledge on the part of the defendant to justify liability in knowing receipt. Unlike knowing assistance, where a clear test for the requisite level of knowledge has been set out by this Court in Air Canada, the case law does not clearly set out the degree of knowledge required to justify liability in cases of knowing receipt. Harpum, supra, states (at p. 267):

> If a trustee transfers trust property [in breach of trust], the recipient must take that property subject to the trusts unless . . . the recipient is a bona fide purchaser without notice of that fact.

However, the exact meaning of "notice" has occasioned some disagreement in the jurisprudence.

43 Two main schools of thought emerge regarding the level of knowledge required to justify liability for knowing receipt. The first holds that a defendant will be liable under knowing receipt only if he or she received the property with actual knowledge (and this includes wilful blindness) of the breach of trust. For example, in Carl Zeiss Stiftung v. Herbert Smith & Co., [1969] 2 Ch. 276, Sachs L.J. said (at p. 298):

> [The plaintiff must prove] both actual knowledge of the trust's existence and actual knowledge that what is being done is improperly in breach of that trust. . . .

This view of the law appears to have found approval in In re Montagu's Settlement Trusts, [1987] 1 Ch. 264, where Megarry V.-C. held that actual knowledge, wilful blindness or recklessness were required for liability in knowing receipt cases.

44 An opposing school of thought holds that a court may impose liability for knowing receipt even if the defendant acted with something less than actual knowledge of the breach of trust. According to this approach, the defendant cannot retain the property in question if it was acquired in circumstances which would have alerted a reasonable person to the possibility of a breach of trust. In Nelson v. Larholt, Denning J. explained (at p. 343):

> [I]f the circumstances were such as to put a reasonable man on inquiry, and he [i.e. the defendant] made none, or if he was put off by an answer that would not have satisfied a reasonable man, . . . then he is taken to have notice. . . .

To similar effect was the decision of this Court in Carl B. Potter Ltd. v. Mercantile Bank of Canada, [1980] 2 S.C.R. 343, where Ritchie J. quoted with approval from the decision of the Court of Appeal (at p. 347):

> [The defendant] had sufficient notice of the unusual nature of the . . . funds to put [it] on its inquiry to determine the exact nature of these funds before dealing further with them.

And, in Cartwright v. Lyster, [1934] 2 D.L.R. 166 (Ont. C.A.), Middleton J.A., writing for the majority, held that the defendant was liable because it "had knowledge of the facts and circumstances that place them [sic] upon inquiry" (p. 169). Finally, in Canadian Pacific Air Lines Ltd. v. Canadian Imperial Bank of Commerce (1987), 27 E.T.R. 281 (Ont. H.C.), Maloney J. imposed liability on the grounds that the circumstances were such as to put the defendant "on alert".

45 In my opinion, this latter approach is the preferable one as it best suits the restitutionary basis of a claim in knowing receipt. Harpum states (at p. 273):

> Because the issue in cases of knowing receipt is essentially a proprietary one, a recipient of trust property may be liable as a constructive trustee if he failed to make the inquiries that he ought to have made, even though he acted in good faith. It is taken for granted in the cases that constructive notice of the impropriety of the transfer suffices for liability . . . .

46 A stranger in receipt of trust property is unjustly enriched at the expense of the trust beneficiary. Participation in a fraudulent breach is irrelevant to the plaintiff's claim. Liability essentially turns on whether or not the defendant has taken property subject to an equity in favour of the plaintiff. The jurisprudence has long held that, in order to take subject to an equity, a person need not have actual knowledge of the equity; notice will suffice. In my view, the same standard applies to cases of knowing receipt.

47 In my view, the test as put forward in both Carl Zeiss Stiftung and Montagu's Settlement is inappropriate to cases of knowing receipt. The basis of liability in both of these cases is a want of probity (see the judgment of Edmund Davies L.J. in Carl Zeiss Stiftung, at p. 301; see also Montagu's Settlement, at p. 285). As such, these cases appear to conflate knowing receipt with knowing assistance.

48 The judgment of Sachs L.J. in Carl Zeiss Stiftung provides further evidence of this collapsing of the two distinct heads of liability where he describes the defendant in knowing receipt cases as a "party to a fraud" (at pp. 298-99). In my view, such a description is inaccurate. Unlike knowing assistance, knowing receipt does not require the plaintiff to show that the breach of trust was fraudulent. And unlike knowing assistance, the defendant in knowing receipt is in no way implicated in any wrongdoing perpetrated by the rogue trustee.

49 Rather, the cause of action in knowing receipt arises simply because the defendant has improperly received property which belongs to the plaintiff. The plaintiff's claim amounts to nothing more than, "You unjustly have my property. Give it back." Unlike knowing assistance, there is no finding of fault, no legal wrong done by the defendant and no claim for damages. It is, at base, simply a question of who has a better claim to the disputed property.

50 In Air Canada, this Court appropriately applied the reasoning developed in Carl Zeiss Stiftung and Montagu's Settlement in support of the actual knowledge requirement for liability in knowing assistance cases. I should add that, as discussed above, Carl Zeiss Stiftung and Montagu's Settlement required actual knowledge on the part of the stranger to justify liability in circumstances of knowing receipt. In my view, actual knowledge is inappropriate as a test for liability in knowing receipt cases.

51 Given the differences between the two causes of action, I can see no good reason why the standard of knowledge which will give rise to liability ought necessarily to be the same. As Millett J. said in Agip (Africa) Ltd. (at p. 292):

> The basis of liability in the two types of cases is quite different; there is no reason why the degree of knowledge required should be the same, and good reason why it should not.

52 Harpum discusses the policy considerations which support the application of a stricter standard on strangers in receipt of trust property than that applied to strangers who assist in a breach of trust (at pp. 126-27):

> In such a case [of knowing receipt], the conflict between the beneficiary and the stranger is at its most acute, because the court has in effect to determine which of them has the better title to the trust property. The winner takes all and the loser is left with a claim against the trustee that is likely to be worthless. Because the beneficiary stands to lose outright his beneficial interest, equity is at her most demanding, and insists upon compliance with her most exacting standard.
>
> In all other cases, a stranger should be liable only if he had actual knowledge of, or wilfully closed his eyes to, the terms of the trust, or as the case may be, to the dishonest and fraudulent design on the part of the trustee. No question as to the title of the trust property is in issue. . . . In cases of knowing inducement and assistance, the stranger may never have received any part of the trust property. . . . In cases of knowing assistance, the emphasis on participation by the stranger in the fraud of the trustee necessarily implies that the stranger will be liable only is he acts in bad faith. [Emphasis added.]

53 Therefore, to conclude my discussion of the applicable legal principles, in order to recover the disputed property, the plaintiff must prove the following:

(1) That the property was subject to a trust in favour of the plaintiff;

(2) That the property, which the defendant received, was taken from the plaintiff in breach of trust; and

(3) That the defendant did not take the property as a bona fide purchaser for value without notice. The defendant will be taken to have notice if the circumstances were such as to put a reasonable person on inquiry, and the defendant made none, or if the defendant was put off by an answer which would not have satisfied a reasonable person.

54 Before turning to consider whether the guarantee in question was subject to a trust in favour of the plaintiff, I must first address the respondent's argument that the principles of knowing receipt are inapplicable to the present case, because the Bank never received any trust assets. Specifically, the Bank contended that the guarantee itself is not property and that, accordingly, in receiving the guarantee, the Bank did not acquire any property which could be the subject of a knowing receipt claim. I do not agree with this argument. There is some commentary which suggests that a guarantee does not constitute security of a proprietary nature since it is contract security and unlike a mortgage or pledge (K. P. McGuinness, The Law of Guarantee (2nd ed. 1996), at p. 5). However, on the facts of this case, when the Bank obtained the guarantee from Primary, it also acquired, as found by Haley J., a $1.2 million collateral mortgage on real estate belonging to Primary in support of the guarantee. As such, the Bank received both a contractual undertaking to assume the obligations of Trojan in the event of its default, and security of a proprietary nature in support of that undertaking. The mortgage, as security for the guarantee, conferred on the Bank a proprietary interest in the trust property. The guarantee provided by Primary, supported by a collateral mortgage over property owned by Primary, in my view, constitutes property which can be made the subject of a knowing receipt claim. Even if one takes the position that the guarantee does not constitute trust property, the giving of the guarantee confers a valuable benefit on the Bank and correspondingly encumbers the estate and

detracts from its value. The benefit conferred on the Bank and the resulting loss in value suffered by the estate are sufficient, in my view, to bring the guarantee within the knowing receipt category of liability.

55 Furthermore, in the present action, the Bank has attempted to enforce the guarantee against Primary. If the guarantee is enforced, then the Bank will clearly receive property. For these reasons and on policy grounds, in my opinion, the disputed guarantee can be the subject of a claim in knowing receipt.

56 I will now turn to the question of whether the guarantee was subject to a trust in favour of Gold. The trial judge found that a trust existed under the testator's will. Gold was a beneficiary of that trust. The respondent disputes neither of these holdings. As discussed above, the guarantee deals with rights in the trust corpus. Therefore, in my view, it constitutes property of the trust. Thus, the first element of knowing receipt has been made out: the disputed property was subject to a trust in favour of the appellant.

57 The second part of the knowing receipt test requires the plaintiff to show that the defendant received property, in its own right, which was taken from him without authority. In this case, it is clear that the Bank took possession of the guarantee in its own right and not as an agent for a third party. With regard to whether or not the guarantee was given to the Bank in breach of trust, it is necessary to examine the circumstances surrounding the agreement. As noted above, Gold was a beneficiary of his grandfather's estate. The assets of the estate included the shares of Primary. Rosenberg was an executor of the estate. The trial judge found that Rosenberg owed a fiduciary duty to Gold under the Power of Attorney and also to him as a 50 percent beneficiary of the estate. The trial judge further found that, in giving the guarantee to the Bank, Rosenberg acted in breach of trust. In my view, deference is due to all of these findings of fact. Furthermore, I fully agree with Haley J.'s conclusions.

58 Rosenberg placed an encumbrance on the assets of the estate in order to secure a loan to himself. The transactions surrounding the guarantee benefited only Rosenberg and the Bank; they did not offer any benefit to the appellant. Indeed, the guarantee represented a subtraction from the value of the estate. This kind of self-dealing is a clear breach of trust. Accordingly, in my opinion, the respondent Bank received property which was taken from Gold in breach of trust.

59 Lastly, the appellant must show that there is no juristic reason for the respondent's enrichment. As the parties did not argue whether or not the Bank was a mere volunteer, I will not address that issue, assuming instead that the Bank did give value for the guarantee. Consequently, in the facts of this case, the appellant must demonstrate that the Bank did not acquire the property as a bona fide purchaser for value without notice. The question then becomes whether the circumstances were such as to place the Bank on inquiry.

60 In my view, the circumstances were sufficiently suspicious to give rise to an obligation on the part of the Bank to make reasonable inquiries to ensure that Rosenberg was not acting in breach of trust. In Barclays Bank plc v. O'Brien, [1993] 4 All E.R. 417, the House of Lords considered the circumstances in which a bank will have a duty to inquire when receiving a guarantee from the debtor's spouse. The House of Lords held that, where a woman enters into a manifestly disadvantageous transaction, and where there is a substantial risk that the husband has committed some equitable or legal wrong (i.e., undue influence or misrepresentation) in order to secure the woman's consent to the guarantee, the Bank is placed on its inquiry. It then must take reasonable steps to ensure that the wife's agreement to stand as surety has been properly obtained.

61 I note that Barclays Bank dealt specifically with circumstances where the debtor and the guarantor were husband and wife and cohabitees, as described by the court. However, the House of Lords indicated that a duty to inquire may also arise in the context of parent-child guarantees (at p. 431). The following comment by Lord Browne-Wilkinson suggests that a bank may have a duty to inquire in a broader range of circumstances (at p. 431):

> in a case where the creditor is aware that the surety reposes trust and confidence in the principal debtor in relation to his financial affairs, the creditor is put on inquiry in just the same way as it is in relation to husband and wife.

62 Further, a mortgage obtained from an employee to secure the debt of the employer and the business of the

employer was held to fall within the rule as developed in Barclays Bank even though the parties were not cohabitees or family members (Credit Lyonnais Bank Nederland NV v. Burch, [1997] 1 All E.R. 144, at p. 147).

63 In light of the foregoing, in my view, the present facts were sufficiently suspicious to put the Bank on inquiry. In reaching this conclusion, I rely particularly on the following facts:

(1) Kenneth Slack, the Toronto-Dominion account manager knew all of the relevant details of Abraham Rosenberg's will and of the estate, in which Rosenberg and Gold held equal interests.

(2) Slack knew that Gold left the management of the estate entirely to Rosenberg, and that Gold had in fact executed a Power of Attorney in favour of Rosenberg.

(3) As the account manager, Slack knew all of the details of the banking arrangements made by Rosenberg in July of 1989.

(4) As mentioned above, Slack knew that Gold had not yet signed the Directors' resolution authorizing the guarantee at the time that the loans were advanced to Trojan.

(5) Slack must have known that these dealings were to the advantage of neither the estate nor Gold. As the trial judge said (at para. 37):

> There can be no doubt that a banker with the experience of Mr. Slack . . . would have been very much aware that the financial position of the Estate Group had been altered to its disadvantage.... He knew that Gold's 50% interest in the estate was now at greater risk than it had been in November 1988 and he also knew that Rosenberg, acting under a Power of Attorney, was in a much better credit position than he had been before the consolidation.

64 These facts are sufficiently unusual to place the Bank on inquiry. It failed to take reasonable steps to ensure that the guarantee did not constitute a breach of trust. Accordingly, it is fixed with notice of the breach of trust.

65 The question which then arises is whether the Bank made sufficient inquiry or, alternatively, whether it received assurances which would have satisfied a reasonable person. In this respect, the respondent relies on the opinion letter sent by Sills, Madorin which stated that the guarantee complied with all legal requirements. However, in my opinion, this letter does not satisfy the Bank's obligation to make reasonable inquiry. My conclusion on this point is supported by the holding in Bertolo v. Bank of Montreal (1986), 57 O.R. (2d) 577 (C.A.). Mrs. Bertolo provided a promissory note and a mortgage on her house to the bank to secure her son's indebtedness. She was not fluent in English and she had little education. The bank required that she obtain independent legal advice and undertook to ensure that she received such advice. A partner to the lawyer who was acting for both the bank and Mrs. Bertolo's son advised Mrs. Bertolo; this advice satisfied the bank. The court held that the bank could not enforce the promissory note against Mrs. Bertolo since she did not understand the nature of the transactions nor the extent of her liability. The court stated that there was no fiduciary relationship as between the debtor and the bank, but that the bank (at p. 587):

> was aware, or ought to have been aware, that this woman had not had the benefit of independent legal advice with respect to a transaction which, from a business viewpoint, was manifestly disadvantageous to her.

66 In the present case, the Bank knew that the law firm was acting on behalf of all parties: it represented Rosenberg, Trojan, the estate and the estate companies. Therefore, it knew that the firm could not have given Gold independent legal advice with regard to signing the directors' resolution which authorized the guarantee. In my view, the opinion letter does not satisfy the Bank's "duty" to inquire. Accordingly, the Bank is fixed with notice of the breach of trust and, therefore, takes the guarantee subject to Gold's equity. For these reasons, in my view, the Bank cannot enforce the guarantee against Primary.

67 Before this Court, counsel for the respondent argued that imposing liability on the Bank in the present case would put an unreasonable burden on banks to ensure that every transaction which they facilitated did not involve a breach of trust. I do not agree. This responsibility will only arise in those circumstances where the Bank beneficially

receives property. In this respect, the Bank will be in the same position as that occupied by any person who receives property, a state of the law which seems eminently fair, in my view.

68 For all of these reasons, I would allow the appeal, set aside the judgment of the Court of Appeal, and substitute therefor an order to the effect that the $1.2 million guarantee shall be unenforceable as against Primary. I would make the foregoing order with costs here and in the Court of Appeal.

The judgment of Sopinka, McLachlin and Major JJ. was delivered by

SOPINKA J.

69 I have had the benefit of reading the reasons of my colleague, Iacobucci J., in this appeal as well as those of La Forest J. in Citadel General Assurance Co. v. Lloyds Bank Canada, [1997] 3 S.C.R. 805, released concurrently, with which I concur subject to my comments in these reasons. While I agree with Iacobucci J.'s approach to liability for knowing assistance, I have serious reservations with his conclusion that this is a knowing receipt case but, assuming it is, I cannot agree that the bank is liable for breach of its duty to inquire.

70 The case was presented in both the trial court and the court of appeal as a knowing assistance case. It was dealt with in those courts on that basis. The theory that it was a knowing receipt was raised in this Court. While, no doubt, we have the jurisdiction to do so, this Court is reluctant to allow a party to depart from the theory of liability as presented in the courts from which an appeal is taken. Assuming the issue should be entertained, I have difficulty believing that when a bank receives a guarantee supported by a collateral mortgage on trust property, it has received the trust property to its own use and benefit. The Oxford English Dictionary (2nd ed. 1989) provides the following principal definition of the verb to receive:

> To take in one's hand, or into one's possession (something held out or offered by another); to take delivery of (a thing) from another, either for oneself or for a third party.

71 In the context of knowing receipt cases, I would say that to receive trust property means, at a minimum, to take the trust property into one's possession. Possession here does not imply any form of ownership. It implies only physical control.

72 Does the bank receive the trust property into its possession simply because it holds a guarantee supported by a collateral mortgage on that property? I believe it does not. A guarantee is a contract whose performance is contingent on the default of the principal debtor: K. P. McGuinness, The Law of Guarantee (2nd ed. 1996), at pp. 318-19. See also Halsbury's Laws of England (4th ed. 1993), vol. 20, at pp. 56-65, 115-16, 123-24. The guarantor is liable to make good the debts of the principal debtor. If the guarantor supports the guarantee with a mortgage on real property, the creditor only enjoys, at best, a contingent interest in that property. The guarantee supported by the mortgage is no more than a contractual undertaking by the guarantor that, if the principal debtor defaults and the guarantor cannot make good the debt from his or her other assets, the creditor will receive the trust property. The mortgage is security for the performance of the contractual provision embodied in the guarantee.

The Bank Acted Reasonably

73 Even if this is properly viewed as a knowing receipt case, in my view the bank, knowing what it knew, acted reasonably in the circumstances. It therefore cannot be found liable and the appeal should be dismissed.

74 In order to establish that the respondent was in "knowing" receipt, the appellant must establish one of the following:

> (i) actual knowledge; (ii) wilfully shutting one's eyes to the obvious; (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make; (iv) knowledge of circumstances which would indicate the facts to an honest and reasonable man; (v) knowledge of circumstances which would put an honest and reasonable man on inquiry.

> Baden v. Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France SA, [1992] 4 All E.R. 161 (Ch.), at p. 235.

75 My colleague finds that the bank had knowledge on the basis of item (v), that is, knowledge of circumstances which would put an honest and reasonable person upon inquiry. What then was the knowledge that the bank had? The bank had knowledge of the following circumstances:

(1) Gold was content to leave the management of the estate to Rosenberg and had signed a general power of attorney in favour of Rosenberg to this effect.

(2) A guarantee along with a collateral mortgage was duly executed by Primary.

(3) The solicitor for the estate (selected by Gold and Rosenberg) and for the guarantor acted on the guarantee and formally attested to its validity by letter.

(4) The accountants for the estate and the guarantor gave financial advice with respect to the guarantee.

(5) Gold had signed a resolution as one of the directors of Primary in the office of Mr. Sills, a senior partner of the law firm representing the estate and the guarantor.

(6) Rosenberg's share of the estate was worth far in excess of the amount of the guarantee.

76 In my opinion, an honest person with knowledge of these facts would not have made further inquiries. Indeed, it is difficult to determine to whom such inquiries would be directed. As stated by Laskin J.A. (25 O.R. (3d) 601, at p. 610):

> Gold argues that the bank had a duty to go behind the resolution and the opinion letter to inquire about the fairness of the transaction. But inquire of whom? Presumably the lawyers and the accountants who acted on the transaction would have affirmed its fairness if asked. And the bank could reasonably assume that Gold would give the guarantee to help his uncle.

I would add that if Gold had been asked about the guarantee, he would hardly have questioned it in view of the fact that he signed the resolution. I agree with Laskin J.A. (at pp. 607-8) that at the time:

> . . . Gold knew what a guarantee was, he knew the reason for this guarantee and he knew the possible consequences of authorizing it. He was not misled about the purpose, the effect or the risk of giving his approval.

It was only later when circumstances changed that he questioned the guarantee. Inquiries to Gold would not, therefore, have alerted the bank to any facts which would have raised a doubt about the transaction.

77 As I read my colleague's reasons, he does not answer the question what would an inquiry have revealed but suggests that the bank should have insisted that Gold receive independent legal advice.

78 In certain circumstances, a third party in the position of the bank will not have discharged its duty to inquire unless the guarantor has been advised to obtain independent legal advice. In certain cases, the law imposes on a creditor a duty to inquire when the transaction is clearly detrimental to the person offering security and the relationship between that person and the principal debtor is particularly close. In such circumstances, the law presumes undue influence on the part of the principal debtor. The clearest type of relationship giving rise to this presumption is that of husband and wife. Iacobucci J. cites Barclays Bank plc v. O'Brien, [1993] 4 All E.R. 417, in which the House of Lords extended this presumption to include cohabitees. Lord Browne-Wilkinson held that when a creditor is approached by cohabitees, one the principal debtor and the other the surety, and the proposed transaction is clearly to the disadvantage of the surety, it will be under a duty to inquire. A creditor can discharge this duty by explaining to the surety in a meeting not attended by the principal debtor the amount of her potential liability and the risks involved and advising her to take independent advice: Barclays, supra, at pp. 431-32.

79 At one point in his reasons, Lord Browne-Wilkinson appeared to extend the duty beyond cohabiting couples when he characterized the kinds of relationships that will trigger the duty to inquire as follows, at p. 431:

> [I]n a case where the creditor is aware that the surety reposes trust and confidence in the principal debtor in relation to his financial affairs, the creditor is put on inquiry in just the same way as it is in relation to husband and wife.

When setting out the strict requirements of a separate meeting with the surety, however, Lord Browne-Wilkinson spoke of "the emotional pressure of cohabitation" (p. 431). Elsewhere, he spoke of how "the sexual and emotional ties between the [married] parties provide a ready weapon for undue influence" (p. 424). When a bank is presented with such a relationship, it should recognize the risk of undue influence (assuming that the transaction is on its face detrimental to the party offering security). But by the same logic, a relationship that is more distant will raise less suspicion of undue influence, even if the transaction is apparently unfavourable to the guarantor. Consequently, less may be required to satisfy an honest and reasonable person that the surety or guarantor is aware of the legal implications of the proposed transaction.

80 At the time that Gold signed the resolution he had three years of university education in which he had taken courses in business, economics and accounting. He was employed by the University of Western Ontario Student Council full-time as Manager of Entertainment and Productions. The purpose of the guarantee was explained to him by Rosenberg. The following sworn statement by Rosenberg was read in as part of Gold's case:

> In July of 1989 I advised Jeffrey that I was required by the Toronto-Dominion Bank to provide further security for the indebtedness of Trojan and that as I was unable to, quote, access, end of quote, my half interest in the estate at that time I requested that Primary guarantee Trojan's indebtedness in the amount of $1,200,000 which was to be secured by a collateral mortgage on 186 Columbia Street, a property owned by Primary. The reasons for the guarantee were fully disclosed to Jeffrey before he signed a resolution as director of Primary authorizing same.
>
> Since my fifty percent share of the estate was worth far in excess of $1,200,000, there was virtually no chance that the guarantee could possibly put Jeffrey's half interest in the estate at risk.

The statement that Rosenberg's share in the estate was worth far more than the guarantee was accurate at the time.

81 The guarantor, it must be remembered, was not Gold but Primary, a corporation whose shares formed part of the estate.

82 In these circumstances, I cannot accept that further explanation or legal advice was required and if it had been offered it would not have made any difference. I am confident that Gold would have found a "chat" with Mr. Slack quite superfluous. As for more legal advice, I am sure that if Gold thought independent legal advice was needed, he would have obtained it. He was aware that the solicitors for the estate also acted for his uncle and it was scarcely necessary for the bank to advise him that he could consult another lawyer if he wished.

83 A bank is only required to act reasonably in the circumstances. Corporate guarantees in situations in which the director of the corporation may be a beneficiary of a trust in relation to the shares of the corporation are common transactions. Is the bank obligated to advise each director, whose consent was necessary to obtain the guarantee, to obtain independent legal advice? I am of the opinion that, in the circumstances, advising Gold to obtain independent legal advice may be a counsel of perfection but goes beyond what is expected of an honest and reasonable banker. To quote Gibson J. in Baden, supra, at p. 268, this would impose "an impractically extensive duty of inquiry" on a bank which is otherwise acting reasonably.

84 My colleague refers to the decision of the Ontario Court of Appeal in Bertolo v. Bank of Montreal (1986), 57 O.R. (2d) 577. In that case, Mrs. Bertolo provided the bank with a promissory note and a mortgage on her house to secure a loan taken out by her son. The bank's policy required that she receive independent legal advice, but this, for various reasons, did not occur. When the son's business failed, the bank sought to enforce the guarantee. At trial and on appeal, Mrs. Bertolo succeeded in having the promissory note and mortgage declared void because

she did not fully understand the consequences of her actions. The bank could not enforce the guarantee because it had failed to ensure that she received independent legal advice.

85 In my opinion, Bertolo is of little assistance. One can explain the necessity for independent legal advice in that case by noting that Mrs. Bertolo was incapable without such advice of understanding any aspect of the transaction. I need only quote from the Court of Appeal's description of her (at p. 579):

> She has no business experience and little formal education. She is not fluent in English and . . . is unable to read and discern such documents as promissory notes, collateral mortgages and financial statements.

Whether or not someone requires independent legal advice will depend on two principal concerns: whether they understand what is proposed to them and whether they are free to decide according to their own will. The first is a function of information and intellect, while the second will depend, among other things, on whether there is undue influence. Leaving aside entirely the possibility of undue influence by her son, something which was never alleged, it is clear that, without independent legal advice, Mrs. Bertolo could not possibly have understood what she was agreeing to. The Ontario Court of Appeal held that Mrs. Bertolo ought to have had independent legal advice and that she did not get it, first, because the lawyer she met worked for the same firm that represented her son and the bank, and, second, because the nature and consequences of the transaction were not explained to her.

86 There is no comparison between Gold and Mrs. Bertolo and the circumstances of the two cases. Indeed, the contrast serves to illustrate the type of case in which independent legal advice is not a prerequisite.

87 I would dismiss the appeal with costs.

The following are the reasons delivered by

GONTHIER J.

88 While I agree with Iacobucci J. that this case is one of knowing receipt of trust property, I share the view of Sopinka J. that the Bank, knowing what it knew, acted reasonably in the circumstances. I concur with his reasons in this respect and his disposition of the appeal.

TAB 12

In the Court of Appeal of Alberta

Citation: Easy Loan Corporation v Wiseman, 2017 ABCA 58

Date: 20170213
Docket: 1601-0044-AC
Registry: Calgary

Between:

Easy Loan Corporation

Appellant
(Plaintiff/ Respondent)

- and -

Mike Terrigno

Not a Party to the Appeal
(Plaintiff)

- and -

Thomas Wiseman, Sandra Unger, Ken Unger, Larry Revitt, Shirley Revitt, Raymond Sampert, Margaret Sampert, Aggregate Recycling Ltd., John Davies, Fred Dowe, Carol Dowe, Resch Construction Ltd.

Respondents
(Applicants)

- and -

Base Mortgage & Investments Ltd., Base Finance Ltd., Arnold Breitkreutz, Susan Breitkreutz, Susan Way and GP Energy Inc.

Not Parties to the Appeal
(Defendants)

The Court:

The Honourable Mr. Justice Ronald Berger
The Honourable Madam Justice Patricia Rowbotham
The Honourable Mr. Justice J.D. Bruce McDonald

Memorandum of Judgment

Appeal from the Order by
The Honourable Mr. Justice K.D. Yamauchi
Dated the 8th day of February, 2016
Filed the 12th day of October, 2016
(2016 ABQB 77, Docket: 1501 11817)

Memorandum of Judgment

The Court:

[1] Base Mortgage & Investments Ltd., Base Finance Ltd., (collectively Base Finance) Arnold Breitkreutz, Susan Breitkreutz, Susan Way and GP Energy Ltd. are alleged to have operated a Ponzi scheme. Following an investigation by the Alberta Securities Commission, a bank account was frozen and a receiver appointed over the assets of Base Finance Ltd. The appellant and the respondents to this appeal were investors in the scheme. A chambers judge directed that the funds in the bank account be distributed according to a specific tracing scheme: *Easy Loan Corporation v Base Mortgage & Investments Ltd*, 2016 ABQB 77, 613 AR 384, (Order). The appellant appeals, contending that a different method of distribution ought to have been imposed.

[2] We dismiss the appeal.

I. Background

[3] The sole director and shareholder of Base Mortgage & Investments Ltd. and Base Finance Ltd is Arnold Breitkreutz. Base Mortgage & Investments Ltd. was incorporated in 1978 to carry on business as a mortgage broker. Base Finance Ltd. was incorporated in 1984 to carry on business as an investment company into which investor funds were deposited and distributed. Base Finance obtained money from investors, which it pooled. The investors were told that the monies would be loaned to borrowers who would provide Base Finance with mortgages on land in Alberta. The investors were to be the beneficial holders of the mortgages held in Base Finance's name. In most cases Base Finance would provide the investors with a document titled, "Irrevocable Assignment of Mortgage Interest". It named the investor, showed the amount that the investor provided to Base Finance, and itemized the terms of the mortgage into which the borrower was entering. It also indicated that the funds were pooled. The Irrevocable Assignment of Mortgage did not identify the mortgagor or the lands upon which the mortgage was placed.

[4] On September 24, 2015, after receiving a telephone call from the Royal Bank raising a concern about an account held by Base Finance, the Alberta Securities Commission commenced an investigation into an alleged $83.5M Ponzi scheme. Ponzi schemes were described in *R v Mazzucco*, 2012 ONCJ 333 at para 9, 101 WCB (2d) 651 as follows (with emphasis added):

> The hallmark of such a fraudulent scheme (named after the infamous speculator Charles Ponzi) is that investments claimed by the fraudster to have been made on behalf of investors are not in fact made. Instead… investors are given forged documents as evidence of non-existent security. The monies supposedly invested are not invested at all, but instead, in the typical Ponzi scheme, the swindled monies are siphoned off by the fraudster(s) for their purposes. Such schemes are kept afloat by making interest payments and returning principle upon request so that there is the appearance of legitimacy. Early investors are paid off with funds fraudulently raised from later investors.

[5] In addition to the investigation by the Securities Commission, there are other proceedings underway. On application by the appellant, Easy Loan Corporation, the court appointed a receiver (BDO Canada Ltd) over Base Finance's assets. The receiver reports that there were no underlying Alberta mortgages. The bulk of investor funds (over $80M) were invested in a U.S. company, Powder River Petroleum International Inc. which had filed for bankruptcy protection under Chapter 7 (Liquidation) of the United States Bankruptcy Code, 11 USC. In an effort to recover the loss, Arnold Breitkreutz continued to solicit investments from the Base Finance investor group in order to maintain the interest payments and principal redemption requirements of the investor group.

[6] One of the assets of Base Finance is an account at the Royal Bank. The account was opened on May 16, 2014 after the Bank of Montreal advised that it would not continue to accept funds into two accounts held by Base Finance. The account at the Royal Bank was frozen on September 25, 2015 with about $1.085M on deposit ("Frozen Funds"). When the receiver applied for the Frozen Funds to fund the receivership, some investors objected. Only as regards the Frozen Funds, the court directed that those investors claiming an entitlement should apply to the court to determine whether they were entitled to funds in the Frozen Account.

[7] The investors, Easy Loan and the respondents (about 20 of the approximately 240 Base Finance investors) argued that Base Mortgage held their invested "funds in trust for them": Reasons at para 1. The receiver opposed the applications and wanted those funds to cover the cost of the receivership: para 2. Before the chambers judge, the receiver took the position that a constructive trust was not appropriate because it would have the effect of elevating the position of some investors over others, and over other (non-investor) creditors. In its first report the receiver wrote that following the receiver's investigation into Base Finance, "at some point in the future, a claims process to determine the priorities of each creditor will be established ... and funds will be systematically distributed".

[8] The receivership is still in progress. The appellant applied to have the receiver's third report dated May 9, 2016 admitted as new evidence on appeal. The respondents did not object and we have admitted and reviewed the new evidence.

II. Chambers Decision

[9] The chambers judge impressed the Frozen Funds with a constructive trust. He cited *Soulos v Korkontzilas*, [1997] 2 SCR 217, 146 DLR (4th) 214 and held that the applicants met the *Soulos* conditions: para 51. As some of the chambers judge's findings of fact are relevant to the issue of tracing, we reproduce them here (with emphasis added):

> (a) They provided their investments to Base Finance based on representations that Base Finance made through Mr. Breitkreutz, that their investments would be used to fund mortgages and that their investments would be protected through security in the form of first mortgages on the properties that their investments were funding.

> Base Finance was not only under a legal obligation, but it was under an equitable obligation, to use (and secure) those funds in that manner. This meets condition 1 of the *Soulos* test.
>
> (b) The Applicants provided their investments to Base Finance on the understanding that Base Finance was the conduit through which the investments would flow through to the mortgagors. … This Court finds that Base Finance held itself out as the investors' agent in using their invested funds for loans that were to be secured by a mortgage for their benefit. In this way, Base was representing them in such a way as to be able to affect their legal position in respect of the various mortgagors. This meets condition 2 of the *Soulos* test.
>
> (c) Base Finance did not obtain any mortgages using the investors' money. **The investors' monies as they relate to the September RBC Statement, can be easily and clearly traced to the Bank Account.** Base Finance's banking records of the Bank Account, including the cancelled cheques, point to the individual investment amounts, and the timing of the deposits. As well, the parties and Ms. Pickering have produced the cancelled cheques for those deposits that show the date of the deposit into the Bank Account. Accordingly, this Court finds that the Applicants have a legitimate reason for seeking a proprietary remedy. The Receiver does not challenge this. This meets condition 3 of the *Soulos* test. (emphasis added)
>
> (d) The Receiver argues that the imposition of a constructive trust, as it relates to the September 2015 advances that the Applicants made would be unjust inasmuch as this elevates their claims over those of previous investors. This is a timing issue, which this Court will discuss later in these reasons. If this Court were to accede to the Receiver's argument, the funds in the Bank Account could be used by the Receiver for purposes other than the payment to the investors. This would be unjust. This Court finds that there are no factors that would render the imposition of a constructive trust of the Applicants' investments unjust, as the whereabouts of those investments are contained in the Bank Account, and their respective deposits can be readily identified. This meets condition 4 of the *Soulos* test.

[10] Next, the chambers judge determined the method to distribute the Frozen Funds. He considered three possible tracing schemes. He quickly rejected the first (the rule in *Clayton's Case*) and no complaint arises in that regard.

[11] Easy Loan and the receiver contended the Frozen Funds should benefit all those wronged by the unlawful scheme in proportion to their investment with set-off for amounts already recouped, whereas the respondents said method three (see below) should apply.

[12] The chambers judge explained the second two methods at para 55:

> (2) *Pro rata* or *pro rata ex post facto* sharing based on the original contribution that the various claimants made, regardless of the time they made their contributions. If there is a shortfall, between the amount the claimant's claim and the amount remaining in the account, the claimants share proportionately, based on the amount of their original contribution;
>
> (3) *Pro rata* sharing based on tracing or the lowest intermediate balance rule ("LIBR") which says that a claimant cannot claim an amount in excess of the lowest balance in a fund subsequent to their investment but before the next claimant makes its investment.

[13] The chambers judge held that the third method was the "general rule", if workable. He held that "calculating entitlement to the Bank Account might be considered by some to be inconvenient and moderately complex. It is not, however, impossible to do the calculations. Inconvenience should not stand in the way of fairness": para 71. The chambers judge concluded set-off was not appropriate.

[14] One of the respondent's lawyers calculated each claimant's entitlement. The entitlements ranged from $480,832.89 (paid to the investor who deposited $500,000, the final deposit in September the day before the account was frozen) to $46.20 paid to an investor who made his deposit of $100,000 three months earlier, in June. As is apparent, the distribution method chosen does not reflect a simple proportional approach: the late September investor recovered significantly more (proportionately) than the June investor. Because all of Easy Loan's investments were made prior to June, 2015, it received $309.95 of the $5.7 million it had invested.

[15] The Order also includes a distribution to Base Finance because it contributed to the Frozen Funds. Those funds were paid into court pending further direction.

[16] The calculations were incorporated into the Order, which also included the following: "The Application by the Receiver for an Order directing that the [Frozen Funds] be vested in the Receiver is hereby denied:" para 2. We draw attention to this paragraph because it puts to rest the receiver's contention that its application had yet to be heard.

III. Grounds of Appeal and Standard of Review

[17] It is important to emphasize that there is no appeal of the chambers judge's imposition of the constructive trust. No notice of appeal was filed by the receiver and counsel for the receiver confirmed at the hearing of the appeal that there was no appeal of that finding.

[18] The benefit of the proprietary remedy of a constructive trust is best illustrated by its impact on the assets available for distribution in the bankruptcy context. Although this is a receivership, similar considerations may apply. Section 67(1)(a) of the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 states: "The property of a bankrupt divisible among his creditors shall not comprise

property held by the bankrupt in trust for any other person". And, when property subject to a constructive trust is removed from the estate of the bankrupt, it is "effectively trumping the priority scheme under the bankruptcy legislation": *306440 Ontario Ltd. v 782127 Ontario Ltd. (Alrange Container Services)*, 2014 ONCA 548 at para 24.

[19] Accordingly, and despite the fact that the receivership was at an early stage when the Order was made, the Frozen Funds are now outside the receivership.

[20] The sole ground of appeal is in relation to the methodology used to trace the Frozen Funds. The appellant submits the chambers judge erred in law by holding that a *pro rata* sharing on the basis of tracing to the lowest intermediate balance in the account is the 'general rule' unless it is practically impossible, and that the chambers judge failed to consider the intention of the beneficiaries to hold commingled funds as co-owners in the mortgage investment.

[21] A careful reading of *Boughner v Greyhawk Equity Partners Limited Partnership (Millenium)*, 2013 ONCA 26 leads to the conclusion that determining the proper tracing method is a question of law and therefore the correctness standard of review applies (paras 7-9), whereas the palpable and overriding error standard applies to calculations, which are questions of fact: paras 10-11.

IV. Analysis

Preliminary Matters

[22] To minimize confusion, these reasons use the term "mixed fund" to mean an account that contains both trust funds (i.e., funds impressed with an express or a constructive trust) and non-trust funds: see generally, *Brookfield Bridge Lending Fund Inc. v Karl Oil and Gas Ltd*., 2009 ABCA 99 at paras 11, 13 and 15, 454 AR 162. Non trust funds include the wrongdoing fiduciary's own funds and those of other non-beneficiaries, for example, creditors. Commingled means the assets subject to the trust are indistinguishable.

Tracing Rules

[23] On the findings of the chambers judge, Base Mortgage was under an equitable obligation in relation to the activities that gave rise to the Frozen Funds, and the Frozen Funds resulted from its breach of those equitable obligations. Equitable tracing principles govern the distribution of the Frozen Funds.

Mixed Fund

[24] The Order reflects a distribution to Base Mortgage associated with its contribution to the Frozen Funds: paras 8-9. Ordinarily this would engage different tracing principles (including the

rule from *Re Hallett's Estate* (1879), 13 Ch D 696 (see *Brookfield* at para 13) because other considerations apply to so-called "mixed" funds.

[25] *Brookfield* states at para 15 (citations omitted, square brackets in original):

> A trustee mixes his own money with trust money; he withdraws money from the mixed fund, dissipates some of it and then deposits more money into the mixed fund. Subsequent deposits of the fiduciary into the mixed fund are not presumed to be impressed with the trusts in favour of the beneficiary. … Consequently if the trustee is insolvent, that part of the mixed fund, equal to the amount paid in, will normally pass to the trustee's general creditors. The beneficiary will be entitled to additions to the mixed fund only if he can prove that thereby the trustee intended to make restitution to the trust. It follows that the trust is entitled only to the lowest intermediate balance of the mixed fund. So, if the fund is wholly dissipated before any additions are made to it, the interest of the trust in the mixed fund is extinguished. Professor Scott has justified this result on the ground that "the real reason for allowing the claimant to reach the balance [of the mixed fund] is that he has an equitable interest in the mingled fund which the wrongdoer cannot destroy as long as any part of the fund remains; but there is no reason for subjecting other property of the wrongdoer to the claimant's claim any more than to the claims of other creditors merely because the money happens to be put in the same place where the claimant's money formerly was, unless the wrongdoer actually intended to make restitution to the claimant. …

[26] The chambers judge made no mention of the fact that the fund was "mixed", and he did not apply the applicable tracing rules that originated with *Re Hallet's Estate*.

[27] Notwithstanding that and paragraphs 8 and 9 of the Order, no appeal is taken on that issue. When counsel was questioned at the hearing, we were advised that all the Frozen Funds were from investors for whose benefit the constructive trust was declared, not from others (including creditors). We therefore proceed as though no non-trust assets were mixed with those of the beneficiaries of the constructive trust.

Tracing Rules and Principles

[28] Three methods are available to trace commingled trust assets on deposit in a bank account. They are: (i) the rule in *Clayton's Case*; (ii) the lowest intermediate balance rule, also referred to as "*pro rata* on the basis of tracing", the "North American method", "rolling charge method" or "LIBR" ("LIBR"); and (iii) the *pro rata* approach, also referred to as the "basic *pro rata* approach", "*pro rata ex post facto*" or "*pari passu ex post facto*" ("Proportionate Distribution").

[29] The following general equitable principles apply.

[30] First, "modern [tracing] rules ... have been ... altered, improved, and refined from time to time": *Re Hallett's Estate* at 710 *per* Jessel MR. And, "equity's ... flexible remedies such as constructive trusts, ..., tracing ... must continue to be moulded to meet the requirements of fairness and justice in specific situations": *Canson Enterprises Ltd. v Boughton & Co*., [1991] 3 SCR 534, 85 DLR (4th) 129 at 538. The significance of this principle will be apparent shortly, in the context of the applicability of the rule in *Clayton's Case*.

[31] Second, the overarching goal of equity is "to serve the ends of fairness and justice": *Canson* at 586 *per* LaForest J. When tracing into a commingled bank account that contains only trust funds, fairness of distribution is paramount. Balanced against fairness is a more pragmatic consideration: practicality and workability. "A rule that is in accord with abstract justice but which, for one or more reasons, is not capable of practical application, may not, when larger considerations of judicial administration are taken into account, be a suitable rule to adopt": *Ontario (Securities Commission) v Greymac Credit Corp* (1986), 55 OR (2d) 673, 17 OAC 88 at para 48, affirmed [1988] 2 SCR 172.

The Rule in *Clayton's Case*

[32] The Rule in *Clayton's* Case, also known as the "first in, first out" rule deems that funds deposited first into a commingled account are also the first funds withdrawn. The rule has been called "unfair, arbitrary, and based on a fiction": *Boughner* at para 81; see also *Greymac*.

[33] In Alberta, *Re Elliott (Legal Profession Act)*, 2002 ABQB 1122, 333 AR 39 rejected the rule in *Clayton's Case*. Case law from this court states that the rule in *Clayton's Case* is the "general" rule: *Sawchuk v Bourne*, 2005 ABCA 382, 144 ACWS (3d) 12; *Kretschmer v Terrigno*, 2012 ABCA 345, 539 AR 212 at para 93 *per* Slatter JA in dissent but not on that point.

[34] However, given the equitable tracing principles set out above and the parties' agreement that the rule in *Clayton's Case* did not apply in the present circumstances, we proceed on the basis that the rule in *Clayton's Case* has no application here. This leaves two other distribution methods.

Proportionate Distribution

[35] Proportionate Distribution divides the final balance in the commingled account in proportion to each claimant's original contribution to the fund. In other words, contributors share the shortfall in the account. An open question is whether set-off should apply against an investor's contribution as a result of funds the investor received from a return on capital, dividends, bonuses, etc. Given our conclusion that this is not the tracing method to use in these circumstances, there is no need to address set-off.

[36] Intermediate balances (see below) are not taken into account. See generally, Christian Chamorro-Courtland, "Demystifying the Lowest Intermediate Balance Rule: The Legal Principles

Governing the Distribution of Funds to Beneficiaries of a Commingled Trust Account for Which a Shortfall Exists", 30 BFLR 39 (Nov 2014) at 42.

LIBR

[37] LIBR considers each beneficiary's contribution to the commingled account and the lowest balance in the account after each beneficiary's contribution. Simply put each beneficiary loses the ability to trace (and therefore claim) its contribution once the funds in the account drop below the amount of the beneficiary's contribution (deposit).

[38] A simple example: if X deposits $100 to a commingled account and the balance in the account later drops to $5, the most X can claim is $5, the lowest balance in the account; the ability to trace to anything more than $5 is lost because anything more comes from a funding source other than X. "Intermediate" refers to the period between X's contribution and when X makes the claim against the account. Once the lowest intermediate balance is determined for each beneficiary, each beneficiary is entitled to claim only the lowest balance's proportional share of the final balance of the account.

[39] *Law Society of Upper Canada v Toronto-Dominion Bank* (1998), 42 OR (3d) 257, 116 OAC 24 ("*LSUC*") at para 14 explains:

> a claimant to a mixed fund cannot assert a proprietary interest in that fund in excess of the smallest balance in the fund during the interval between the original contribution and the time when a claim with respect to that contribution is being made against the fund.

[40] It is self-evident that calculating the lowest balance in the account for each beneficiary's contribution is not workable or practical if the commingled account has many contributors, supporting records are unavailable or incomplete or the timeframe in question is lengthy. These problems do not arise in this case.

[41] Indeed, the proof is in the pudding. Counsel for one of the respondents calculated the lowest intermediate balance for each beneficiary and the proportion that each balance comprised of the Frozen Funds, all to the satisfaction of the chambers judge who personally signed the Order. No respondent disputes the amount.

Tracing Cases

[42] The leading tracing cases involving shortfalls in a commingled account are from Ontario. The first in time is *Greymac*, followed by *LSUC*, *Re Graphicshoppe* and finally, *Boughner*. The Supreme Court approved *Greymac*. In *Greymac* all the funds were trust funds although there were at least two trusts. In *LSUC* the fund was mixed and included the lawyer's clients' funds (trust funds) and a creditor's funds (Toronto Dominion Bank). In *Graphicshoppe* the account included

what were once trust funds (pension plan contributions) but their trust fund characterization was lost when the account to which they were paid became overdrawn, and therefore the trust funds could no longer be traced.

[43] Only *Boughner* involved a Ponzi scheme and an account that was not mixed, i.e., 100% trust funds.

[44] The court in each case rejected the rule in *Clayton's Case* so the central issue became whether Proportionate Division or LIBR should be used to distribute the funds.

[45] Much has been written (in support and otherwise, academically and by judges in subsequent cases) about all these cases but for present purposes it is only necessary to discuss their legal propositions. By way of preview, the guiding principle is that courts should "apply the method which is the more just, convenient and equitable in the circumstances": *LSUC*. And, there appears to be little doubt that LIBR (even if not applied) is the fairest rule but also the most difficult to apply in practice because of the detailed calculations it requires.

Greymac

[46] In reasons later adopted by the Supreme Court, Morden J.A. held that LIBR was the "general" rule: para 45. He accepted that it might be unworkable in some situations because of the complexities associated with calculating the lowest balance applicable to each contributor: paras 45-48. Morden JA also acknowledged another exception: if the claimants expressly or by implication intended to distribute on some other basis, including Proportionate Distribution: paras 48-50.

[47] This Court recognized *Greymac* as authority for a general rule of LIBR. *Brookfield* at para 13 held that the "claim of the beneficiaries is *prima facie* limited to the lowest intermediate balance in the account".

LSUC

[48] The court should "seek to apply the method which is the more just, convenient and equitable in the circumstances": para 31. The *LSUC* court agreed that LIBR was "manifestly fairer" but also recognized the complexity of calculating it: para 32.

[49] The court held that LIBR was too complex and impractical to adopt as a general rule "for dealing with cases such as this" (over 100 claimants and multiple withdrawals and contributions). Instead, the basic *pro rata* approach (i.e., Proportionate Distribution) was preferable because of its relative simplicity.

[50] The court also held that it "is always open to a trust contributor to gain protection from having to share a shortfall with others by insisting upon the funds being placed in a separate trust

account": para 27. In short, there was agreement with *Greymac* that beneficiaries could contract out of the general rule or other tracing rules.

[51] *Re Elliott* followed *LSUC* and ordered a Proportionate Distribution of funds from a lawyer's trust account which had a shortfall: para 47.

Re Graphicshoppe

[52] Unlike *Greymac* and *LSUC*, the impugned account included deposits other than those made by innocent beneficiaries. And, after the beneficiaries made their final contributions, the lowest balance of the account was (at one point) negative. This meant the beneficiaries lost their ability to trace their funds: para 120. "While this may seem harsh, it must be remembered that in the commercial context and particularly in the realm of bankruptcy, innocent beneficiaries may well be competing with innocent unsecured creditors for the same dollars. This raises policy considerations which the courts in *Greymac* and *LSUC* did not have to face": para 130.

[53] Moldaver J.A. (for the majority) also distinguished *LSUC* and *Greymac* on other grounds: para 124. He noted that "in the present case" it was still necessary to determine "if any or all of the funds in the bankrupt's bank account at the date of bankruptcy were trust funds". And, at para 126:

> At this preliminary stage, we are not concerned about calculating the amount each beneficiary may claim from the trust funds, if it turns out that some such funds do in fact exist. Instead, we are simply trying to determine what, if any, of the money in the Graphicshoppe's bank account at the date of bankruptcy was trust money and therefore did not belong to it.

[54] Here the chambers judge did impose a constructive trust over the Frozen Funds despite the fact that the receivership was still (as in *Graphicshoppe*) at a preliminary stage.

Boughner

[55] *Boughner* involved a Ponzi scheme; the question at trial was which distribution method (Proportionate Distribution or LIBR) should be used. A sub-issue was whether the case law dictated a "general" rule. The Court held that LIBR was the general rule, and *LSUC* could be explained by the complexity of the LIBR calculations in that case: paras 7-9.

[56] Neither the trial decision nor the Court of Appeal make reference to whether set-off is appropriate for interest and return of capital.

Conclusion on Tracing Rules

[57] LIBR is the general rule for allocating funds among innocent beneficiaries when there is a shortfall in a trust account or in an account that has been impressed with a constructive trust by

operation of law. There are two exceptions: LIBR is unworkable or the beneficiaries expressly or impliedly intended another method of distribution.

[58] As already concluded, the "unworkable" exception does not apply because the Order demonstrates that LIBR is, in fact, workable. That leaves discussion of the investors' intentions.

Intention of the Parties

[59] Was there evidence of any intention by the beneficiaries about how the funds were to be distributed in the event of a shortfall? *Greymac* states at para 53: "Another exception, an obvious and necessary one ... would be the case where the court finds that the claimants have, either expressly or by implication, agreed among themselves to a distribution based otherwise than on a *pro rata* division following equitable tracing of contributions.". Blair J. also noted that it "is always open to a trust contributor to gain protection from having to share a shortfall with others by insisting upon the funds being placed in a separate trust account.": *LSUC* at para 27 . Finally, in *Demystifying the Lowest Intermediate Balance Rule*, *supra*, Chamorro-Courtland wrote at 66-67 (emphasis in original):

> In summary, consideration must first be given to the express or implied contractual *intention* of the beneficiaries in the case of a shortfall in a commingled trust fund; the beneficiaries may opt for any distribution method that satisfies their business needs.
>
> If the contract is silent as to the method of distribution, the presumed intention, as the general rule, should be that the beneficiaries intended to segregate their funds and use LIBR. This is the presumption even in cases where the parties have opted to commingle their funds in an omnibus account, as it is possible to legally segregate the funds...

[60] In summary, nothing in the evidence suggests that the investors intended there be any particular distribution method, therefore absent anything more, LIBR applies.

Funds Commingled

[61] It appears from the investors' affidavits that they knew their investments would be pooled or commingled. For example, one affiant deposed he "understood ... [that] Base would obtain investments from individuals like myself that would be pooled by Base, and then loaned by Base to borrowers who would provide Base with mortgages on real estate": Wiseman Affidavit (with emphasis). Another stated: "My wife and I understood that Base Mortgage was merely acting as an intermediary in the proposed transaction, in order to pass the accumulated pool of mortgage funds through to the mortgager": Revitt Affidavit (with emphasis).

[62] However, the parties' contract also specified that:

> 2. … Should the lender request any portion or the entire amount of the investment back prior to the due date without proper written notice, the assigned bonus, if any, and/or the interest shall not be due or payable… by the borrowers and the assignment may be renewed at the borrower's option.

[63] In other words, the contract appears to contemplate something less than full pooling or commingling because the investor beneficiaries are entitled to request a return of their capital at a time of their choosing or, in any event, at the maturity date of their investment. This suggests an element of segregation.

[64] The only document from which the court might discover the intention of the investors is the Irrevocable Assignment of Mortgage Interest. It is a contract between Base Mortgage and the investor, defined as "lender". There is also reference to an undefined and unnamed "borrower" who is obviously not a party to the contract. Also undefined and unnamed are the "demised premises" referred to in clause 3. Of interest are clauses 3 and 4 (with emphasis):

> 3. It is further agreed that the lender shall indemnify and save harmless Base from any and all claims and demands against Base with respect to the assigned portion of the mortgage. <u>The lender agrees that its sole remedies with respect to default by the borrowers shall be against the demised premises and the borrowers</u>.
>
> 4. It is understood that Base and the lender are not partners or joint venturers … and nothing contained herein shall be construed so as to make them partners or joint venturers <u>or impose any liability as such on either of them</u>.

[65] Nothing can be gleaned from this document about the investors' intentions as to which distribution method to use.

[66] In summary, there is nothing to suggest that the investors considered the question of how a shortfall in the commingled funds would be distributed among the investors, and therefore the general rule, LIBR, is not displaced.

V. Conclusion

[67] The chambers justice applied LIBR. The cases say this is the fairest rule absent two exceptions (unworkability or the contrary intention of the beneficiaries) which we have concluded do not apply.

[68] We leave the question of whether set-off should apply in the context of a Ponzi scheme for another time. The issue in this appeal is narrow given the imposition of the constructive trust which, as noted, is not appealed. However, had all the assets of Base Mortgage formed part of the traceable pool of assets, set-off may have been an appropriate consideration.

[69] The appeal is dismissed.

Appeal heard on December 6, 2016

Memorandum filed at Calgary, Alberta
this 13th day of February, 2017

As authorized to sign for: Berger J.A.

Rowbotham J.A.

McDonald J.A.

Appearances:

C.M.A. Souster and P. Higgerty, Q.C.
for the Appellant

R.N. Billington, Q.C.
for the Respondent BDO Canada LTD

P. Mahoney
for the Respondent Larry Revitt and others

D. Hutchison and M. Kheong
for the Respondent Thomas Wiseman and others

TAB 13

Date of Release: January 22, 1992 No. C917938
Vancouver Registry

IN THE SUPREME COURT OF BRITISH COLUMBIA

BETWEEN:	REASONS FOR JUDGMENT
J-V IMPORT CO. LTD.	OF THE HONOURABLE
PETITIONER	MR. JUSTICE SPENCER
AND:	(IN CHAMBERS)
DELOITTE & TOUCHE INC. and CANADIAN IMPERIAL BANK OF COMMERCE	
RESPONDENTS	

Counsel appearing for the petitioner: Stephen R. Ross

Counsel appearing for the respondent Deloitte & Touche Inc.: Benjamin J. Ingram

Place and date of hearing: Vancouver, B.C. January 20, 1992

The petitioner seeks a declaration of entitlement to funds in the hands of the respondent trustee which acts in the bankruptcy of a partnership known as Wing Wah Company. The other respondent, Canadian Imperial Bank of Commerce, is no longer interested in the outcome of proceedings and was not represented. Counsel agreed to treat this hearing as the final determination of the rights to the funds in question as between the petitioner and the trustee.

The necessary facts of the case are as follows. The petitioner was the supplier of certain goods to Shoppers Drug Mart at various of its retail stores. The evidence of Stephen Ingvaldson and Charles Ingvaldson, officers of the petitioner,

shows that it entered an arrangement with Wing Wah Company under which the latter would collect the petitioner's accounts receivable from Shoppers Drug Mart's various stores on its behalf and remit the proceeds to the petitioner after deducting a 5% fee for its services. The way in which the arrangement was carried out was that the petitioner would deliver its goods to the Shoppers Drug Mart stores against purchase orders from those stores and send its invoice to Wing Wah Company for the value of the goods with a copy of the invoice going to the particular Shoppers Drug Mart store. Wing Wah Company would then invoice the Shoppers Drug Mart store itself, attaching to its invoice a copy of the petitioner's invoice. The store would then pay Wing Wah Company which would in turn pay the petitioner after deducting the 5% fee. Under the arrangement, Wing Wah's invoice to the Shoppers Drug Mart store was payable within 21 days but the petitioner's invoice to Wing Wah Company was payable after 30 days. Thus the arrangement seems to have envisaged that Wing Wah should receive money from Shoppers Drug Mart before it paid money to the petitioner.

The evidence of Charles Ingvaldson was that he made the arrangement with Wing Chu, a principle of Wing Wah Company, and that part of the arrangement, all of which was oral, was that Wing Wah Company would not be required to pay the petitioner anything owing on a particular invoice until it in turn had collected the money from Shoppers Drug Mart. It is true that the petitioner's invoices to Wing Wah Company carry a notation showing that late payments are subject to interest at 2½% per month. However, the affidavit evidence of Charles Ingvaldson is that nothing was

payable by Wing Wah Company to the petitioner until monies were collected from Shoppers Drug Mart and there is no evidence to contradict that. In particular, Wing Chu is no longer in Canada and has declined to cooperate with the trustee in bankruptcy. The invoice forms sent by the petitioner to both Shoppers Drug Mart and Wing Wah Company are a pre-printed form containing a standard provision that interest is chargeable on overdue accounts. Such a term is not enforceable unless it is found to represent the arrangement contracted for between the parties. It is possible that the form was used between the petitioner and Wing Wah Company without any thought being given to its suitability to the arrangement they had reached between them. In the absence of any contradictory evidence, I accept the affidavit of Charles Ingvaldson. I note that there is no suggestion of any formal assignment of monies owing by Shoppers Drug Mart to the petitioner in favour of Wing Wah Company nor any evidence to indicate the transfer of property in the goods supplied from the petitioner to Wing Wah Company. All the evidence points to a direct transfer of property in the goods from the petitioner to Shoppers Drug Mart.

The petitioner's position is that Wing Wah Company was simply an agent on behalf of the petitioner for the collection of its accounts for a fee. Some commercial justification for that arrangement is suggested in Charles Ingvaldson's affidavit.

The question at bar arises with respect to monies receivable from Shoppers Drug Mart for goods supplied by the petitioner which was still unpaid at the time of Wing Wah Company's bankruptcy. The

petitioner claims that the bankruptcy terminated Wing Wah's agency and that the accounts belong to it. The respondent trustee in bankruptcy claims them as the property of Wing Wah Company and alleges that the petitioner is merely an unsecured creditor in the bankruptcy.

I accept the interpretation of the facts which is proposed by the petitioner. It is supported, in my opinion, by the fact that the petitioner remained liable to Shoppers Drug Mart under the terms of contract included in each purchase order for goods. It is further supported by the fact that where goods were returnable by Shoppers Drug Mart for proper cause, they were returned directly to the petitioner and not to Wing Wah Company. The petitioner would issue a credit note to the store and notify Wing Wah Company to adjust its collection records by the amount of the credit note. That evidence satisfies me that there was never any transfer of property in the goods to Wing Wah. Nor, as I have pointed out, is there any evidence of an assignment of the accounts to it. Had Wing Wah itself sued for the collection of the accounts it would have failed on the basis it could prove no right to them. Any action to collect them would have had to have been brought by the petitioner.

On that state of facts, the petitioner relies upon a series of old cases to support its proposition that where an agent is authorized to collect money on behalf of a principle but the agent becomes bankrupt before the money is received, no property in the account passes to the trustee in bankruptcy. That is the law as

illustrated by the following cases. In *Giles vs. Perkins* (1807) 9 East 12, the plaintiff delivered unmatured bills of exchange to its bank for collection. The bank became bankrupt before the bills matured and without them being discounted or any credit allowed upon to them to the plaintiff in any way. The trustee in bankruptcy claimed the proceeds of the bills when they became due but Lord Ellenborough C.J. held in favour of the plaintiff, the bank's customer, that the proceeds belonged to it. In my opinion, the fact that the bankrupt party there was a bank makes no difference to the result of the case. That bank was as much an agent for collection as was Wing Wah Company in this case. In this case however, there is evidence that on a number of occasions Wing Wah Company in fact paid the amount of the invoices, less the 5% fee, to the petitioner before it collected them from Shoppers Drug Mart. If that applies to any of the amounts owing on the invoices here then those separate amounts would, under the authority of *Giles vs. Perkins*, have become the property of Wing Wah Company. Counsel did not suggest that there had been a prepayment on any of the subject invoices but, if that is the case, then the amounts due on those specific invoices would pass to the trustee as the property of the bankrupt.

In *Tennant vs. Strachan* (1829) (4) C.P. 31, the petitioner delivered unmatured bills to its banker for presentment when due. Again the banker became bankrupt. The judgment of Lord Tenterden C.J. is to the effect that where no monies had been collected on the bills before the bankruptcy, they remained the property of the plaintiff and the trustee had no right to claim the proceeds

collected after the bankruptcy. To the same effect is a more recent case, *Farrow's Bank, in Re Lim* (1922) Ch. Div. 153. It again is a case involving the bankruptcy of a bank. Its customer had delivered to it a crossed cheque for collection and before collection was complete the bank became bankrupt. The proceeds were held not to be the property of the trustee in bankruptcy on behalf of the creditors but the property of the customer.

That conclusion is supported also by *Solloway vs. Johnson, Trustee in Bankruptcy* [1934] 2 D.L.R. 241 (P.C.). That was an appeal from this province. It involved the bankruptcy of the Frontier Company, a stockbroker which, on behalf of its clients, used the services of Solloway, another broker, to trade on the Vancouver Exchange. At trial and on appeal, Frontier's trustee in bankruptcy was awarded damages for conversion by Solloway of money paid to it by Frontier on behalf of its clients for the purchase and sale of shares. The Privy Council however held that once the Frontier Company became bankrupt, it ceased to have any interest in monies owing by Solloway except as a bare trustee on behalf of its own clients. At p.250 Lord Blanesburgh put it this way:

> "Accordingly it is hardly possible to support the judgment of the trial judge for the figure contained in it. With its bankruptcy all authority of the Frontier Co. as agent came to an end, and in relation to any question arising out of any transaction - certainly any closed transaction - the two contracting parties, Frontier's client and the Solloway Co., thereafter stood face to face. And be it observed that this is in no way met by conceding to Frontier's clients a right of proof in the bankruptcy in respect of any money of theirs paid to the trustee under the judgment. These clients have no more claim against Frontier's general assets in respect of these moneys than have Frontier's general creditors any right to participate in them. In the same way these monies when recovered can never properly become general assets in the bankruptcy. They would constitute a

> separate trust fund for the benefit of Frontier's different clients, who in the first instance provided them. All of which is another way of saying that even if they might have been recoverable by the Frontier Co. before its bankruptcy no title to sue for them ever vested in the plaintiff as trustee in that bankruptcy."

I am unable to see any difference between what the Privy Council said there about the recoverability of monies advanced, and the facts of the present case where the subject matter is a series of accounts for monies which stand in the place of goods delivered by the petitioner to the Shoppers Drug Mart stores. All those cases support the first ground upon which the petitioner claims the amounts which were due but unpaid for shipments of goods it made to Shoppers Drug Mart, the accounts for which it had delivered to Wing Wah Company as its agent for collection.

In answer to this line of argument advanced on behalf of the petitioner, counsel for the respondent cited no case authorities but took the position that the fact of the bankruptcy could not alter the debtor-creditor relationship already established between them. Based upon the evidence of Stephen Ingvaldson and Charles Ingvaldson, I have found that there was no such debtor-creditor relationship but that Wing Wah Company was simply an agent to collect these accounts. That finding makes it unnecessary for me to deal with the respondent's major argument that the evidence of what was agreed between the petitioner and the Wing Wah Company did not impress any trust upon the monies actually received by the latter on behalf of the petitioner. That argument, and the cases mentioned in support of it, would have relevance only to the question of what should be done with monies actually

collected and has no bearing upon the ownership of monies which were not in Wing Wah Company's hands when it became a bankrupt. Nor is it necessary to deal that the petitioner's secondary argument that the respondent is a constructive trustee based upon the doctrine of unjust enrichment.

There will be a declaration that the petitioner is entitled to those funds in the amount of $68,346.98 comprising various accounts receivable owing by Shoppers Drug Mart stores for goods supplied by the petitioner, whose collection was undertaken by Wing Wah Company as agent for the petitioner but which accounts had not been paid to the agent at the time of its bankruptcy. The petitioner is entitled to its costs.

"Spencer, J."

Vancouver, B.C.
January 22, 1992

TAB 14

Her Majesty the Queen in Right of Ontario as Represented by the Minister of Training, Colleges and Universities v.Two Feathers Forest Products LP et al.

[Indexed as: Ontario (Minister of Training, Colleges and Universities) v. Two Feathers Forest Products LP]

Ontario Reports

Court of Appeal for Ontario,

Feldman, Lauwers and Strathy JJ.A.

October 2, 2013

117 O.R. (3d) 227 | 2013 ONCA 598

Case Summary

Trusts and trustees — Trusts — Quistclose trust — Ministry advancing grant moneys to limited partnership to provide skills training in two proposed plants — Grant moneys which were not spent before appointment of interim receiver not subject to Quistclose trust for benefit of ministry — Parties not intending that partnership would hold funds in trust for ministry — Funding agreement specifically providing that any unused funds would constitute debt owing to ministry — Agreement giving partnership considerable freedom to use majority of funds.

The ministry granted funds to a First Nations limited partnership to provide skills training in two proposed plants. Ultimately, two of the limited partners applied to dissolve the partnership and an interim receiver and manager was appointed. On an application by the receiver, the application judge found that grants which were not spent before the receiver was appointed were subject to a *Quistclose* trust for the ministry's benefit and ordered the receiver to pay those moneys to the ministry. The receiver appealed.

Held, the appeal should be allowed.

The requirements for a *Quistclose* trust were not met. On the issue of the intention to create a trust, it is not the subjective intention of the lender or grantor that governs but the intention of the two parties, discerned from the terms of the loan or grant. In this case, an examination of the terms of the funding agreement showed that the parties did not intend that the partnership would hold the funds in trust for the ministry. The funding agreement specifically provided that any unused funds constituted a debt owing to the ministry. Moreover, under the funding agreement, while specific funds were designated for the actual costs of training, the partnership had significant freedom to use the majority of the funds. Finally, the circumstances of the grant transaction in this case did not have many of the characteristics that caused a trust to be found in either of the two seminal cases on *Quistclose* trusts. It was not a situation where the limited partnership needed immediate funding to stave off bankruptcy; the funds were not needed to make a specific payment to a group of creditors or to make a specific purchase but were

obtained as a basic source of business funding for a [page228] long-term project; and the funds were not advanced on a short or quickly drawn contractual agreement.

Barclays Bank Ltd. v. Quistclose Investments Ltd., [1970] A.C. 567, [1968] 3 All E.R. 651, [1968] 3 W.L.R. 1097 (H.L.); *Cliffs Over Maple Bay Investments Ltd. (Re)*, [2011] B.C.J. No. 677, 2011 BCCA 180, 304 B.C.A.C. 116, 17 B.C.L.R. (5th) 60, 18 P.P.S.A.C. (3d) 11, 67 E.T.R. (3d) 1, [2011] 8 W.W.R. 266, 77 C.B.R. (5th) 1; *Twinsectra Ltd. v. Yardley*, [2002] 2 A.C. 164, [2002] UKHL 12 (H.L.), **consd**

Other cases referred to

Abulyha v. Montemurro, [1984] O.J. No. 962 (H.C.J.); *Continental Bank of Canada v. Boekamp Manufacturing Inc*., [1990] O.J. No. 1043 (H.C.J.); *Cummings Estate v. Peopledge HR Services Inc*., [2013] O.J. No. 2296, 2013 ONSC 2781, 2 C.B.R. (6th) 45, 228 A.C.W.S. (3d) 1195 (S.C.J.); *Del Grande v. McLeery*, [2000] O.J. No. 61, 127 O.A.C. 394, 31 E.T.R. (2d) 50, 94 A.C.W.S. (3d) 132 (C.A.), affg [1998] O.J. No. 2896, 70 O.T.C. 127, 40 B.L.R. (2d) 202, 5 C.B.R. (4th) 36, 24 E.T.R. (2d) 30, 80 A.C.W.S. (3d) 1276 (Gen. Div.); *Edwards v. Glyn* (1859), 2 E. and E. 29; *Ernst & Young Inc. v. Central Guaranty Trust Co*., [2006] A.J. No. 1413, 2006 ABCA 337, [2007] 2 W.W.R. 474, 66 Alta. L.R. (4th) 231, 397 A.R. 225, 24 B.L.R. (4th) 218, 28 E.T.R. (3d) 174, 153 A.C.W.S. (3d) 971, revg [2004] A.J. No. 600, 2004 ABQB 389, [2005] 3 W.W.R. 97, 29 Alta. L.R. (4th) 269, 365 A.R. 302, 8 E.T.R. (3d) 169, 131 A.C.W.S. (3d) 1186 [Leave to appeal to S.C.C. refused [2007] S.C.C.A. No. 9]; *Gignac, Sutts v. National Bank of Canada*, [1987] O.J. No. 298, 5 C.B.R. (4th) 44, 4 A.C.W.S. (3d) 172 (H.C.J.); *In re Drucker (No. 1)*, [1902] 2 K.B. 237 (C.A.); *In re Hooley, Ex parte Trustee*, [1915] H.B.R. 181; *In re Rogers, Ex parte Holland and Hannen* (1891), 8 Morr. B.C. 243; *Ling v. Chinavision Canada Corp*. (1992), 10 O.R. (3d) 79, [1992] O.J. No. 1438, 34 A.C.W.S. (3d) 664 (Gen. Div.); *Niedner Ltd. v. Lloyds Bank of Canada* (1990), 74 O.R. (2d) 574, [1990] O.J. No. 1346, 72 D.L.R. (4th) 147, 38 E.T.R. 306, 22 A.C.W.S. (3d) 271 (H.C.J.); *Ontario (Securities Commission) v. Consortium Construction Inc.*, [1993] O.J. No. 1408, 1 C.C.L.S. 117, 41 A.C.W.S. (3d) 18 (Gen. Div.); *Smith v. Gold Key Construction Ltd*., [1993] O.J. No. 157 (Gen. Div.); *Teperman v. Teperman*, [2000] O.J. No. 4133 (S.C.J.); *Toovey v. Milne* (1819), 2 B. & Ald. 683, 106 E.R. 514; *Triax Resource Ltd. Partnership v. Research Capital Corp*., [1999] O.J. No. 1920, 96 O.T.C. 290, 88 A.C.W.S. (3d) 767 (S.C.J.); *Ventas, Inc. v. Sunrise Senior Living Real Estate Investment Trust* (2007), 85 O.R. (3d) 254, [2007] O.J. No. 1083, 2007 ONCA 205, 222 O.A.C. 102, 29 B.L.R. (4th) 312, 56 R.P.R. (4th) 163, 156 A.C.W.S. (3d) 95; *Venture Capital USA Inc. v. Yorkton Securities Inc*. (2005), 75 O.R. (3d) 325, [2005] O.J. No. 1885, 197 O.A.C. 264, 4 B.L.R. (4th) 324, 139 A.C.W.S. (3d) 4 (C.A.) [Leave to appeal to S.C.C. refused [2005] S.C.C.A. No. 334]

Statutes referred to

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 [as am.]

Personal Property Security Act, R.S.O. 1990, c. P.10 [as am.]

Authorities referred to

Bridge, Michael G., et al., "Formalism, Functionalism, and Understanding the Law of Secured Transactions" (1999), 44 McGill L.J. 567

APPEAL from the judgment of Fregeau J., [2012] O.J. No. 4461, 2012 ONSC 5077 (S.C.J.) ordering the receiver to pay moneys to the ministry. [page229]

Richard W. Schwartz, for appellant.

Ronald E. Carr and *Eric Wagner*, for respondent.

The judgment of the court was delivered by
FELDMAN J.A.:

Introduction

[1] The issue in this case is whether grant moneys that were advanced by the respondent, Ontario's Minister of Training Colleges and Universities (the "ministry"), to a First Nations limited partnership in Northern Ontario, but not spent before the partnership sought to dissolve and appoint an interim receiver, were subject to a "*Quistclose* trust"[1] for the benefit of the ministry. The application judge held that they were trust moneys and that the receiver should therefore pay the moneys to the ministry. The receiver appeals. For the reasons that follow, I agree with the receiver that the moneys are not subject to a *Quistclose* trust and are therefore available to be distributed in the receivership.

Facts

[2] Two Feathers Forest Products was a limited partnership consisting of three First Nations limited partners and a general partner. It was formed in 2007 to develop and operate two plants, a planer mill and manufacturing plant in Dryden, Ontario and a saw mill in Red Lake, Ontario. In 2010, Two Feathers applied to the Northern Training Partnership Fund, recently established by the respondent ministry to support project-based skills training for Northern Ontario residents, for a grant to provide skills training for Aboriginal and non-Aboriginal residents of Northern Ontario in its two proposed plants.

[3] The application was accepted and a detailed written agreement for the advance of the funds was executed, effective February 14, 2011 (the "funding agreement"). In September 2011, after the ministry had advanced a total of $1,895,870 under the funding agreement in three installments, one in March, one in May and one in July, two of the limited partners applied to dissolve Two Feathers. The appellant was appointed interim receiver and manager in October 2011.

[4] The appellant traced the funds that had been advanced by the ministry and found that $1,580,000 was paid to the third [page230] limited partner, Wabigoon Lake Forest Products LP ("WLFP"). From those funds, $563,911.25 had been used to purchase a planer mill. The

balance was intended to be used to lease premises for the mill but was still in the hands of WLFP. Ultimately, those moneys were returned to the appellant pending the disposition of this court application.

[5] The application judge found that the ministry had satisfied the onus to prove that the original grant funds were impressed with a trust, known as a *Quistclose* trust, in the hands of Two Feathers and the funds were therefore now being held by the interim receiver for the benefit of the ministry.

[6] To make that finding, the application judge examined the provisions of the funding agreement in detail. The funds were to be used only for the purpose of carrying out the project. The project is defined in art. 1.2 of the funding agreement to mean the undertaking as set out in Schedule "A".[2] In addition to a [page231] requirement that it implement on-the-job training, the project is defined in the funding agreement with reference to Two Feathers' proposal to the ministry (the "proposal"). The proposal describes a specialized lumber manufacturing and export business where skills training would take place. It sets out specified amounts of proposed funding in three categories. The request was for $160,920 and $288,080 for on-the-job and classroom training, respectively. The larger portion of the funding, $3,026,000, was designated for "[o]ther", which it further describes as "[c]lassroom and equipment lease".[3]

[7] The funding agreement restricted Two Feathers to using the funds only in accordance with that agreement. Two Feathers had to segregate any funds not immediately required into an interest-bearing account, and the amount of any interest earned would be deducted from any further funds advanced under the funding agreement. The ministry was not obliged to advance the funds unless it was satisfied with the progress of the project. It could also terminate the funding agreement on 30 days' notice and demand return of any unused funds still in the possession or under the control of Two Feathers. Similarly, if the ministry considered that Two Feathers breached the agreement, it could demand repayment of any remaining funds. Likewise, on the expiry of the funding agreement, Two Feathers was required to return any unused funds. In respect of the repayment or return of funds already advanced, art. 17 provides that moneys owing to the ministry by Two Feathers "shall be deemed to be a debt due and owing to" the ministry. [page232]

[8] The application judge concluded, based on his review of the entire funding agreement, that the funds advanced and not yet spent by Two Feathers were held subject to a *Quistclose* trust for the benefit of the ministry and must be returned to the ministry by the interim receiver. He based his conclusion on the following findings: (1) There was no intention that Two Feathers would be able to freely dispose of the advanced funds; rather, the funds were to be used only for the specific purpose of carrying out the project. To that end, the ministry had the ability and the mechanisms to ensure that the funds were used only for that purpose and to have the funds returned if they were not being so used. (2) The three certainties of a trust, certainty of intention, certainty of subject-matter and certainty of object, had been established on a balance of probabilities. The object of the trust was the on-the-job skills training to be provided in the project.

Analysis

A. *History of the Quistclose trust*

[9] The genesis of the concept of the "*Quistclose* trust" was the House of Lords' decision in *Barclays Bank Ltd. v. Quistclose Investments Ltd.*, *supra*. In that case, the trust arose in the following way: Rolls Razor was a client of Barclays Bank that was in financial difficulties and had exceeded its allowed overdraft at the bank by a significant margin. In order to try to recover financially, Rolls Razor found a lender who agreed to lend it ú1 million but on the condition that Rolls Razor obtain funds from another source to pay its shareholders the dividend of ú209,719 8s. 6d, which it had already declared and which was to be paid within a short time. Quistclose became that source, agreeing to lend Rolls Razor the sum necessary to pay the dividend, on the condition that the funds would be used only for that purpose and that they would be held in a special account, newly opened for that purpose, until the dividend was paid.

[10] One of the directors of Rolls Razor then made an oral agreement with its bank manager at Barclays, confirmed by the letter that Rolls Razor later sent to the bank with Quistclose's cheque. They agreed that the cheque was to be deposited into a special account and was to be used only to pay the declared dividend. Unfortunately, the company was unable to raise the further funds it needed to remain in business, and decided to voluntarily liquidate. Contrary to the agreement that the Quistclose loan would only be used to pay the shareholders' dividend, the bank then set off the balance in the special account against part of the debit balance owed to it. [page233]

[11] Quistclose sued the bank for return of the funds. Lord Wilberforce explained that in order for Quistclose to be able to claim the funds from the bank, it had to meet two requirements. First, it had to establish that the funds were impressed with a trust in its favour if the funds were not used to pay the dividend, and second, that "[the bank] had such notice of the trust or of the circumstances giving rise to it as to make the trust binding upon them" (at p. 579 A.C.).

[12] Lord Wilberforce had no trouble finding that the mutual intention of Rolls Razor, the borrower, and Quistclose, the lender, was that the funds were to be used only to pay the declared dividend and were not to form part of the assets of Rolls Razor. He concluded that a necessary consequence of their mutual intention was that if the dividend could not be paid, then the funds were to be returned to Quistclose. He stated that it had long been recognized that this type of arrangement created a fiduciary obligation to hold the funds in trust [at p. 580 A.C.]:

> That arrangements of this character for the payment of a person's creditors by a third person, give rise to a relationship of a fiduciary character or trust, in favour, as a primary trust, of the creditors, and secondarily, if the primary trust fails, of the third person, has been recognised in a series of cases over some 150 years.

[13] He referred to five historical cases, at pp. 580-81 A.C., all of which involved moneys loaned for the purpose of paying a specific group of the borrower's creditors in order to stave off bankruptcy: *Toovey v. Milne* (1819), 2 B. & Ald. 683, 106 E.R. 514; *Edwards v. Glyn* (1859), 2 E. and E. 29; *In re Rogers, Ex parte Holland and Hannen* (1891), 8 Morr. B.C. 243; *In re Drucker (No.1)*, [1902] 2 K.B. 237 (C.A.); [and] *In re Hooley, Ex parte Trustee*, [1915] H.B.R. 181.

[14] Turning to the notice issue, Lord Wilberforce was satisfied that the bank had notice that the moneys were provided by a third person as a loan, and were to be used only to pay the dividend. This information was sufficient to constitute notice of the trust. Therefore, the bank could not claim the money for its own benefit: at p. 582 A.C.

[15] The *Quistclose* trust concept was originally drawn by Lord Wilberforce with narrowly defined parameters in the *Barclays Bank* decision. In particular, the fiduciary relationship arose where money was lent in emergent circumstances to allow a debtor to pay a certain creditor or group of its creditors in order to keep the debtor in business. If the funds could not be used for that purpose, then the funds were returned to the lender. Those parameters were, however, significantly broadened some 30 years later, when the House of Lords found a *Quistclose* trust [page234] arose in *Twinsectra Ltd. v. Yardley*, [2002] 2 A.C. 164, [2002] UKHL 12 (H.L.).

[16] In that case, Twinsectra agreed to lend ú1 million to Y for the purpose of purchasing property, but on three conditions: (1) that Y's solicitor undertake to hold the funds until they were used by Y to purchase property; (2) that Y's solicitor undertake that the funds would only be used for that purpose; and (3) that Y's solicitor would guarantee repayment of the loan. When Y's solicitor would not give the guarantee, Y found another solicitor who agreed to give the undertakings and the guarantee. However, that solicitor essentially ignored his undertaking and paid the money over to Y's solicitor who allowed Y to use the money freely and not to purchase property. The loan was not repaid and the solicitor who gave the guarantee went bankrupt. In the action against Y's solicitor, one of the issues was whether Y's solicitor could be held responsible as a party to a breach of trust. As a threshold matter, therefore, the House of Lords first had to determine whether the circumstances of the loan gave rise to a *Quistclose* trust.

[17] Both Lord Hoffmann and Lord Millett wrote on the issue. Lord Hoffmann stated that the trust and its terms were found in the undertaking contained in the first two conditions of the loan. Y was not free to dispose of the money as he wished but only to purchase property. The effect of the undertaking was that the money remained Twinsectra's until it was used to buy property. Therefore, the solicitor who held the money held it in trust for the lender, Twinsectra, subject to a power to apply it as a loan to Y in accordance with the terms of the undertaking. Whether the subject funds were "at the free disposal" of the recipient is one of the essential identifying elements of a *Quistclose* trust.

[18] Lord Hoffmann addressed the two problems that the trial judge believed prevented him from finding a *Quistclose* trust in the circumstances. The first was that the terms of the undertaking were too vague -- no particular property was identified. Dealing with this point, Lord Hoffmann agreed that the undertaking was an unusual one: Twinsectra was not seeking any security over the property to be purchased, so that there was nothing to prevent Y from subsequently mortgaging the property and using the money for whatever he wished. Lord Hoffmann's response was that as long as a court could say whether the money was used for the described purpose, then the purpose was not too vague and not void for uncertainty.

[19] The second objection was that Twinsectra did not intend to create a trust based on the undertakings because its security [page235] was the solicitor's guarantee. To that, Lord Hoffmann responded that the lender's intention was irrelevant [at para. 17]:

> Whether a trust was created and what were its terms must depend upon the construction of the undertaking.

[20] Lord Millett's main focus was to properly characterize the operation of the *Quistclose* trust under trust principles by conducting an analysis of the locus of the legal and beneficial interest in the trust property.[4] He concluded that the moneys are always held on a resulting trust for the lender who never parts with the entire beneficial interest in them and that it is the lender who is the person who can enforce the trust. He rejected the theory that anyone but the lender can enforce the trust, including the persons who are the primary objects of the trust, such as a subgroup of the borrower's creditors. In the context of that analysis, he addressed the question whether a *Quistclose* trust's primary purpose must be to benefit a subset of identified creditors as in the *Barclays Bank* case itself. He rejected that premise, referring to cases where his characterization of the purpose of the loan was not to benefit a group of people but to purchase equipment or to enable a bank to meet a run and where only the lender could oversee its enforcement. He concluded that, as in the *Twinsectra* circumstances, a *Quistclose* trust "must be able to accommodate gifts and loans for an abstract purpose" (at para. 89).

[21] Lord Millett also reviewed the three certainties required for a trust: certainty of intention, of subject-matter and of objects, at paras. 71, 101. On the issue of the significance of certainty of the objects of the trust, Lord Millett agreed with Lord Hoffmann, pointing out as well that if the objects were not sufficiently certain, the result in law is that the moneys revert back to the lender under a resulting trust -- the same result as when the purpose cannot be carried out (para. 101).

[22] One could conclude that after *Twinsectra*, any time moneys are advanced on an undertaking to use the moneys only [page236] for a stated purpose, which can be an abstract purpose, then regardless of the subjective intention of the person providing the funds and of the nature of the purpose, there is a resulting trust for the lender. This represents a significant expansion of the *Quistclose* trust, which had been narrowly described in the *Barclays Bank* case.

[23] As I have concluded that the requirements for a *Quistclose* trust have not been met in this case, I do not need to decide to what extent that expansion should be adopted in Ontario. However, when that decision does have to be made, the court will have to consider a number of commercial consequences, one of the most significant of which is the potential effect on the creditors of the borrower (or grantee) of the subject funds. For example, as in this case, where funds are advanced to a business with no registration under the *Personal Property Security Act*, R.S.O. 1990, c. P.10, creditors will have no notice, and in many cases no knowledge, that they are dealing with a debtor whose money is subject to a trust and not available to general creditors.[5]

B. *Was there a Quistclose trust in this case?*

[24] The House of Lords authorities are clear that on the issue of the intention to create a trust, it is not the subjective intention of the lender (here the granter) but the intention of the two parties, discerned from the terms of the loan (here the grant). As Lord Millett put it [*Twinsectra*, at para. 71]:

> A settlor must, of course, possess the necessary intention to create a trust, but his subjective intentions are irrelevant. If he enters into arrangements which have the effect of creating a trust, it is not necessary that he should appreciate that they do so; it is sufficient that he intends to enter into them.

[25] The application judge came to the factual conclusion -- based on all of the terms of the funding agreement that had the effect of (a) limiting Two Feathers' use of the funds, and (b) providing that the unused funds be returned to the ministry -- that Two Feathers did not receive the funds for its free disposal but only for the purpose of carrying out the project. He then followed with the legal conclusion that [at para. 107], "[v]iewed objectively, I am satisfied that the parties intended to enter into a trust arrangement." [page237]

[26] However, a close examination of the terms of the funding agreement shows that the parties did not intend that Two Feathers would hold the funds in trust for the ministry. In particular, the funding agreement specifically provides that any unused funds constitute a debt owing to the ministry, not trust funds, and that Two Feathers had significant freedom to use the majority of the funds. As a result, in my view, the application judge erred in law in finding that the funds were held on a *Quistclose* trust.

[27] First, the funding agreement specifically identifies the nature of the relationship between the parties respecting the funds while they are in the hands of Two Feathers but not yet expended -- the critical time -- as one not of trust, but of debtor/creditor. Article 17.1 provides that any moneys under the funding agreement that the recipient, Two Feathers, owes to the ministry "shall be deemed to be a debt due and owing to the Ministry by the Recipient".

[28] If the grant moneys that Two Feathers has not yet spent constitute a debt that Two Feathers owes to the ministry, they cannot be held by Two Feathers on trust for the ministry. While the courts in a number of the *Quistclose* trust cases state that it is not necessary for the parties to use the word "trust" when creating their agreement, no court has said that when the parties have explicitly characterized their legal relationship in one way, the court will override their agreement and characterize it another way.

[29] To be clear, there was an argument made in *Barclays Bank* that because the transaction between Quistclose and Rolls Razor was one of loan creating the legal obligation of debt, that excluded the implication of a trust, enforceable in equity. The House of Lords rejected that argument. The loan only arose once the funds were used for the designated purpose -- until that time, the funds were held by the borrower on trust for the lender, and did not become the property of the borrower [*Barclays Bank*, *supra*, at p. 581 A.C.]:

> There is surely no difficulty in recognising the co-existence in one transaction of legal and equitable rights and remedies: when the money is advanced, the lender acquires an equitable right to see that it is applied for the primary designated purpose . . . : when the purpose has been carried out (*i.e*., the debt paid) the lender has his remedy against the borrower in debt.

[30] In this case, the transaction is one of grant, not loan. However, before the funds are actually expended for the purposes of the grant, or if they are left over and not needed for the agreed purposes, the parties agreed that they constituted, not a trust, but a debt owed by Two

Feathers to the ministry. To be a debt, the property in the funds belongs to the debtor, *i.e*., to Two [page238] Feathers, unlike a trust where only the legal title is held by the trustee, with the beneficial title in the trust beneficiary.

> [31] The application judge stated that [at para. 102]
> [t]he fact that the word "trust" does not appear in the agreement, and that Article 17 of the agreement stipulates that moneys owing to [the ministry] by Two Feathers "shall be deemed to be a debt due and owing to . . ." [the ministry] is not, in my opinion, determinative of the intention of the parties as to whether the funds were to be at the free disposal of Two Feathers once advanced by [the ministry].

[32] I agree with the application judge that agreeing that moneys owed back to the ministry are deemed to be a debt does not determine whether they are at the free disposal of Two Feathers. However, the effect of this characterization of the granted funds that have to be returned to the ministry if they are not spent or needed for the project is that until Two Feathers pays those funds back, it holds them as a debt due to the ministry, not in trust for the ministry. To override the express agreement of the parties, that any funds owed back to the ministry under the agreement constitute a debt and for the court instead to imply a trust, would be contrary to the "cardinal rule" of interpreting written commercial contracts that the parties "have intended what they said": *Ventas, Inc. v. Sunrise Senior Living Real Estate Investment Trust* (2007), 85 O.R. (3d) 254, [2007] O.J. No. 1083, 2007 ONCA 205, at para. 24; *Venture Capital USA Inc. v. Yorkton Securities Inc.* (2005), 75 O.R. (3d) 325, [2005] O.J. No. 1885 (C.A.), at para. 26, leave to appeal to S.C.C. refused [2005] S.C.C.A. No. 334.

[33] The second error is the application judge's conclusion that the funds were not at the free disposal of Two Feathers, and it arises from an examination of Schedule "B" to the funding agreement. Schedule "B" is the budget that governs the actual spending requirement for the grant funds. It covers the three fiscal years of the term of the agreement, 2010-2011, 2011-2012 and 2012-2013. As discussed above, of the sum of $3,535,000, the total maximum amount to be granted, only $449,000, was to be spent on on-the-job and in-class training costs, while the vast majority of the funds, $3,026,000, are designated only as "other" in Schedule "B". In the proposal, the "other" funds were described as being for "[c]lassroom and equipment lease".

[34] Since specific funds are designated in Schedule "B" for the actual costs of training, which was the purpose of the grant from the ministry, the vast majority of the "other" funds appear to be available over the term of the funding agreement to set up the business more generally, including lease and equipment costs for the whole business. [page239]

[35] As a result, although the funding agreement requires that Two Feathers spend the grant money on the project, in fact, the budget in Schedule "B" gives Two Feathers significant discretion to spend the largest part of those moneys. Contrary to the conclusion reached by the application judge, those moneys were essentially "at the free disposal" of Two Feathers.

[36] Finally, the circumstances of the grant transaction in this case do not have many of the characteristics that caused a trust to be found in either of the two seminal cases. It was not a situation where the limited partnership needed immediate funding to stave off bankruptcy; the funds were not needed to make a specific payment, whether to a group of creditors or to make a

specific purchase; instead, they were obtained as a basic source of business funding for a long-term project.

[37] Nor were the funds advanced based on a short or quickly drawn contractual arrangement; instead, they were the subject of a detailed government-approved funding agreement, fully executed by both parties that prescribed all aspects of the funding relationship between them. It is difficult to see the basis for implying a trust where a sophisticated party, such as a provincial ministry, provides funding by means of a commercial agreement in which its contractual rights and remedies are carefully and extensively defined.

[38] This court has not yet applied the *Quistclose* trust concept.[6] However, the British Columbia Court of Appeal in [page240] *Cliffs Over Maple Bay Investments Ltd. (Re)*, [2011] B.C.J. No. 677, 2011 BCCA 180, 17 B.C.L.R. (5th) 60 recently reversed a decision of a motion judge that had implied a *Quistclose* trust in circumstances where funds were loaned to be used for a general, long-term purpose, as in this case. There, funds were advanced by a debtor-in-possession lender in the context of a *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 order "[t]o facilitate further construction of [a] golf course and development of [a series of] home lots and source an irrigation solution for the golf course": at para. 56. In rejecting the implication of a *Quistclose* trust for a number of reasons, the British Columbia Court of Appeal stated [at para. 69]:

> In short, although it is obvious that Cliffs agreed as a matter of contract that the funds would be used for the general purpose stated, I disagree that this restriction gives rise to any inference of an intention on the part of both parties . . . to create the specialized vehicle that is a *Quistclose* trust[.]

[39] To summarize my analysis, the ministry entered into a detailed funding agreement with Two Feathers setting out the terms under which the ministry granted funding for Two Feathers to provide on-the-job skills training to residents of Northern Ontario. Although the funds provided were intended to be used only for the purpose described in the funding agreement, there is no basis to infer a mutual intention that the funds were to be held on trust for the ministry. To the contrary, under the budget attached to the funding agreement, the recipient, Two Feathers, had significant discretion to spend the majority of the funds as long as it was for the general purpose stated, as in the *Cliffs Over Maple Bay* case. And, most importantly, art. 17 of the funding agreement defines the relationship between the parties with respect to any funds that have to be returned to the ministry under the agreement as a debt, not a trust.

Conclusion

[40] In my view, the application judge erred in law in concluding that in these circumstances, the court could imply a *Quistclose* trust. I would therefore allow the appeal, set aside the order of the application judge and dismiss the application with costs, fixed at $15,000, inclusive of disbursements and HST.

Appeal allowed.

Notes

1 *Barclays Bank Ltd. v. Quistclose Investments Ltd.*, [1970] A.C. 567, [1968] 3 All E.R. 651 (H.L.).

2 Schedule "A" is comprised of the following "Project Description":

> Background. The purpose of the Project is to provide support to project-based skills training to help Aboriginal and non-Aboriginal Northern Ontarians participate in and benefit from emerging economic development opportunities. The Province of Ontario announced this new initiative under the project of "Jobs and Growth in Northern Ontario".
>
> Objective. The objective of this initiative is to help Aboriginal and non-Aboriginal Northern Ontarians
>
> -- [A]ttain workplace skills and sustain employment in the resource related sectors of mining, energy and greener economy, forestry, environment, bio-economy, tourism and agriculture by providing employers in Northern Ontario with skilled workers for current and future needs.
>
> -- Develop innovative collaborations and models of delivery that are tailored to specific circumstances and needs of the community.
>
> -- [E]nhance and add value to resources, programs and services already available in the community.
>
> The Recipient shall carry out the Project in accordance with the Proposal.
>
> The Ministry shall provide up to 75% of the overall eligible costs of approved projects. Project partners will provide a minimum of 25% of the overall funding of approved projects. The Ministry funding shall not exceed $15,000 per participant for each year of the Project.
>
> On-the-Job Component. The Recipient shall ensure that the Project has an on-the-job component, including as part of a pre-apprenticeship type program must comply with all applicable legislation and regulations. The on-the-job component of a pre-apprenticeship type, must be trade-appropriate and based on the current Apprenticeship Training Standard or Schedule of Training.
>
> The Recipient shall ensure participants and employers comply with all applicable legislation and regulations as well as the current Apprenticeship Training Standard or Schedule of Training.

> The Recipient shall ensure where projects delivering the Level 1 Apprenticeship In-School Curriculum Standard are an approved Apprenticeship Training Delivery Agent for the trade including delivery format and for that location. Participants who successfully complete all of the requirements of Level 1 will be given credit for this level of training.
>
> Apprenticeship Training Delivery Agents are required to issue participants who successfully complete Level 1 will be provided the same documentation given to registered apprentices (e.g. transcript). Project participants must meet the same requirements as registered apprentices to pass level 1.
>
> In compulsory or restricted trades, Level 1 must be taught by a journeyperson with a current Certification of Qualification in that trade.
>
> Performance Targets. The Recipient shall meet [a series of] performance targets . . .

3 The details of the proposal are in Schedule "F" of the funding agreement.

4 Lord Millett embarked on his analysis to resolve the question of which party could enforce performance of a *Quistclose* trust: at paras. 77-100. This issue is significant because non-charitable purpose trusts may be invalid at common law if there is no party with standing to enforce performance of the trustee's obligations ? since an abstract purpose cannot come to court. The Alberta Court of Queen's Bench invalidated a similar trust on this basis in *Ernst & Young Inc. v. Central Guaranty Trust Co.*, [2004] A.J. No. 600, 2004 ABQB 389, 29 Alta. L.R. (4th) 269 (Q.B.), though the decision was reversed on appeal on other grounds: [2006] A.J. No. 1413, 2006 ABCA 337, leave to appeal to S.C.C. refused [2007] S.C.C.A. No. 9.

5 See, also, concerns raised in: Michael G. Bridge et al., "Formalism, Functionalism, and Understanding the Law of Secured Transactions" (1999), 44 McGill L.J. 567, at pp. 610-14 ("Security and Trust").

6 A number of Ontario trial level decisions have implied *Quistclose* trusts. These may be divided into four categories. First, two decisions accepted the *Quistclose* trust principle, but refused to apply it in the circumstances: *Del Grande v. McLeery*, [1998] O.J. No. 2896, 24 E.T.R. (2d) 30 (Gen. Div.), affd [2000] O.J. No. 61, 31 E.T.R. (2d) 50 (C.A.); *Niedner Ltd. v. Lloyds Bank of Canada* (1990), 74 O.R. (2d) 574, [1990] O.J. No. 1346 (H.C.J.). Second, two decisions are consistent with the long line of authority cited in *Barclays Bank* in which a trust was implied with respect to a payment for a specific debt: *Ling v. Chinavision Canada Corp.* (1992), 10 O.R. (3d) 79, [1992] O.J. No. 1438 (Gen. Div.); *Continental Bank of Canada v. Boekamp Manufacturing Inc.*, [1990] O.J. No. 1043 (H.C.J.). Third, a series of decisions implied a *Quistclose* trust, but with some ambiguity as to how much the case turned on the *Quistclose* trust analysis: *Cummings Estate v. Peopledge HR Services Inc.*, [2013] O.J. No. 2296, 2013 ONSC 2781 (S.C.J.); *Teperman v. Teperman*, [2000] O.J. No. 4133 (S.C.J.); *Triax Resource Ltd. Partnership v. Research Capital Corp*., [1999] O.J. No. 1920, 96 O.T.C. 290 (S.C.J.); *Smith v. Gold Key Construction Ltd.*, [1993] O.J. No. 157 (Gen. Div.); *Abulyha v. Montemurro*, [1984] O.J. No. 962 (H.C.J.). Finally, two decisions prior to *Twinsectra* extended the *Quistclose* trust concept beyond a payment to discharge a specified debt*: Ontario (Securities Commission) v. Consortium Construction Inc*., [1993] O.J. No. 1408, 1 C.C.L.S. 117 (Gen. Div.); *Gignac, Sutts v. National Bank of Canada*, [1987] O.J. No. 298, 5 C.B.R. (4th) 44 (H.C.J.).

End of Document

TAB 15

Re Ontario Securities Commission and Greymac Credit Corp.

Ontario Judgments

Ontario Court of Appeal

Lacourciere, Morden and Tarnopolsky JJ.A.

September 4, 1986

[1986] O.J. No. 830 | 55 O.R. (2d) 673 | 30 D.L.R. (4th) 1 | 17 O.A.C. 88 | 34 B.L.R. 29 | 23 E.T.R. 81 | 39 A.C.W.S. (2d) 490

Counsel

W. V. Sasso, for appellants, Greymac Trust Company, Crown Trust Company and Seaway Trust Company.

C. C. Lax, Q.C., and C. H. Kochberg, for respondent, Chorny Mortgage Investor Participants.

David C. Moore, for respondents, Coopers & Lybrand Ltd. and Ontario Securities Commission.

The judgment of the court was delivered by

MORDEN J.A.

1 In this case a trustee deposited in an account in its name funds entrusted to it by two separate beneficiaries. Following this mingling of the funds the trustee made unauthorized disbursements from the account, with the result that there were insufficient funds remaining in the name of the trustee to reimburse each beneficiary in full. This proceeding is concerned with the resolution of the beneficiaries' competing proprietary claims to the remaining funds.

2 Against the background of the comprehensive and detailed reasons of Parker A.C.J.H.C., the judge of first instance, which are reported at 51 O.R. (2d) 212, 19 D.L.R. (4th) 470, 19 E.T.R. 157, I can state the facts which are material to this appeal in relatively brief compass. The trustee is Greymac Credit Corporation. For the purpose of this proceeding three trust companies, Greymac Trust Company, Crown Trust Company and Seaway Trust Company ("the companies") can be regarded, collectively, as one of the two beneficiaries. The other beneficiary, again collectively, is the Chorny Mortgage Investor Participants ("the participants").

3 On December 14, 1982, the trustee held $4,683,000 in trust for the companies in its account at the Greymac Trust Company. On December 15, 1982, the trustee deposited into this account the sum of $1,013,600. Of this amount, $841,285.26 belonged to the participants and the balance of $172,314.74 belonged to the trustee itself. The balance in the account at that time, then, was $5,696,600.

4 In the light of the ultimate findings of the trial judge respecting other transactions, which are accepted by the parties to this appeal, the next material transaction was the trustee's withdrawal of $4,000,000 from the Greymac Trust account on December 17, 1982, and its deposit, in the trustee's name, in an account at the Crown Trust Company. Following this the balance in the Greymac Trust account was $1,696,600.

5 Further withdrawals by the trustee which, unlike the $4,000,000 withdrawal deposited in the Crown Trust account, were dissipated, brought the balance in the Greymac Trust account down to $353,408.66 as of January 7, 1983.

6 In summary, when the funds were originally mingled in the Greymac Trust account, the trustee, the companies, and the participants had deposited, or had deposited on their behalves the amounts of $172,314.74, $4,683,000 and $841,285.26, respectively, for a total of $5,696,600. The amount remaining, after dissipated withdrawals of $1,343,191.34, was $4,353,408.66 -- $4,000,000 in the Crown Trust account and $353,408.66 in the Greymac Trust account.

7 The companies and the participants each asserted proprietary claims against the remaining funds of $4,353,408.66. The general issue, then, is: in the light of the shortfall of $1,343,191.34 what principle should be applied to govern how these funds are divided between the claimants?

Parker A.C.J.H.C.'s disposition and the parties' basic contentions

8 Parker A.C.J.H.C. held that the total loss of $1,343,191.34 must be allocated first against the trustee's interest. There is no appeal from this decision. He then decided that the funds should be divided in proportion to the respective contributions of the claimants. This resulted in the finding that the companies were entitled to a total amount of $3,690,434.47 ($299,588.58 from the Greymac Trust account and $3,390,845.89 from the Crown Trust account) on their total claim of $4,683,000 and that the participants were entitled to $662,974.19 ($53,820.08 from the Greymac Trust account and $609,154.11 from the Crown Trust account) on their total claim of $841,285.26.

9 The companies appeal from this decision. Their basic submission is that the trial judge erred in distributing the funds on a pro rata basis rather than on the basis of the rule in Claytons' Case (Devaynes v. Noble; Clayton's Case (1816), 1 Mer. 572, 35 E.R. 781). This well-known case was concerned with the resolution of the state of accounts between a bank and its customer. Parker A.C.J.H.C. considered it in some detail (at pp. 231-3 O.R., pp. 489-91 D.L.R.) and I will not repeat what he said beyond also quoting from a portion of the reasons of Sir William Grant M.R. in Clayton's Case at pp. 608-9:

> But this is the case of a banking account, where all the sums paid in form one blended fund, the parts of which have no longer any distinct existence. Neither banker nor customer ever thinks of saying, this draft is to be placed to the account of the (STERLING)500 paid in on Monday, and this other to the account of the (STERLING)500 paid in on Tuesday. There is a fund of (STERLING)1000 to draw upon, and that is enough. In such a case, there is no room for any other appropriation than that which arises from the order in which the receipts and payments take place, and are carried into the account. Presumably, it is the sum first paid in, that is first drawn out. It is the first item on the debit side of the account, that is discharged, or reduced, by the first item on the credit side. The appropriation is made by the very act of setting the two items against each other. Upon that principle, all accounts current are settled, and particularly cash accounts. When there has been a continuation of dealings, in what way can it be ascertained whether the specific balance due on a given day has, or has not, been discharged, but by examining whether payments to the amount of that balance appear by the account to have been made? You are not to take the account backwards, and strike the balance at the head, instead of the foot, of it.

(Emphasis added.)

10 The short form statement of the rule in Clayton's Case is "first in, first out". The result of its application in the present case, which the appellants seek, is as follows. The first moneys paid into the trustee's account (the Greymac Trust account) were those of the companies in the amount of $4,683,000 and the second moneys paid in were those of the participants in the amount of $841,285.26. Accordingly, the $4,000,000 which was taken out and deposited into the Crown Trust account must be regarded as the money of the companies. On this approach, the companies would still, at that point, have $683,000 in the Greymac Trust account. However, this amount must be taken to have been dissipated as the first part of the subsequent withdrawals of $1,343,191.34. The remainder in the account must then be regarded as the money of the participants. The result is that the participants are entitled, and only entitled, to the balance of $353,408.66 in this account.

11 The participants submit that if the rule in Clayton's Case is to be applied it should apply only to the transactions

following the deposit of the $4,000,000 into the Crown Trust account, with the result that the participants would be entitled to $590,727.99 from the Crown Trust account (as found by Parker A.C.J.H.C.) and the balance in the Greymac Trust account of $353,408.66, minus the amount of the overpayment of their total claim that would result from applying this approach. I should mention that Mr. Lax, on behalf of the participants, did not press this approach. The main burden of his submission was that Parker A.C.J.H.C.'s approach is the correct one.

12 Parker A.C.J.H.C. (at pp. 221-6 O.R., pp. 479-84 D.L.R.) dealt first with the $4,000,000 deposit in the Crown Trust account. He held that at the time the $4,000,000 was deposited in the Crown Trust account the companies and the participants could have traced their funds into both the Crown Trust and the Greymac Trust accounts. In reference to the judgment of the English Court of Appeal in Re Diplock; Diplock v. Wintle (and Associated Actions), [1948] 1 Ch. 465, where the effect of the application of the rule in Clayton's Case was to enable a beneficiary to trace its funds into an investment made from a mixed account, he said at p. 224 O.R., p. 482 D.L.R.:

> With the greatest respect, in my view, the error in the argument is that the court perceived the rule in Clayton's Case as being a rule developed to create interests in funds, whereas in fact it is a rule designed to allocate losses. Had no disbursements from the account occurred, it would seem from the general principles outlined at pp. 533 and 539 [of Re Diplock] that the volunteer and beneficiaries would have ranked equally and shared pro rata. Why should the priorities change if the only disbursement is not a loss but the purchase of an asset?

13 Then returning to the facts of the case before him he said at pp. 225-6 O.R., pp. 483-4 D.L.R.:

> It seems to me that the trustees and beneficiaries therefore had an interest in the separate account proportionate to their respective traceable interests in the mingled fund at the date the $4,000,000 was disbursed from that fund and put into the separate account.
>
> As between the trustee and the beneficiaries, it is my view that, at that time, both beneficiaries ranked ahead of the trustee in their claims to the separate account and the mingled fund to the extent of their respective traceable contributions to the mingled funds.
>
> As between the two innocent beneficiaries, it is my view that, at that time, they ranked equally in their claims to the separate account and the mingled fund to the extent of their respective traceable contributions to the mingled fund.
>
> If the rule in Clayton's Case does apply to allocate subsequent losses to the mingled fund, I do not see how a rule triggered by subsequent disbursements in an account can retroactively transform interests in a separate account from interests which ranked equally into interests which ranked in an order of priority.
>
> Therefore, it is my view that whether or not the rule in Clayton's Case applies to allocate the losses sustained in the Greymac Trust General Account, nevertheless, the $4,000,000 in the Crown Trust Savings Account ought to be allocated in proportion to the trustee's, the companies' and the Participants' respective traceable interests in the Greymac Trust General Account at the date the $4,000,000 was disbursed. As between themselves, the beneficiaries of course rank equally. However, since the beneficiaries rank ahead of the trustee, the trustee's interest in the separate account, unlike the interests of the beneficiaries in that account, can be affected by disbursements out of the mingled fund which occurred subsequent to the opening of the separate account. It is also my view that that part of the trustee's interest which is required to satisfy the beneficiaries' outstanding claims must be shared rateably between the beneficiaries in proportion to each beneficiary's share of the losses.

14 Parker A.C.J.H.C. (at pp. 226-41 O.R., pp. 484-99 D.L.R.) then dealt with whether the rule in Clayton's Case should be applied in determining the allocation of the losses in the Greymac account and, hence, the entitlement of the two competing beneficiaries to the $353,408.66 balance available for distribution. For reasons which he gave immediately following he said at p. 226 O.R., p. 484 D.L.R.:

> Such an allocation of losses and distribution of trust funds between innocent beneficiaries [resulting from the application of the rule in Clayton's Case] is, in my view, neither logical nor fair. Nor am I alone in my expression of consternation over such a result.

15 He then (at pp. 226-30 O.R., pp. 484-8 D.L.R.) set forth several published criticisms of the application of the rule in Clayton's Case to the determination of the competing claims of beneficiaries to trust moneys and then (at pp. 230-41 O.R., pp. 488-99 D.L.R.) he examined the origin of the rule in Clayton's Case and several authorities, beginning with Pennell v. Deffell (1853), 4 De G. M. & G. 372, 43 E.R. 551, concerned with its application to beneficiaries' claims relating to mingled trust funds. He concluded at pp. 239-40 O.R., pp. 497-8 D.L.R.:

> Having reviewed the authorities on the origins and extension of the rule in Clayton's Case, and the views of the academic commentators, it is my view that the rule in Clayton's Case arose out of the debtor-creditor relationship and should be restricted to that relationship. In my view, the general equitable rules of tracing, as stated in Re Diplock, supra, at pp. 533 and 539, are quite capable of dealing with the problem of allocating losses to a mingled fund.
>
> In the present case, the trustee and the beneficiaries originally had an interest in the mingled fund in proportion to their respective traceable contributions to the fund. As between the trustee and the beneficiaries, the beneficiaries ranked ahead of the trustee with respect to their claims to the mingled fund. Hence, losses to that fund must first be allocated against the interest of the trustee in the fund.
>
> As between the two innocent beneficiaries, they each had an interest in the mingled fund in proportion to their respective traceable contributions to the fund. Those interests ranked equally. Therefore, losses to that fund should be allocated against the interests of the beneficiaries in proportion to their respective traceable interests in the fund at the time the loss occurred. Hence, the beneficiaries (and the trustee to the extent of his remaining interest after losses have been deducted) would rank equally and share proportionately in the remaining funds. I express no opinion on the power of the court to make a disposition on some other basis where it is not possible to determine what proportion the mixed funds bear each to the other.
>
> . . . . .
>
> The application of the general equitable rules of tracing referred to supra is both logical and fair. In this age of computerized banking, it can hardly be argued that in most instances an application of such principles will cause much inconvenience, difficulty or complication. These same principles are often applied to quite complicated dealings which do not involve bank accounts.

16 He concluded at pp. 240-1 O.R., pp. 498-9 D.L.R., that the requirements of stare decisis did not stand in the way of his view of the proper way in which the funds should be distributed.

The appellants' challenge

17 The appellants challenge the judgment on two bases, principle and authority. This reflects a fair approach to the problem and I shall follow it in addressing the issues that require resolution.

The right principle

18 Under this compendious heading I include matters relating to the most relevant concepts and to logic, justice and convenience.

19 Before entering the area of contention it is of value to state what is undoubtedly common ground between the parties. Before the $4,000,000 withdrawal on December 17, 1982, there was $5,696,600 in the Greymac Trust account and, at that point, the companies had a $4,683,000 property interest in the account and the participants had a $841,285.26 property interest in it. The mixing of their contributions did not stand in the way of the assertion of these property rights: Pennell v. Deffell, supra; Frith v. Cartland (1865), 2 H. & M. 417, 71 E.R. 525; Re Hallett's Estate (1879), 13 Ch. D. 696 (C.A.), and Goodbody et al. v. Bank of Montreal et al. (1974), 4 O.R. (2d) 147, 47 D.L.R. (3d) 335.

20 The potential remedies for enforcing these property rights were either those of an equitable lien (also called a

charge) or by way of constructive trust. At that point the selection of the particular remedy would have been immaterial. The parties' position is described in Scott, The Law of Trusts, vol. 5, 3rd ed. (1967), at pp. 3612-3, as follows:

> As long as the mingled fund remains intact it is immaterial whether the owner of the misappropriated money claims a lien upon the mingled fund for the amount of his money which went into it, or claims by way of constructive trust a share of the mingled fund in such proportion as his contribution to the fund bears to the whole of the fund. In either event he is entitled to receive out of the fund the amount of his contribution, no more and no less. The character of his claim, whether to enforce an equitable lien or a constructive trust, becomes important only if other property is acquired with the mingled fund, or withdrawals are made from the fund, or the fund diminishes in value. Such cases are considered in the sections which follow. If the fund remains intact, he is entitled to reimbursement out of the fund on either theory, and although the wrongdoer is insolvent, he is entitled to priority over other creditors with respect to the fund.

21 In this case, however, the total fund did not remain intact and the shortfall has put an end to the common ground between the parties.

22 The appellants' basic argument with respect to the division of the $4,000,000 in the Crown Trust account is that the judge of first instance erred in failing to keep separate two issues: (a) the identification of whose property went into the Crown Trust account, and (b) the appropriate rule or remedy to apply in the allocation of the loss between two innocent beneficiaries. They submit, with respect to (a), that mingled funds were not placed in the Crown Trust account. This would have been the case only if the full amount of the Greymac account had been transferred to the Crown Trust account.

23 The judge of first instance was wrong, the appellants submit, to have relied upon Sinclair v. Brougham et al., [1914] A.C. 398 (at p. 222 O.R., p. 480 D.L.R.), in support of his conclusion that the parties were entitled to share pari passu according to their respective contributions in the $4,000,000 deposit because Sinclair v. Brougham was concerned with competing entitlements to a total fund and not with entitlement to funds withdrawn from a mingled fund.

24 The appellant's argument comes down to the assertion that the only concept or rule available to enable the court to identify "whose" money went into the Crown Trust account is the rule in Clayton's Case, which clearly identifies it as the companies' money because it preceded the participants' money into the Greymac Trust account.

25 The basic rejoinder of the participants is the adoption of the position accepted by Parker A.C.J.H.C. that, whatever application the rule in Clayton's Case may have with respect to allocating losses in mingled trust funds, it cannot be used, as the appellants seek to use it, to trace trust funds from one account to another or to an investment or some other purchase.

26 In a sense the appellants' approach -- that only by the application of the rule in Clayton's Case can one identify the beneficial ownership of the money deposited into the Crown Trust account -- begs the question to be decided. There are, I think, two approaches to the question which are in conflict and the answer should turn on which is the better one.

27 The other approach, contrary to that asserted by the appellants, may be outlined as follows. Immediately before the transfer of the $4,000,000 each beneficiary had a property right in the total fund of $5,696,600 in proportion to its contribution. This position did not alter after the transfer of the $4,000,000. All that then occurred was that their respective entitlements, in the same proportions, were spread over the two accounts. In this respect I refer to the following passages in Scott, The Law of Trusts, vol. 5, 3rd ed. (1967), at p. 3620:

> The claimant has an equitable lien upon the mingled fund, and when a part of the fund is withdrawn he has an equitable lien on the part withdrawn and on the part which remains. If the part which is withdrawn is dissipated so that it can no longer be traced, the claimant still has his equitable lien on the part which remains. So also, as we shall see, if the part which is withdrawn is preserved and the part which remains is subsequently dissipated, the claimant has an equitable lien upon the part which is withdrawn. It is

> impossible and unnecessary to determine whether the claimant's money is included in the part withdrawn or in the part which remains. It is impossible to determine which part is the claimant's money, since his money has been so commingled as to lose its identity. It is unnecessary to determine which part is the claimant's money, since he is entitled to an equitable lien upon both parts.

(Emphasis added.) At p. 3623:

> It is true that where the part of the fund which is withdrawn is dissipated and the balance is preserved, the claimant is certainly entitled to payment of his claim out of the balance. The reason is that his lien on the entire fund undoubtedly includes the balance of the fund after a part has been withdrawn.

At p. 3624:

> The only tenable principle is that the claimant can enforce a lien upon any part of the product of any part of the mingled fund.

28 It is true that these passages appear in the context of situations where the mingled funds are those of only one beneficiary and of the trustee, but this does not, in my view, affect their applicability to the situation where the money of more than one beneficiary is mingled. Certainly this is the view of Scott as appears later on in his treatise where he deals with the mingling of the money of several beneficiaries (pp. 3639-41). While acknowledging that there is a conflict of authority on the question he says, with respect to the situation where the money of several claimants is mingled and subsequently withdrawals are made by the wrongdoer from the mingled fund (at p. 3639):

> It seems clear on principle that they should be entitled to share pro rata both in the money withdrawn or its product and in that remaining. If the amount withdrawn is dissipated or cannot be traced, the claimants should share the balance remaining in proportion to their contributions.

29 This is an appropriate place to deal briefly with the appellants' argument that Parker A.C.J.H.C. misapplied the decision of the House of Lords in Sinclair v. Brougham, supra, to support his conclusion that the parties were entitled to share pari passu in the $4,000,000 deposit. In my view, the learned judge did not misapply this rather difficult and complex decision: see Re Diplock; Diplock v. Wintle, supra, at pp. 516 and 518.

30 First, I do not think that Parker A.C.J.H.C. relied upon Sinclair v. Brougham for anything more than the proposition that where a trustee mixes the money of each of two innocent beneficiaries "the relationship of the innocent beneficiaries one to the other" (p. 222 O.R., p. 480 D.L.R.) is that of equality, i.e., neither can claim priority over the other. No exception can be taken to this.

31 Secondly, even if Sinclair v. Brougham were relied upon in support of the view that following the transfer of the $4,000,000 the respective interests of the innocent beneficiaries were then spread, pro rata, over each of the two accounts, this would, in my view, be a reasonable application of one of the basic principles implicit in the reasoning in that decision -- that the beneficiaries had equitable liens over the whole and each part of the mingled fund: see Sinclair v. Brougham, pp. 422 (Viscount Haldane), 438 (Lord Dunedin) and 442 (Lord Parker). This point is made by P. F. P. Higgins in "Re Diplock -- A Reappraisal" (1963-64), 6 U. W. Aust. L. Rev. 428 at pp. 434-5. Indeed Higgins forcefully expresses the view that Re Diplock, which was criticized by Parker A.C.J.H.C., "was contrary to the express decision" in Sinclair v. Brougham. At pp. 438-9 he says:

> In Re Diplock a large part of the judgment in rem was devoted to a careful analysis of what was said in Sinclair v. Brougham but in its conclusions the Court of Appeal completely ignored what the House of Lords had eventually decided. In that case the House of Lords having laid down the equitable principles upon which the equal equities of the rival claimants to the mixed funds were based, proceeded to make an order that they should have a charge pari passu on the mixed fund. Now, as we have already observed the balance of the fund was not sufficient to meet the claims in full and, therefore, there must have been some withdrawals from the fund after the depositors and shareholders had made their respective contributions. However, it was at no time suggested that the rule in Clayton's Case should be applied to determine the respective rights of the rival claimants to the balance of the mixed fund. On the contrary, it was decided that they should share the balance rateably.

> It is true that it was said in Re Diplock that where the equities of the contributors to a mixed fund are equal, they will have a charge upon it pari passu but, if this charge is confined, as it was in that case, to cases where there have been no withdrawals from the mixed fund after the trust funds were deposited in it, it involves giving a different interpretation to the expression pari passu from the one placed upon it in Sinclair v. Brougham. If there have been no withdrawals there can be no question of a rateable disposition of the mixed fund because each of the claimants will be fully reimbursed. Exceptionally, if there were an overdraft at a time when the account owners' money and the trust money were deposited simultaneously in the account there would be a proportionate disposition of the balance even though the principles in Re Diplock were to be applied. It would only be in such an unlikely combination of events that the principles laid down in Re Diplock can possibly produce the same result as the decision in Sinclair v. Brougham.
>
> It is submitted that in so far as Re Diplock decided that the rule in Clayton's Case is to be applied to the determination of the respective rights of claimants to the balance of a mixed fund, when the equitable rights of the claimants are equal, it was contrary to the express decision of the House of Lords in Sinclair v. Brougham that in such circumstances the balance is to be shared rateably.

32 The decision of Joyce J. in Re Oatway, [1903] 2 Ch. 356, also supports the proposition that a beneficiary can assert his equitable title on any part of the mixed fund even after it has been divided into more than one part. If this be so with respect to the claim of a beneficiary against a trustee it should also be the case with respect to the claims of more than one beneficiary against the trustee and, also, as between or among themselves.

33 With respect, I do not think that it is a direct approach to the problem to say that the rule in Clayton's Case is to be used only for the purpose of allocating losses when there is a shortfall in a mingled account and not for enabling an owner to trace funds withdrawn from it. It appears to me that if it is a proper approach to determining "whose" money remains in an account to ascertain "whose" money was taken out, it would be inconsistent not to allow a claimant whose money is deemed to be taken out to claim the product in which this money was invested and, at the same time, to reduce his claim to the remaining balance by the amount of "his" money which was earlier disbursed.

34 As I have already indicated, however, the real question is which is the better approach.

35 Before there is a shortfall in the total amount of the mingled funds, there is no need to decide upon the theory underlying the respective claims of the beneficiaries. In the present case, immediately following the transfer of the $4,000,000 to the Crown Trust account there were sufficient total funds in both accounts to satisfy the claims of both beneficiaries on the approach of either the rule in Clayton's Case or pro rata sharing. At that point, however, before there was a loss, I do not think that it would have made much sense to say that the trust companies owned the $4,000,000 in the Crown Trust account and the "top" $683,000 in the Greymac Trust account -- and that the participants' claim lay against the "next" $841,285.26 in the Greymac account. If a theory had to be adopted the most obvious and natural one is that each beneficiary had an equitable lien on both accounts to secure the amount of its total contribution.

36 When the Greymac account, following this, went into a shortfall position, thus requiring resort to some kind of theory to justify a resolution of the competing proprietary claims of the two beneficiaries, it appears to me to be the more natural and reasonable of the two alternative ones to say that the beneficiaries continued to share pro rata in the two accounts rather than to say that it was the companies' money that was first taken from the Greymac account and then that of the participants. This latter approach does involve, as Parker A.C.J.H.C. noted, the retroactive application of a rule upon a loss subsequently occurring, which has the effect of altering existing property entitlements -- specifically, in this case, expanding the entitlement of the companies and reducing that of the participants to the same extent.

37 The foregoing indicates to me that the fundamental question is not whether the rule in Clayton's Case can properly be used for tracing purposes, as well as for loss allocation, but, rather, whether the rule should have any application at all to the resolution of problems connected with competing beneficial entitlements to a mingled trust fund where there have been withdrawals from the fund. From the perspective of basic concepts I do not think that it

should. The better approach is that which recognizes the continuation, on a pro rata basis, of the respective property interests in the total amount of trust moneys or property available.

38 There is another aspect of the underlying concepts at work which should be examined. Parker A.C.J.H.C. rightly, in my view, questioned "why a court could not apply the rule in Clayton's Case to determine which debts owed by the bank to its customer were paid off, and still apply tracing rules to allocate losses to the account among the customer as trustee and his innocent beneficiaries" (p. 234 O.R., p. 493 D.L.R.). That is, he would confine the rule in Clayton's Case strictly to the bank-customer relationship and would not extend it to the relationship between two innocent beneficiaries.

39 Pennell v. Deffell (1853), 4 De G. M. & G. 372, 43 E.R. 551, was the first case to apply the rule in Clayton's Case to determine the rights of beneficiaries whose funds were deposited by the trustee in a bank account. In that case the funds were mixed with the personal funds of the trustee. It may be noted that the court's holding that the rule in Clayton's Case should be applied to resolve the conflicting claims of the beneficiaries, on the one hand, and of the trustee on the other, was overruled by the Court of Appeal in Re Hallett's Estate (1879), 13 Ch. D. 696. Pennell v. Deffell was not concerned with a competition between beneficiaries. I refer to this case, however, for its underlying reasoning relating to the suggested connection between the rule in Clayton's Case and the distribution of trust funds in bank accounts. With respect to this, Turner L.J. said at pp. 393-4:

> Now Green [the trustee] opened and kept these banking accounts upon the usual footing, and the Plaintiff [who represented the beneficiaries], taking the benefit of the accounts, cannot, as I think, be entitled to alter their character. Adopting them for the purpose of establishing his demand against Green's estate he must, I think, adopt them with all their incidents, one of which is that the monies drawn out are to be applied to the monies first paid in. Upon any other footing this consequence would follow, that a debt which had been extinguished at law by the course of payment would be revived in equity by an alteration in that course.

40 Since this reasoning apparently goes to the root of a beneficiary's claim it is appropriate to quote at length the following criticism of it, which I accept, of D. A. McConville in "Tracing and the Rule in Clayton's Case" (1963), 79 Law Q. Rev. 388 at p. 401:

> But is it true that the beneficiary takes the "benefit of the accounts" between the banker and the trustee or seeks to alter them in any way to make good his claim? The reasoning of Turner L.J. would be appropriate where the beneficiary was claiming to be subrogated to the rights of the trustee against the banker, for there he might be interested in how accounts stood between them. But in Pennell v. Deffell (and in all the tracing situations reviewed), the claim was not against the banker at all but against the trustee. Also it was not in any sense a "personal claim" depending on the enforcing of debts, but "proprietary" in that it sought to take out of a particular asset, property which belonged to the trust. As the claim is made against the trustee, it pre- supposes that it is he who has the asset and not the banker. As between the trustee and the beneficiary the bank account is a piece of property or an asset in the trustee's hands. This is something quite distinct and independent of its position as between the banker and the trustee, where it is a series of debts or personal liabilities inter se.
>
> A bank account should therefore be considered as two different things and consequently two different sets of rules apply to decide problems arising in respect of it. When it is necessary to consider it as a debt, rules as to appropriation of debts, including Clayton's Case apply, but when it has to be considered as a piece of property, rules as to competing titles and confusion of identical property are appropriate.

At p. 403:

> Nor should it make any difference that instead of a mixing taking place between one trust fund and the trustee's private money, the mixing is that of two or more trust funds either with each other or with private money as well. Here, instead of there being one charge on the mixed fund, there are two or more. If there is not enough money to pay all claims, the charges should abate proportionately.

41 In the light of the foregoing it can be seen that the application of the rule in Clayton's Case to the problem under

consideration is arbitrary and unfair. It is based on a fiction. As Learned Hand J. said in Re Walter J. Schmidt & Co. (1923), 298 Fed. 314 at p. 316, in a passage quoted by Parker A.C.J.H.C. (at pp. 227-8 O.R., pp. 485-6 D.L.R.):

> "The rule in Clayton's Case is to allocate the payments upon an account. Some rule had to be adopted, and though any presumption of intent was a fiction, priority in time was the most natural basis of allocation. It has no relevancy whatever to a case like this. Here two people are jointly interested in a fund held for them by a common trustee. There is no reason in law or justice why his depredations upon the fund should not be borne equally between them. To throw all the loss upon one, through the mere chance of his being earlier in time, is irrational and arbitrary, and is equally a fiction as the rule in Clayton's Case, supra. When the law adopts a fiction, it is, or at least it should be, for some purpose of justice. To adopt it here is to apportion a common misfortune through a test which has no relation whatever to the justice of the case ... Such a result, I submit with the utmost respect, can only come from a mechanical adherence to a rule which has no intelligible relation to the situation."

42 In this case, however, Hand J. was obliged by authority, Re A. Bolognesi & Co. (1918), 254 Fed. 770, to apply the rule in Clayton's Case. He said of Bolognesi, a judgment of the Circuit Court of Appeals, Second Circuit, that "it constitutes authority absolutely binding upon me" (p. 320).

43 I am not aware of any argument of logic (apart from that in Pennell v. Deffell which, for the reasons I have set out, I do not accept) or fairness which would support the application of the rule to the problem. The only argument advanced in its favour is that of convenience: see, e.g., Pennell v. Deffell at pp. 393-4, and Re Diplock; Diplock v. Wintle at pp. 553-4. It is said to be more convenient to apply than that of pro rata sharing.

44 Before considering the convenience argument in favour of the rule, I should, however, deal with one of the appellants' criticisms of the judgment under appeal related to its logic and fairness. The matter covered by this criticism also has some bearing on the question of convenience. The appellants submit that if the equality, that is, pro rata sharing, approach is to be followed, then to do justice more money furnished by the companies to the trustee than the $4,683,000 balance of December 15, 1982, should be taken into account. The ledger of the trustee's account with Greymac Trust shows that the companies were the source of $9,698,000 placed into the account between November 30 and December 15, 1982, and not just the $4,683,000 balance. If the proper approach is equality, then, it is submitted, this fact should be taken into account. On this point reference is made to the comment of Professor Donovan Waters in his Law of Trusts in Canada (1974), p. 895, quoted by Pennell J. in Re Law Society of Upper Canada and Riviera Motel (Kitchener) Ltd. et al. (1981), 33 O.R. (2d) 65 at pp. 70-1, 123 D.L.R. (3d) 409 at p. 415, 9 E.T.R. 188 sub nom. Re Delaney:

> " ... it would have been preferable, if, instead of juggling with the accidental time sequence of events [this was said of the judgment in Bailey v. Jellett et al. (1882), 9 O.A.R. 187], the court had proportioned the loss between the clients <u>according to the amounts due them respectively</u>."

(Emphasis added. The same passage appears in Waters, Law of Trusts in Canada, 2nd ed. (1984), at pp. 1050-1.)

45 Quite apart from the fact that the question of whether any part of the original $9,698,000, down to the $4,683,000, was returned to the companies in some form was not inquired into, I do not think that this particular argument of the appellants is of assistance to them. We are concerned with the resolution of competing proprietary, not personal, claims. At the time of the mingling of the trust funds the companies had $4,683,000 in the account. Regardless of how much they had earlier in the account, they cannot say that they had a proprietary interest in any more than the amount in the account to their credit on and after December 15, 1982: see James Roscoe (Bolton), Ltd. v. Winder, [1915] 1 Ch. 62, and Re Norman Estate, [1951] O.R. 752, [1952] 1 D.L.R. 174.

46 While it might, possibly, be appropriate in some circumstances to recognize claims on the basis of a claimant's original contribution (but see Scott The Law of Trusts, vol. 5, 3rd ed. (1967), at pp. 3647-52), I do not think that it is appropriate where the contributions to the mixed fund can be simply traced, as in the present case. See also the very useful report of the Law Reform Commission of British Columbia -- Report on Competing Rights to Mingled Property: Tracing and the Rule in Clayton's Case (1983), at pp. 48-9 and 53-7.

47 Returning to the matter of convenience, it must be noted that the rule in Clayton's Case, if it is to be applied, applies only to trustees' current bank accounts. It does not apply where the trust property of more than one beneficiary is mingled otherwise than in a current bank account. This indeed was the result with respect to one of the claims in Re Diplock itself (at pp. 554-6), one concerned with the shortfall in a mixture of corporate shares. At p. 555 Lord Greene M.R. said with respect to this claim: "We see no justification for extending that rule [the rule in Clayton's Case] beyond the case of a banking account."

48 While acknowledging the basic truth of Lord Atkin's observation that "[c]onvenience and justice are often not on speaking terms" (General Medical Council v. Spackman, [1943] A.C. 627 at p. 638), I accept that convenience, perhaps more accurately workability, can be an important consideration in the determination of legal rules. A rule that is in accord with abstract justice but which, for one or more reasons, is not capable of practical application, may not, when larger considerations of judicial administration are taken into account, be a suitable rule to adopt. However, I am not persuaded that considerations of possible inconvenience or unworkability should stand in the way of the acceptance, as a general rule, of pro rata sharing on the basis of tracing. That it is sufficiently workable to be the general rule is indicated by the fact that it appears to be the majority rule in the United States (see Scott, The Law of Trusts, vol. 5, 3rd ed. (1967), pp. 3639-41; J. F. Ghent, Distribution of Funds Where Funds of More Than One Trust Have Been Commingled by Trustee and Balance is Insufficient to Satisfy Act Trust Claims (Annotation) (1968), 17 A.L.R. (3d) 937) and has been adopted in the Restatement of the Law: Trusts (2nd) (s. 202) and the Restatement of Restitution (s. 213). D. A. McConville, in the article from which I have earlier quoted ("Tracing and the Rule in Clayton's Case" (1963), 79 Law Q. Rev. 388 at p. 405), after citing examples firmly expressed the following view:

> Applying strictly proprietary rules ... and by always going back to the amounts originally mixed and treating the claimants on the footing of equality, it is submitted there will be found no situations, "incapable of solution" as the Court of Appeal thought was the fatal objection to any rule other than the rule in Clayton's Case to decide the problem in Re Diplock noted earlier.

He went on to say at p. 405:

> Naturally the number of accounts, investments and transactions can be multiplied to a point where calculations become too complicated and expensive to undertake.

One of the examples he gave of a solution to this kind of problem was Sinclair v. Brougham itself where the "House of Lords split the assets in the proportion indicated by the respective total amounts of deposits [by the depositors] and investments [by the shareholders] one to another. There being a deficiency of assets, each bore the loss rateably" (p. 407).

49 Ford and Lee's Principles of the Law of Trusts (1983), deals with the matter of convenience as follows at p. 744:

> It is submitted that whether moneys in a bank account should be shared between claimants following the rule in Clayton's Case or on a proportionate basis depends on whether it is feasible to ascertain the proportions attributable to all possible claimants. It is unlikely that it will be feasible where there have been many deposits and withdrawals of funds belonging to many claimants. The difficulties of ascertainment, including the difficulties of evidence, are conveniently resolved by resort to the rule in Clayton's Case, following the practice of bankers in similar cases. But where the convenience of that rule is not needed because the account is of short duration and the position of claimants is clear, it is submitted that a proportionate shareout is preferable.

50 I refer to this passage simply to indicate the authors' point that where the convenience of the rule in Clayton's Case is not needed, because it is feasible to ascertain the proportions attributable to all claimants, proportionate sharing is preferable. I might add that it may well be that proportionate sharing on the basis of the claimants' original contributions (that is, not on the basis of tracing) may be just as convenient or, possibly, more convenient than the application of the rule in Clayton's Case and, also, fairer.

51 With respect to this point Parker A.C.J.H.C. said (at p. 240 O.R., p. 498 D.L.R.) in a part of his reasons which have already been quoted:

> I express no opinion on the power of the court to make a disposition on some other basis where it is not possible to determine what proportion the mixed funds bear each to the other.

52 I accept this qualification and would add the modifier "practically" before "possible" to introduce an element of flexibility to the approach and to avoid the situation where the nature of the substantive justice to be achieved would not justify the tracing exercise.

53 Another exception, an obvious and necessary one, which might often overlap with the kind of case just referred to, would be the case where the court finds that the claimants have, either expressly or by implication, agreed among themselves to a distribution based otherwise than on a pro rata division following equitable tracing of contributions.

Are we bound to apply the rule in Clayton's Case?

54 Apart from examining the case-law in Ontario, I do not intend to review the state of the law on this point in detail. In England, in view of the decision of the Court of Appeal in Re Diplock; Diplock v. Wintle, supra, one might reasonably think that the Court of Appeal in that country and all lower courts would apply the rule in Clayton's Case to the competing claims of beneficiaries (or of a beneficiary and an innocent volunteer) where the trust moneys have been mingled in a current bank account. Although there are several judicial dicta to this effect, the only other English decision of which I am aware which actually applied the rule in these circumstances is that of Fry J. at first instance in Re Hallett's Estate (1879), 13 Ch. D. 696. (On the appeal there was, ultimately, no issue of priorities between beneficiaries and so the Court of Appeal did not decide the question.)

55 English texts on the subject, while not generally questioning that the point has been decided or the clarity of the judicial dicta, have not hesitated to criticize or question the application of the rule in Clayton's Case to the competing claims of beneficiaries. I refer to: Hanbury & Maudsley Modern Equity, 12th ed. (1985), p. 643 -- "[the rule should not] appear in any aspect of the present subject, but it has unfortunately been applied as a means of determining entitlement in a mixed banking account between rival persons with a right to trace ... "; Sheridan & Keeton, The Law of Trusts, 11th ed. (1983), p. 419: "The rule in Clayton's Case probably applies to the account of a trustee as between beneficiaries under two separate trusts ... though it is open to argument that such beneficiaries rank on the account pari passu"; Underhill, Law of Trusts and Trustees, 13th ed. (1979), at p. 719: "This rule can operate most unfairly in making one trust bear the whole brunt of losses"; and in footnote 4 on p. 719: "A rateable burden would seem fairer ... "; Nathan & Marshall, A Casebook on Trusts, 5th ed. (1967), p. 324 in footnote 7: "The contrary view is persuasively argued ... that Clayton's case has no application" (referring to the McConville article in 79 Law Q. Rev. 388 and to Higgins, "Re Diplock -- A Reappraisal" (1963-64), 6 U. W. Aust. L. Rev. 428), and Goff & Jones, The Law of Restitution, 2nd ed. (1978), p. 58: "The result is capricious and arbitrary."

56 McConville, in the concluding part of his article "Tracing and the Rule in Clayton's Case" (1963), 79 Law Q. Rev. 388 at p. 408, says:

> ... it is submitted the introduction of [Clayton's Case] into the law of tracing arose from a confusion of two unconnected branches of law, deceptively similar in that they both relate to bank accounts. In view of the fact that the underlying principles have only once been examined [by Turner L.J. in Pennell v. Deffell, supra, at pp. 393-4] and the authorities are conflicting [here, I believe, he refers to Re Oatway, [1903] 2 Ch. 356 and Re British Red Cross Balkan Fund, British Red Cross Society v. Johnson, [1914] 2 Ch. 419 -- see pp. 399-400], it is hoped a modern court might feel at liberty to remodel the law of tracing on more rational lines in this respect by holding Clayton's Case to be irrelevant.

57 I have earlier quoted the view of P. F. P. Higgins that Re Diplock is contrary to the decision of the House of Lords in Sinclair v. Brougham et al., [1914] A.C. 398: "Re Diplock -- A Reappraisal" (1963-64), 6 U. W. Aust. L. Rev. 428 at pp. 438-9.

58 With respect to Canada, Professor Waters has expressed the opinion that "a similar view [to that of Fry J. in Re Hallett's Estate that the rule in Clayton's Case applies] has been reiterated on sufficient occasions that it must be considered as finally settled in this country": The Law of Trusts in Canada, 2nd ed. (1984), at p. 1050. He cites, by way of example, three decisions: Bailey v. Jellett (1882), 9 O.A.R. 187 (C.A.); British Canadian Securities Ltd. v. Martin et al., [1917] 1 W.W.R. 1313, 27 Man. R. 423 (Man. Q.B.), and Re C. A. Macdonald & Co. Ltd. (1958), 17 D.L.R. (2d) 416, 26 W.W.R. 116, 37 C.B.R. 119 (Alta. S.C.). With respect, I do not read the British Canadian Securities judgment as applying the rule in Clayton's Case to an issue between beneficiaries. In any event, reference may also be made to the following additional decisions which have applied the rule in Clayton's Case to issues between beneficiaries: Re Coville Transport Co. Ltd. (1947), 28 C.B.R. 262 (Ont. S.C. in Bankruptcy); Re Law Society of Upper Canada and Riviera Motel (Kitchener) Ltd. et al., supra, and Corbett et al. v. McKee, Calabrese & Whitehead et al. (1984), 54 N.B.R. (2d) 107, 16 E.T.R. 200 (N.B.Q.B.).

59 Professor Waters also observed, after the quoted sentence: "As one might suppose, the operation of the rule is sufficiently formulaic that it works some odd and hardly justifiable results" (p. 1050).

60 The report of the Law Reform Commission of British Columbia, to which I have already referred, although it leaves no doubt as to the unsuitability of the rule in Clayton's Case in this context, says " ... given the preponderance of case authority in favour of the rule in Clayton's Case, we doubt whether courts will depart from it. There is a need for legislative action." (Report on Competing Rights to Mingled Property: Tracing and the Rule in Clayton's Case (1983), at p. 44.) This appears to be a less firm view than that of Waters. It is, possibly, more one of pessimism respecting judicial action, accompanied by a corresponding exhortation for a legislative solution.

61 Although I appreciate that the value of uniformity among the provinces is an important one to be weighed in the balance, I am not persuaded that the decisions from Alberta, Manitoba (if, indeed, it bears on the point in issue) and New Brunswick, to which I have referred, necessarily represent the law of those provinces. None of these decisions are of appellate courts and, even if this were the case, we would not be obliged to follow them, even if a point of federal law were at issue, unless we were persuaded to do so on their merits or for other independent reasons: Wolf v. The Queen, [1975] 2 S.C.R. 107 at p. 109, 47 D.L.R. (3d) 741 at p. 742, 17 C.C.C. (2d) 425. As far as the dictates of precedent are concerned our main attention must be employed in examining the 1882 decision of this court in Bailey v. Jellett, supra.

62 I shall take the facts of this case as set forth in the reasons for judgment of Spragge C.J.O. and refer only to those essential to the point under consideration. In that case a trustee, Jellett, had on deposit in his personal bank account the funds of two beneficiaries: first in time, those of the plaintiff, in the amount of $4,901 and, second in time, those of the defendant Mrs. Suzor, in the amount of $1,182.95. The balance at that time was, then, $6,083.95. From this balance he paid $3,000 into another account for the plaintiff and dissipated $93. The final balance was $2,991. Accordingly, there was a shortfall of $93 having regard to the contributions of the plaintiff and the defendant Mrs. Suzor as of the date these were mixed in the account. Spragge C.J.O.'s reasons on the point are set forth in pp. 201-2:

> It is not, as it appears to me, necessary to determine whether the rule in Clayton's Case should apply as between cestuis que trust of the same fund (except, perhaps, as to a small sum which I will notice presently), because we can in this case trace and follow the moneys of Mrs. Suzor at the bank, as well as what may have remained of the moneys of the plaintiff. Before the payment in of Mrs. Suzor's money there stood to Jellett's credit $4,901 that being $1,599 (not counting cents) less than the moneys of the plaintiff, the difference it is to be assumed having been used by Jellett himself. If Jellett had died at that time, and Mrs. Suzor's money had not been paid in, the plaintiff would have been entitled to that sum, $4,901. What occurred after the date that I have named was this: Mrs. Suzor's money, $1,182.95, was paid in, and no other sum; and there were paid out four cheques, amounting together to $93: and $3,000 was drawn out and placed to the plaintiff 's credit, leaving at Jellett's credit, at the date of his death, $2,991. That sum was composed of the $1,182, belonging to Mrs. Suzor, which is as distinctly traceable as it would have been if it had been the only entry on the face of the account after the paying in of that money. It is in fact the only entry on that side of the account.

> The only possible question could be as to the cheques amounting to $93, and as to them it may be necessary to resort to the rule in Clayton's Case as a convenient rule, where some rule is necessary.
>
> There is indeed room for the presumption that Jellett drew those cheques intending not to touch Mrs. Suzor's money, for he had drawn against the plaintiff 's money before her money was paid in; and when he did make a payment to the plaintiff he left unpaid a considerable sum which he might have paid, still leaving Mrs. Suzor's money intact.
>
> Upon that branch of the case my conclusion, therefore, is that Mrs. Suzor's claim is to be preferred.

63 With respect, it may be thought that it is not quite accurate to begin with the assumption that the moneys of each of the plaintiff and Mrs. Suzor could be traced and followed and, later, that Mrs. Suzor's money was "distinctly traceable". If this was meant to refer to all of her money it does not take into account that there was a shortfall of $93 and that this shortfall had to be allocated in some manner. This may have been conceded in the statement that the "only possible question could be as to the cheques amounting to $93 ... ".

64 It is not clear to me, however, from the passage that I have quoted, that Spragge C.J.O. clearly endorsed the application of the rule in Clayton's Case ("[i]t is not ... necessary to determine whether the rule in Clayton's Case should apply as between cestuis que trust of the same fund (except, perhaps, as to a small sum which I will notice presently) ... ") or, indeed, that he applied it rather than making a finding of fact on the evidence that the trustee had expended the plaintiff 's money in withdrawing the $93.

65 I shall return to these reasons but before doing so I shall indicate the reasons of the other three members of the court.

66 Burton J.A. made no mention of Clayton's Case, or any other decision, in concluding that Mrs. Suzor's money remained in the account throughout (p. 204) and that the money improperly withdrawn, a large part of which must have preceded the deposit of Mrs. Suzor's money, was the plaintiff 's (p. 205).

67 Patterson J.A. is reported merely as having concurred (p. 206).

68 Osler J.A. had no hesitation in holding that on the basis of the rule in Clayton's Case Mrs. Suzor should be reimbursed in full and that the plaintiff should absorb the shortfall of $93. He said at pp. 209-10:

> ... the case of Re Hallett-Knatchbull v. Hallett, 13 Ch. D. 696, appears to be a sufficient authority for the contention that the plaintiff and Mrs. Suzor are respectively entitled to a charge on the balance at Jellett's credit in the bank; and also, as Mr. Scott argued, that as between them the rule in Clayton's Case applies in dealing with the question of the appropriation of payments, so that the earliest drawings are to be appropriated to the earliest deposits.

69 If the judgment of Osler J.A. were that of the Court it could not be denied that the decision was based on the rule in Clayton's Case. However, as I have indicated, the judgment of Spragge C.J.O. on this point is, I think, ambiguous, possibly intentionally so. Burton and Patterson JJ.A. gave no indication at all of the basis of their decisions.

70 I will not dwell much longer on the judgment of the court in Bailey v. Jellett. With respect, I do not agree with Re Coville Transport Co. Ltd., supra, and Re Law Society of Upper Canada and Riviera Motel (Kitchener) Ltd. et al., supra, which treated it as a decision in favour of the application of the rule in Clayton's Case. No doubt, the result was to place the total loss, as small as it was, on one of the beneficiaries rather than dividing it pro rata and so it clearly cannot be regarded as a decision which supports pro rata sharing of losses. Also, if Spragge C.J.O. relied on the trustee's factual intent rather than the Clayton's Case fiction, it was obviously still an approach closer to that of the rule in Clayton's Case than to that of pro rata sharing.

71 Notwithstanding these considerations I do not interpret the decision in Bailey v. Jellett as resting on the "first in, first out" approach of Clayton's Case. In this regard contrast the clear statement of the rule of the Second Circuit

Court of Appeals in Re A. Bolognesi & Co. (1918), 254 Fed. 770 at p. 773, which Learned Hand J. held to be binding on him in Re Walter J. Schmidt & Co. (1923), 298 Fed. 314.

72 In summary, for the following reasons I think that, as a matter of authority, Parker A.C.J.H.C. was right in not applying the rule in Clayton's Case:

(1) Bailey v. Jellett does not squarely decide the point.

(2) If the rule in Clayton's Case is not to be applied, it is not necessary to fashion a new rule or set of rules to replace it. There are already in place basic concepts and principles upon which to base the pro rata sharing approach. Indeed, the application of the rule in Clayton's Case to trust money in active bank accounts is itself the exception to these general principles: see Re Diplock; Diplock v. Wintle, supra, at p. 555.

(3) The pro rata approach is more logical and just.

(4) Assuming that the rule in Clayton's Case is part of the law of Ontario on the point in question, its function in this context is not such that it would be relied upon by affected persons in drawing documents or arranging their affairs. It is, more or less, a remedial rule, which is applied after all of the relevant events have taken place without regard to the future application of any particular rule. Contrast, for example, the function of the rule in Howe v. Earl of Dartmouth (1802), 7 Ves. Jun. 137, 32 E.R. 56, the authoritative nature of which was dealt with in the Supreme Court of Canada in Lottman et al. v. Stanford et al., [1980] 1 S.C.R. 1065, 107 D.L.R. (3d) 28, 6 E.T.R. 34.

73 In the absence of binding authority clearly on point it may reasonably be said that the law is what it ought to be. "Do not the questions 'Is it law?' and 'Is it good law?' generally overlap?": Laskin, Book Review (1940), 18 Can. Bar Rev. 660 at p. 660. In Re Hallett's Estate (1879), 13 Ch. D. 696 at p. 710, Jessel M.R. said:

> ... the moment you establish the fiduciary relation, the modern rules of Equity, as regards following trust money, apply. I intentionally say modern rules, because it must not be forgotten that the rules of Courts of Equity are not, like the rules of the Common Law, supposed to have been established from time immemorial. It is perfectly well known that they have been established from time to time -- altered, improved, and refined from time to time.

(Emphasis added.)

74 Clearly, if the application of the pro rata approach is seen as an alteration in the rule to be applied, it is one that involves improvement and refinement. In this respect see, for example, the developing treatment of the constructive trust from Murdoch v. Murdoch, [1975] 1 S.C.R. 423, 41 D.L.R. (3d) 367, 13 R.F.L. 185, through Rathwell v. Rathwell, [1978] 2 S.C.R. 436, 83 D.L.R. (3d) 289, 1 R.F.L. (2d) 1, to Pettkus v. Becker, [1980] 2 S.C.R. 834, 117 D.L.R. (3d) 257, 19 R.F.L. (2d) 165.

75 For the reasons given I would dismiss this appeal with costs.

Appeal dismissed.

End of Document

TAB 16

COURT OF APPEAL FOR ONTARIO

CITATION: Sirius Concrete Inc. (Re), 2022 ONCA 524
DATE: 20220713
DOCKET: C70020

Benotto, Zarnett and Sossin JJ.A.

In the Matter of the Bankruptcy of Sirius Concrete Inc. of the City of Waterloo, in the Province of Ontario

Scott Turton, for the appellant Ayerswood Development Corporation

Melinda Vine and Jason DiFruscia, for the respondent BDO Canada Limited, as Trustee for the Estate of Sirius Concrete Inc.

Heard: June 14, 2022

On appeal from the order of Justice Jonathon C. George of the Superior Court of Justice, dated December 14, 2020, with reasons at 2020 ONSC 7733.

REASONS FOR DECISION

Introduction

[1] The appellant, Ayerswood Development Corporation ("Ayerswood"), appeals the order of the bankruptcy judge, made on a motion for directions brought by the respondent, BDO Canada Limited, as trustee in bankruptcy of Sirius Concrete Inc. ("Sirius"). In particular, Ayerswood appeals from those parts of the order by which the bankruptcy judge directed that the amount of $381,578.40 (the "funds") that Ayerswood paid to Sirius on March 1, 2019, one business day before Sirius made an assignment into bankruptcy on March 4, 2019, forms part of the bankrupt estate of Sirius and is to be distributed to its creditors.

[2] The bankruptcy judge rejected Ayerswood's position that it had a claim to a remedial or constructive trust over the funds, such that the funds were not property of Sirius that became available for distribution to creditors upon its bankruptcy, and that adjudicating this claim required a fuller evidentiary record. Ayerswood contended that payment of the funds had been induced by Sirius's deceit and constituted an unjust enrichment, and Ayerswood provided evidence about the circumstances of the payment that the bankruptcy judge described as raising a "live question as to whether Ayerswood was manipulated and duped" into paying the funds. However, the bankruptcy judge held that even accepting that evidence as true, "none of … [it] could possibly lead to the imposition of a trust."

[3] In our view, the bankruptcy judge erred, and the appeal must be allowed. Below, we explain our reasons for coming to this conclusion.

Ayerswood's Evidence

[4] On the motion before the bankruptcy judge, only Ayerswood's representative, Mr. Camara, filed an affidavit. There was no cross-examination on it, nor was there any evidence that directly contradicted it. The affidavit was the only evidence about the precise circumstances of the payment of the funds in issue.

[5] Mr. Camara explained that Ayerswood was the general contractor on an apartment building project in Guelph, Ontario. Sirius, a concrete forming company,

was hired by Ayerswood in 2018 to provide the labour, equipment, and materials to construct the concrete structure of the three underground parking levels, the twelve above ground levels, the roof slab, and the penthouse of the project.

[6] Mr. Camara went on to describe how Sirius's performance was marked by delays and deficiencies. He stated that while Ayerswood had been paying Sirius's periodic invoices to incentivize Sirius to get its work done, Ayerswood decided to take a different tack with an invoice that Sirius rendered in January 2019 in the amount of the funds, namely $381,578.40. It decided not to pay the invoice until Sirius demonstrated progress in rectifying the problems and getting the project back on track.

[7] Mr. Camara described the circumstances that led to the ultimate payment of the funds. A site meeting was planned for March 1, 2019, at which Sirius was to present a detailed plan that would address the problems with its deficiencies and delays, but Sirius failed to attend. A Sirius representative, Mr. Waite, then called Mr. Camara to apologize, and asked for the meeting to be delayed until March 5, 2019 because Sirius was discussing its plan to get back on track with its work at the project and needed a bit more time. Mr. Waite asked for a cheque for the January invoice, and when Mr. Camara expressed reluctance to pay without a satisfactory plan from Sirius, Mr. Waite assured Mr. Camara that his providing a cheque would ensure that Sirius would push things along to get its work done. Mr. Camara believed this representation and provided a cheque. However, Sirius

in fact had no intention of doing any further work. It completed a statement of affairs for its bankruptcy filing on the very same day as these representations were being made to Mr. Camara, March 1, 2019. Sirius made an assignment into bankruptcy on the next business day, March 4, 2019. In short, Ayerswood claims that it was "lied to", and it was in reliance on those lies that the funds were paid over when they otherwise would not have been.

[8] As Mr. Camara stated in his affidavit:

> So when Sirius wrote to me on 1 March 2019 – "Tobin and myself will be making more site appearances to get things on track. Please be patient with us as we work through the issues." – Ayerswood was being lied to.
>
> Exhibit E to this affidavit is a copy of the Statement of Affairs of Sirius. While it shows a date of 1 March 2019, the amount of information in that form was self-evidently not compiled only after 12:44 p.m. that day [the time of the above quoted email]. Sirius knew they would not be returning to site and deceived me.
>
> I, and hence Ayerswood, was assured by Sirius that if the payment of their January invoice was given to them they would come to the meeting on 5 March 2019 with a concrete plan to solve the problems and would move their work ahead promptly. This was pure deception with the object of getting Ayerswood to release the cheque. I, and hence Ayerswood, believed these lies, and in the belief that Sirius would be not just continuing their work to completion, but promptly to completion, I relented on the decision to withhold the cheque and released to Sirius the cheque of 1 March 2019 for $381,578.40.
>
> If Sirius had told me the truth on March first 2019 that they had already been working with BDO Canada Limited ("the Trustee") and were going to assign Sirius into

> bankruptcy and abandon their contract for the Building I never would have released the $381,578.40 cheque to them; Ayerswood would not have made that payment. The value of the work by Sirius, coupled with the deficiencies in it, and the delay of the completion of the Building that they caused, meant that they had been overpaid for the work they had done. Sirius was not owed $381,578.40, or any part of that money, and it only received that cheque due to their deceit as I have outlined above.

Analysis

[9] The parties argued about both the process followed and also the correctness of the disposition made.

[10] As to process, the parties agree that, on a motion for directions in an insolvency matter, the supervising court may determine an issue of entitlement to assets or funds as between the insolvent estate and a third party by following a summary procedure modelled on that used on a motion for summary judgment, or may order a trial to determine the dispute where there is a genuine issue requiring one: *Ontario Securities Commission v. Money Gate Mortgage Investment Corporation*, 2020 ONCA 812, 153 O.R. (3d) 225, at paras. 10, 32-35 and 40. Although *Money Gate* dealt with a receivership, the same analysis can apply in a bankruptcy.

[11] It is unnecessary to consider the argument that the record was not appropriate for final factual determinations to be made because, in our view, that is not how the bankruptcy judge proceeded. He proceeded on the basis that taking

Ayerswood's evidence as true, as a matter of law no trust claim could possibly succeed.

[12] A motion for directions with a summary procedure would be appropriate to resolve the issue of entitlement to the funds as between the bankrupt estate and Ayerswood if it could have been determined, as a matter of law, that taking Ayerswood's allegations as true, Ayerswood could not possibly establish a proprietary entitlement to the funds.

[13] As to the correctness of the disposition, however, the bankruptcy judge did not cite any authority for his conclusion that Ayerswood's evidence, taken as true, could not possibly establish a trust, and in our respectful view it was incorrect.

[14] Property of the bankrupt divisible among creditors does not include property that the bankrupt holds in trust for any other person: *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 ("*BIA*"), s. 67(1)(a). It is well established that unjust enrichment, arising from certain types of debtor misconduct prior to bankruptcy, may impress funds with a constructive trust in favour of a third party and that the successful assertion of a constructive trust means that the property subject to it does not form part of the property of the bankrupt that vests in the trustee under s. 71 of the *BIA*: *Credifinance Securities Limited v. DSLC Capital Corp.*, 2011 ONCA 160, 277 O.A.C. 377, at paras. 33-37.

[15] According to Lloyd W. Houlden, Geoffrey B. Morawetz and Janis P. Sarra, *Bankruptcy and Insolvency Law of Canada*, loose-leaf (2022-Rel. 6), 4th ed. (Toronto: Thomson Reuters, 2009), at para. 5-17:

> Constructive trusts may apply in bankruptcy. If, in a bankrupt estate, the requirements for a constructive trust are met, the beneficiary of the trust will receive payment out of a fund that would otherwise form part of the assets of the bankrupt estate: Barnabe v. Touhey (1995), 37 C.B.R. (3d) 73, 26 O.R. (3d) 477, 10 E.T.R. (2d) 68, 1995 CarswellOnt 167 (C.A.).

[16] Similarly, in *306440 Ontario Ltd. v. 782127 Ontario Ltd. (Alrange Container Services)*, 2014 ONCA 548, 384 D.L.R. (4th) 278, at para. 24, this court stated:

> Because a constructive trust is a proprietary remedy, it carries with it certain benefits that do not attach to personal remedies. Those benefits include the removal of the property from the estate of the bankrupt, effectively trumping the priority scheme under the bankruptcy legislation: Peter D. Maddaugh and John D. McCamus, *The Law of Restitution*, loose-leaf edition (Toronto: Canada Law Book, 2013), at para. 5:200.

[17] We see no reason why, in law, the facts asserted by Ayerswood could not give rise to a constructive trust as a remedy for unjust enrichment.

[18] To establish unjust enrichment, a claimant must show an enrichment, a corresponding deprivation, and the absence of a juristic reason: *Moore v. Sweet*, 2018 SCC 52, [2018] 3 S.C.R. 303, at para. 37. The payment to Sirius by Ayerswood on March 1, 2019 would meet the requirements of a benefit and a corresponding deprivation. It is not clear that the existence of a contract would

constitute a juristic reason, given that on Ayerswood's evidence, the payment was procured by deceit and a breach of the duty of honest performance, and the amount paid was not owing.

[19] Where an unjust enrichment is established, a court may award a proprietary remedy in the form of a constructive trust where a personal remedy is inadequate and the plaintiff's contribution is linked to the property over which the trust is claimed: *Moore*, at paras. 90-91. Here, a court may view a personal remedy as inadequate given the bankruptcy, and the funds paid by Ayerswood on the eve of bankruptcy may be traceable into the funds in the trustee's hands.

[20] We do not accept the argument that policy reasons necessarily preclude the finding of a constructive trust since giving effect to one would allow money paid to the bankrupt to be clawed back by the payor instead of being shared rateably among all creditors. Parliament has answered this policy question by exempting property that the bankrupt holds in trust from property of the bankrupt that is divisible among creditors.

[21] Nor do we accept the argument that nothing in the evidence distinguishes the March 1, 2019 payment made by Ayerswood from any of the prior payments it made to Sirius. On Ayerswood's uncontradicted evidence, it decided to treat that payment differently and would not have turned the funds over but for being lied to.

[22] Since, accepting the evidence of Ayerswood as true, a trust was a legally viable potential remedy, the decision of the bankruptcy judge, rendered on the basis that it was not a viable potential remedy, cannot stand.

[23] We do not accept the respondent's submission that the bankruptcy judge was going beyond a determination of the legal possibility of a trust claim and was exercising his discretion not to impose a constructive trust in these circumstances. He did not say he was doing so, nor did he refer to the factors that inform the exercise of that discretion.

Disposition

[24] Ayerswood did not argue below that its claim to a constructive trust should be finally determined in its favour. Instead, it asked for a process to allow that determination, fairly recognizing that in that process, its evidence might be challenged by cross-examination, or contradicted by other evidence that it in turn would have the opportunity to respond to or challenge.

[25] We therefore allow the appeal, set aside the determination of the bankruptcy judge that the funds form part of the bankrupt estate of Sirius and are to be distributed to its creditors, and direct that the matter return to bankruptcy court for directions on the procedure to be followed for a determination of the issue of entitlement to the funds paid by Ayerswood to Sirius on March 1, 2019.

[26] Ayerswood is entitled to its costs of the appeal in the sum of $12,000, inclusive of disbursements and applicable taxes.

“M.L. Benotto J.A.”
“B. Zarnett J.A.”
“L. Sossin J.A.”

TAB 17

Twinsectra Limited v Yardley and Others [2002] UKHL 12 (21st March, 2002)

HOUSE OF LORDS

Lord Slynn of Hadley Lord Steyn Lord Hoffmann Lord Hutton Lord Millett

OPINIONS OF THE LORDS OF APPEAL FOR JUDGMENT

IN THE CAUSE

TWINSECTRA LIMITED

(RESPONDENTS)

v

YARDLEY AND OTHERS

(APPELLANTS)

ON 21 MARCH 2002

[2002] UKHL 12

LORD SLYNN OF HADLEY

My Lords,

1. My noble and learned friend Lord Hoffmann has referred to the facts relevant to the issues which arise on this appeal and I gratefully adopt them.

2. The first main issue is whether the monies received by Sims and Roper were held in trust. The judge found that they were not; the Court of Appeal held that they were. For the reasons given by Lord Hoffmann I agree firmly with the Court of Appeal.

3. The second issue I have found more difficult. The judge found that Mr Leach had shut his eyes to the problems or the implications of what happened, yet he acquitted him of dishonesty. The Court of Appeal in a careful analysis by Potter LJ concluded that deliberately shutting his eyes in this way was dishonesty within the valuable analysis by Lord Nicholls of Birkenhead in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378.

4. There are conflicting arguments. Prima facie shutting one's eyes to problems or implications and not following them up may well indicate dishonesty; on the other hand prima facie it needs a strong case to justify the Court of Appeal reversing the finding as to dishonesty of the trial judge who has heard the witness and gone in detail into all the facts.

5. The real difficulty it seems to me is whether in view of these two conflicting arguments the case should go for a retrial with all the disadvantages that entails or whether one of the arguments was sufficiently strong for your Lordships to accept it and to conclude the question. In the end I am not satisfied that the Court of Appeal were entitled to substitute their assessment for that of the trial judge. Despite my doubts as to the implications to be drawn on a finding of "shutting one's eyes" it seems to me clear that the judge was very conscious of Lord Nicholls' analysis and I do not think he can possibly have left out of account the question whether Mr Leach knew or realised that what he was doing fell below the required standards when he deliberately shut his eyes eg to the implications of the undertaking given by Mr Sims. Mr Leach may have been naïve or misguided but I accept that the judge after hearing lengthy evidence from Mr Leach was entitled to conclude that he had not been dishonest.

6. Accordingly it would be wrong to send the matter for retrial and for these brief reasons and the reasons given by Lord Hutton I would allow the appeal.

LORD STEYN

My Lords,

7. I agree that the law is as stated in the judgments of my noble and learned friends Lord Hoffmann and Lord Hutton. In particular I agree with their interpretation of the decision in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378. In other words, I agree that a finding of accessory liability against Mr Leach was only permissible if, applying what Lord Hutton has called the combined test, it were established on the evidence that Mr Leach had been dishonest.

8. After a trial Carnwath J was not satisfied that Mr Leach had been dishonest. I agree with Lord Hutton's reasons for concluding that the Court of Appeal was not entitled to reverse the judge on the central issue of dishonesty. I too would allow the appeal.

LORD HOFFMANN

My Lords,

9. Paul Leach is a solicitor practising in Godalming under the name Paul Leach & Co. Towards the end of 1992 he acted for a Mr Yardley in a transaction which included the negotiation of a loan of £1m from Twinsectra Limited. Mr Leach did not deal directly with Twinsectra. Another firm of solicitors, Sims and Roper of Dorset ("Sims"), represented themselves as acting on behalf of Mr Yardley. They received the money in return for the following undertaking:

> "1. The loan monies will be retained by us until such time as they are applied in the acquisition of property on behalf of our client.
>
> 2. The loan monies will be utilised solely for the acquisition of property on behalf of our client and for no other purposes.
>
> 3. We will repay to you the said sum of £1,000,000 together with interest calculated at the rate of £657.53 such payment to be made within four calendar months after receipt of the loan monies by us."

10. Contrary to the terms of the undertaking, Sims did not retain the money until it was applied in the acquisition of property by Mr Yardley. On being given an assurance by Mr Yardley that it would be so applied, they paid it to Mr Leach. He in turn did not take steps to ensure that it was utilised solely for the acquisition of property on behalf of Mr Yardley. He simply paid it out upon Mr Yardley's instructions. The result was that £357.720.11 was used by Mr Yardley for purposes other than the acquisition of property.

11. The loan was not repaid. Twinsectra sued all the parties involved including Mr Leach. The claim against him was for the £357,720.11 which had not been used to buy property. The basis of the claim was that the payment by Sims to Mr Leach in breach of the undertaking was a breach of trust and that he was liable for dishonestly assisting in that breach of trust in accordance with the principles stated by Lord Nicholls of Birkenhead in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378.

12. The trial judge (Carnwath J) did not accept that the monies were "subject to any form of trust in Sims and Roper's hands". I do not imagine that the judge could have meant this to be taken literally. Money in a solicitor's client account is held on trust. The only question is the terms of that trust. I should think that what Carnwath J meant was that Sims held the money on trust for Mr Yardley absolutely. That is the way it was put by Mr Oliver QC, who appeared for Mr Leach. But, like the Court of Appeal, I must respectfully disagree. The terms of the trust upon which Sims held the money must be found in the undertaking which they gave to Twinsectra as a condition of payment. Clauses 1 and 2 of that undertaking made it clear that the money was not to be at the free disposal of Mr Yardley. Sims were not to part with the money to Mr Yardley or anyone else except for the purpose of enabling him to acquire property.

13. In my opinion the effect of the undertaking was to provide that the money in the Sims client account should remain Twinsectra's money until such time as it was applied for the acquisition of property in accordance with the undertaking. For example, if Mr Yardley went bankrupt before the money had been so applied, it would not have formed part of his estate, as it would have done if Sims had held it in trust for him absolutely. The undertaking would have ensured that Twinsectra could get it back. It follows that Sims held the money in *trust* for Twinsectra, but subject to a *power* to apply it by way of loan to Mr Yardley in accordance with the undertaking. No doubt Sims also owed fiduciary obligations to Mr Yardley in respect of the exercise of the power, but we need not concern ourselves with those obligations because in fact the money was applied wholly for Mr Yardley's benefit.

14. The judge gave two reasons for rejecting a trust. The first was that the terms of the undertaking were too vague. It did not specify any particular property for which the money was to be used. The second was that Mr Ackerman, the moving spirit behind Twinsectra, did not intend to create a trust. He set no store by clauses 1 and 2 of the undertaking and was content to rely on the guarantee in clause 3 as Twinsectra's security for repayment.

15. I agree that the terms of the undertaking are very unusual. Solicitors acting for both lender and borrower (for example, a building society and a house buyer) commonly give an undertaking to the lender that they will not part with the money save in exchange for a duly executed charge over the property which the money is being used to purchase. The undertaking protects the lender against finding himself unsecured. But Twinsectra was not asking for any security over the property. Its security was clause 3 of the Sims undertaking. So the purpose of the undertaking was unclear. There was nothing to prevent Mr Yardley, having acquired a property in accordance with the undertaking, from mortgaging it to the hilt and spending the proceeds on something else. So it is hard to see why it should have mattered to Twinsectra whether the immediate use of the money was to acquire property. The judge thought it might have been intended to give some protective colour to a claim against the Solicitors Indemnity Fund if Sims failed to repay the loan in accordance with the undertaking. A claim against the fund would depend upon showing that the undertaking was given in the context of an underlying transaction within the usual business of a solicitor: *United Bank of Kuwait Ltd v Hammoud* [1988] 1 WLR 1051. Nothing is more usual than for solicitors to act on behalf of clients in the acquisition of property. On the other hand, an undertaking to repay a straightforward unsecured loan might be more problematic.

16. However, the fact that the undertaking was unusual does not mean that it was void for uncertainty. The charge of uncertainty is levelled against the terms of the power to apply the funds. "The acquisition of property" was said to be too vague. But a power is sufficiently certain to be valid if the court can say that a given application of the money does or does not fall within its terms: see *In re Baden's Deed Trusts* [1971] AC 424. And there is no dispute that the £357,720.11 was not applied for the acquisition of property.

17. As for Mr Ackerman's understanding of the matter, that seem to me irrelevant. Whether a trust was created and what were its terms must depend upon the construction of the undertaking. Clauses 1 and 2 cannot be ignored just because Mr Ackerman was not particularly interested in them.

18. The other question is whether Mr Leach, in receiving the money and paying it to Mr Yardley without concerning himself about its application, could be said to have acted dishonestly. The judge found that in so doing he was "misguided" but not dishonest. He had "shut his eyes" to some of the problems but thought he held the money to the order of Mr Yardley without restriction. The Court of Appeal reversed this finding and held that he had been dishonest.

19. My noble and learned friend Lord Millett considers that the Court of Appeal was justified in taking this view because liability as an accessory to a breach of trust does not depend upon dishonesty in the normal sense of that expression. It is sufficient that the defendant knew all the facts which made it wrongful for him to participate in the way in which he did. In this case, Mr Leach knew the terms of the undertaking. He therefore knew all the facts which made it wrongful for him to deal with the money to the order of Mr Yardley without satisfying himself that it was for the acquisition of property.

20.

I do not think that it is fairly open to your Lordships to take this view of the law without departing from the principles laid down by the Privy Council in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378. For the reasons given by my noble and learned friend Lord Hutton, I consider that those principles require more than knowledge of the facts which make the conduct wrongful. They require a dishonest state of mind, that is to say, consciousness that one is transgressing ordinary standards of honest behaviour. I also agree with Lord Hutton that the judge correctly applied this test and that the Court of Appeal was not entitled, on the basis of the written transcript, to make a finding of dishonesty which the judge who saw and heard Mr Leach did not.

21.

The ground upon which the Court of Appeal reversed the judge's finding was that he had misdirected himself in law. His finding about Mr Leach shutting his eyes to problems meant that he did not appreciate that a person may be dishonest without actually knowing all the facts if he suspects that he is about to do something wrongful and deliberately shuts his eyes to avoid finding out. As Lord Nicholls said in the *Royal Brunei* case, at p 389, an honest person does not:

> "deliberately close his eyes and ears, or deliberately not ask questions, lest he learn something he would rather not know, and then proceed regardless."

So the Court of Appeal said that, when the judge said that Mr Leach was not dishonest, he meant that he was not "consciously dishonest". But the finding about shutting his eyes meant that in law he had nevertheless been dishonest.

22.

I do not believe that the judge fell into such an elementary error. He had himself quoted the passage I have cited from the opinion of Lord Nicholls in the *Royal Brunei* case a little earlier in his judgment. He could not possibly have overlooked the principle. That said, I do respectfully think it was unfortunate that the judge three times used the expression "shut his eyes" to "the details", or "the problems", or "the implications". The expression produces in judges a reflex image of Admiral Nelson at Copenhagen and the common use of this image by lawyers to signify a deliberate abstinence from inquiry in order to avoid certain knowledge of what one suspects to be the case: see *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd* [2001] 2 WLR 170, 179, per Lord Hobhouse of Woodborough, and Lord Scott of Foscote, at pp 207-210. But, as my noble and learned friend Lord Millett points out, there were in this case no relevant facts of which Mr Leach was unaware. What I think the judge meant was that he took a blinkered approach to his professional duties as a solicitor, or buried his head in the sand (to invoke two different animal images). But neither of those would be dishonest.

23.

Mr Leach believed that the money was at the disposal of Mr Yardley. He thought that whether Mr Yardley's use of the money would be contrary to the assurance he had given Mr Sims or put Mr Sims in breach of his undertaking was a matter between those two gentlemen. Such a state of mind may have been wrong. It may have been, as the judge said, misguided. But if he honestly believed, as the judge found, that the money was at Mr Yardley's disposal, he was not dishonest.

24.

I do not suggest that one cannot be dishonest without a full appreciation of the legal analysis of the transaction. A person may dishonestly assist in the commission of a breach of trust without any idea of what a trust means. The necessary dishonest state of mind may be found to exist simply on the fact that he knew perfectly well that he was helping to pay away money to which the recipient was not entitled. But that was not the case here. I would therefore allow the appeal and restore the decision of Carnwath J

LORD HUTTON

My Lords,

25.

I have had the advantage of reading in draft the speeches of my noble and learned friends Lord Hoffmann and Lord Millett. For the reasons which they give I agree that the undertaking given by Mr Sims to Twinsectra Ltd ("Twinsectra") created a trust, and I turn to consider whether the Court of Appeal was right to hold that Mr Leach is liable for assisting in Mr Sims' breach of trust. Carnwath J held that the undertaking did not create a trust, but he also held that Mr Leach had not been dishonest. The Court of Appeal reversed his findings and held that the undertaking gave rise to a trust and that Mr Leach had acted dishonestly and was liable as an accessory to Mr Sims' breach of trust.

26.

My Lords, in my opinion, the issue whether the Court of Appeal was right to hold that Mr Leach had acted dishonestly depends on the meaning to be given to that term in the judgment of Lord Nicholls of Birkenhead in *Royal Brunei Airlines Snd Bhd v Tan* [1995] 2 AC 378. In approaching this question it will be helpful to consider the place of dishonesty in the pattern of that judgment. Lord Nicholls considered, at pp 384 and 385, the position of the honest trustee and the dishonest third party and stated that dishonesty on the part of the third party was a sufficient basis for his liability notwithstanding that the trustee, although mistaken and in breach of trust, was honest. He then turned to consider the basis on which the third party, who does not receive trust property but who assists the trustee to commit a breach, should be held liable. He rejected the possibility that such a third party should never be liable and he also rejected the possibility that the liability of a third party should be strict so that he would be liable even if he did not know or had no reason to suspect that he was dealing with a trustee. Therefore Lord Nicholls concluded that the liability of the accessory must be fault-based and in identifying the touchstone of liability he stated, at p 387 H: "By common accord dishonesty fulfils this role." Then, at pp 388 and 389, he cited a number of authorities and the views of commentators and observed that the tide of authority in England had flowed strongly in favour of the test of dishonesty and that most, but not all, commentators also preferred that test.

27.

Whilst in discussing the term "dishonesty" the courts often draw a distinction between subjective dishonesty and objective dishonesty, there are three possible standards which can be applied to determine whether a person has acted dishonestly. There is a purely subjective standard, whereby a person is only regarded as dishonest if he transgresses his own standard of honesty, even if that standard is contrary to that of reasonable and honest people. This has been termed the "Robin Hood test" and has been rejected by the courts. As Sir Christopher Slade stated in *Walker v Stones* [2000] Lloyds Rep PN 864, 877 para 164:

> "A person may in some cases act dishonestly, according to the ordinary use of language, even though he genuinely believes that his action is morally justified. The penniless thief, for example, who picks the pocket of the multi-millionaire is dishonest even though he genuinely considers that theft is morally justified as a fair redistribution of wealth and that he is not therefore being dishonest."

Secondly, there is a purely objective standard whereby a person acts dishonestly if his conduct is dishonest by the ordinary standards of reasonable and honest people, even if he does not realise this. Thirdly, there is a standard which combines an objective test and a subjective test, and which requires that before there can be a finding of dishonesty it must be established that the defendant's conduct was dishonest by the ordinary standards of reasonable and honest people and that he himself realised that by those standards his conduct was dishonest. I will term this "the combined test".

28.

There is a passage in the earlier part of the judgment in *Royal Brunei* which suggests that Lord Nicholls considered that dishonesty has a subjective element.

Thus in discussing the honest trustee and the dishonest third party at [1995] 2 AC 378, 385 A-C he stated:

> "These examples suggest that what matters is the state of mind of the third party …. But [the trustee's] state of mind is essentially irrelevant to the question whether the third party should be made liable to the beneficiaries for breach of trust."

29. However, after stating, at p 387 H, that the touchstone of liability is dishonesty, Lord Nicholls went on at page 389 B-C to discuss the meaning of dishonesty:

> "Before considering this issue further it will be helpful to define the terms being used by looking more closely at what dishonesty means in this context. Whatever may be the position in some criminal or other contexts (see, for instance, *R v Ghosh* [1982] QB 1053), in the context of the accessory liability principle acting dishonestly, or with a lack of probity, which is synonymous, means simply not acting as an honest person would in the circumstances. This is an objective standard."

30. My noble and learned friend Lord Millett has subjected this passage and subsequent passages in the judgment to detailed analysis and is of the opinion that Lord Nicholls used the term "dishonesty" in a purely objective sense so that in this area of the law a person can be held to be dishonest even though he does not realise that what he is doing is dishonest by the ordinary standards of honest people. This leads Lord Millett on to the conclusion that in determining the liability of an accessory dishonesty is not necessary and that liability depends on knowledge.

31. In *R v Ghosh* [1982] QB 1053 Lord Lane CJ held that in the law of theft dishonesty required that the defendant himself must have realised that what he was doing was dishonest by the ordinary standards of reasonable and honest people. The three sentences in Lord Nicholl's judgment, at p 389 B-C, which appear to draw a distinction between the position in criminal law and the position in equity, do give support to Lord Millett's view. But considering those sentences in the context of the remainder of the paragraph and taking account of other passages in the judgment, I think that in referring to an objective standard Lord Nicholls was contrasting it with the purely subjective standard whereby a man sets his own standard of honesty and does not regard as dishonest what upright and responsible people would regard as dishonest. Thus after stating that dishonesty is assessed on an objective standard he continued, at p 389 C:

> "At first sight this may seem surprising. Honesty has a connotation of subjectivity, as distinct from the objectivity of negligence. Honesty, indeed, does have a strong subjective element in that it is a description of a type of conduct assessed in the light of what a person actually knew at the time, as distinct from what a reasonable person would have known or appreciated. Further, honesty and its counterpart dishonesty are mostly concerned with advertent conduct, not inadvertent conduct. Carelessness is not dishonesty. Thus for the most part dishonesty is to be equated with conscious impropriety. However, these subjective characteristics of honesty do not mean that individuals are free to set their own standards of honesty in particular circumstances. The standard of what constitutes honest conduct is not subjective. Honesty is not an optional scale, with higher or lower values according to the moral standards of each individual. If a person knowingly appropriates another's property, he will not escape a finding of dishonesty simply because he sees nothing wrong in such behaviour."

Further, at p 391 A-C, Lord Nicholls said:

> "Ultimately, in most cases, an honest person should have little difficulty in knowing whether a proposed transaction, or his participation in it, would offend the normally accepted standards of honest conduct.

> Likewise, when called upon to decide whether a person was acting honestly, a court will look at all the circumstances known to the third party at the time. The court will also have regard to personal attributes of the third party, such as his experience and intelligence, and the reason why he acted as he did."

32. The use of the word "knowing" in the first sentence would be superfluous if the defendant did not have to be aware that what he was doing would offend the normally accepted standards of honest conduct, and the need to look at the experience and intelligence of the defendant would also appear superfluous if all that was required was a purely objective standard of dishonesty. Therefore I do not think that Lord Nicholls was stating that in this sphere of equity a man can be dishonest even if he does not know that what he is doing would be regarded as dishonest by honest people.

33. Then, at p 392 F-G, Lord Nicholls stated the general principle that dishonesty is a necessary ingredient of accessory liability and that knowledge is not an appropriate test:

> "*The accessory liability principle*
>
> Drawing the threads together, their Lordships' overall conclusion is that dishonesty is a necessary ingredient of accessory liability. It is also a sufficient ingredient. A liability in equity to make good resulting loss attaches to a person who dishonestly procures or assists in a breach of trust or fiduciary obligation. It is not necessary that, in addition, the trustee or fiduciary was acting dishonestly, although this will usually be so where the third party who is assisting him is acting dishonestly. 'Knowingly' is better avoided as a defining ingredient of the principle, and in the context of this principle the *Baden* [1993] 1 WLR 509 scale of knowledge is best forgotten."

I consider that this was a statement of general principle and was not confined to the doubtful case when the propriety of the transaction in question was uncertain.

34. At p 387 B-C, Lord Nicholls stated that there is a close analogy between "knowingly" interfering with the due performance of a contract and interfering with the relationship between a trustee and a beneficiary. But this observation was made in considering and rejecting the possibility that a third party who did not receive trust property should never be liable for assisting in a breach of trust. I do not think that in referring to "knowingly" procuring a breach of contract Lord Nicholls was suggesting that knowingly assisting in a breach of trust was sufficient to give rise to liability. Such a view would be contrary to the later passage, at p 392 F-G, dealing directly with this point.

35. There is, in my opinion, a further consideration which supports the view that for liability as an accessory to arise the defendant must himself appreciate that what he was doing was dishonest by the standards of honest and reasonable men. A finding by a judge that a defendant has been dishonest is a grave finding, and it is particularly grave against a professional man, such as a solicitor. Notwithstanding that the issue arises in equity law and not in a criminal context, I think that it would be less than just for the law to permit a finding that a defendant had been "dishonest" in assisting in a breach of trust where he knew of the facts which created the trust and its breach but had not been aware that what he was doing would be regarded by honest men as being dishonest.

36. It would be open to your Lordships to depart from the principle stated by Lord Nicholls that dishonesty is a necessary ingredient of accessory liability and to hold that knowledge is a sufficient ingredient. But the statement of that principle by Lord Nicholls has been widely regarded as clarifying this area of the law and, as he observed, the tide of authority in England has flowed strongly in favour of the test of dishonesty. Therefore I consider that the courts should continue to apply that test and that your

Lordships should state that dishonesty requires knowledge by the defendant that what he was doing would be regarded as dishonest by honest people, although he should not escape a finding of dishonesty because he sets his own standards of honesty and does not regard as dishonest what he knows would offend the normally accepted standards of honest conduct.

37. In cases subsequent to *Royal Brunei* there has been some further consideration of the test to be applied to determine dishonesty (the cases being helpfully discussed in an article by Mr Andrew Stafford QC on "Solicitors' liability for knowing receipt and dishonest assistance in breach of trust" in (2001) 17 Professional Negligence 3. For the reasons which I have given I consider that in *Abbey National PLC v Solicitors Indemnity Fund Ltd* [1997] PNLR 306 Steel J applied the correct test. In that case, at p 310, she referred to the test set out in *R v Ghosh* [1982] QB 1053 and to Lord Nicholl's judgment in *Royal Brunei* [1995] 2 AC 378 and observed that it was to the effect that honesty is to be judged objectively, and she continued:

> "What in this case, did, Mr Fallon do, and was he acting as a reasonable and honest solicitor would do? In that case it was laid down that individuals are not free to set their own standards. Mr Fenwick on behalf of the defendant says that if I find that by those standards Mr Fallon was dishonest that would be enough. I need to consider what he did and ask the question: Was he acting as an honest person should? Was what he did dishonest by the standards of a reasonable and honest man or a reasonable and honest solicitor? Having read that case, however, it seems to me that the judgment does not set down a wholly objective test for civil cases. Lord Nicholls particularly refers to a conscious impropriety. The test there, it seems, does embrace a subjective approach, and I have to look at the circumstances to see whether they were such that Mr Fallon must have known that what he did was by the standards of ordinary decent people dishonest. I accept totally that individuals should not be free to set their own standards, but there is in my view a subjective element both in civil and in criminal cases."

38. Therefore I turn to consider the judgment of Carnwath J and the Court of Appeal on the basis that a finding of accessory liability can only be made against Mr Leach if, applying the combined test, it were established on the evidence that he was dishonest.

39. At the trial Mr Leach was cross-examined very closely and at length about his state of mind when he paid to Mr Yardley the monies transferred to him by Mr Sims. The tenor of his replies was that he paid the monies to his client because his client instructed him to do so. Thus in the course of that cross-examination counsel for Twinsectra put the following questions to him (page 55 of the transcript):

> "Q. That is not what you said in your pleading which is what I am putting to you. In your pleading you said that with the exception of the Glibbery payment every other payment was made by you in the belief that the money was going to be used for the acquisition of property by companies of Mr Yardley.
>
> A. I had no reason to disbelieve that it was not. As I said, I believed my client. He borrowed the money. I followed his instructions.
>
> Q. £200,000 was being transferred to Y C Sales, you did not believe for a moment that that company was going to use it to acquire property, did you?
>
> A. My Lord, I merely followed my client's instructions.
>
> CARNWATH J: I think there is a difference. I mean I understand you are saying that, but there is a difference between saying: "I simply paid it in accordance with my client's instructions", and saying, as is said in the pleading: "I paid it in the belief it was going to be used on the acquisition

of property". Now, if your evidence that the former was true and the latter was not then fair enough, but I think Mr Tager is entitled to ask you whether it is right positively to state that you paid the monies in the belief that they were being applied in the acquisition of property.

A. I merely believed in the sense that the monies my client had borrowed were being used for the purpose for which he borrowed them. I actually didn't consider the point.

Q. No, so it is probably that pleading goes rather farther than your own recollection?

A. Yes, I think it is probably ….

MR TAGER: You were putting forward a case in your pleading that Mr Sims had confirmed with you on 23 December that it was going to be used for property. You asked your client if that was so and you got him to confirm the details. The money comes in, you pay it out and you believe each time that that is how the money was used.

A. I had no reason to disbelieve my client.

CARNWATH J: I think I am clear what the witness is saying, Mr Tager."

40.

Carnwath J stated, at pp 50, 51 and 52 of his judgment:

"I do not find Mr Leach to have been dishonest, but he was certainly misguided. He found himself in a difficult position. His retainer for Mr Yardley on the Apperley Bridge transaction was very important to his practice (at a time when large conveyancing jobs were few), and offered the prospect of similar work in the future. When asked to review the documentation on the Nigerian venture, he was understandably reluctant to prejudice his relationship with his client.

I do not accept his evidence that he paid no regard to the details. He was specifically asked to review the terms. He must have realised that it was a very unusual venture, and that the returns of the kind offered were very unlikely to be associated with a wholly legitimate business transaction. ….

His attitude to the Twinsectra loan was not dissimilar. When asked to give the undertaking himself, he regarded it as a very unusual request, and one outside the normal course of a solicitor's practice. This did not lead him to advise Mr Yardley against it, but rather to distance himself from any responsibility for its terms. He told Mr Sims that they were a matter for him. This unease ought to have put him on notice of the need for caution when dealing with the money received under the undertakings. He was clearly aware of their terms. Indeed, his pleaded defence asserts (paragraph 25(4)) that he believed their 'substance … to be that the advance would be applied in the acquisition of property' and that he had received them on the footing that they would be so applied. Yet, in evidence, he frankly admitted that he had regarded the money as held simply to the order of Mr Yardley, without restriction. Again, I have to conclude that he simply shut his eyes to the problems. As far as he was concerned, it was a matter solely for Mr Sims to satisfy himself whether he could release the money to Mr Yardley's account."

Later in the judgment after holding that the undertaking given by Mr Sims did not create a trust the judge stated, at p 73:

"Were any of the defendants knowing recipients or accessories?

The above conclusion makes it unnecessary to resolve the more difficult question whether any of the defendants (that is, the Yardley companies, or Mr Leach) had the necessary state of mind to

make them liable under these headings. For these purposes the companies must realistically be taken to have had the same knowledge and state of mind as Mr Yardley. I have already given my views as to the extent to which I regard him as having acted dishonestly. In Mr Leach's case, I have found that he was not dishonest, but that he did deliberately shut his eyes to the implications of the undertaking. Whether in either case this would be sufficient to establish accessory liability depends on the application of the *Royal Brunei* principles to those facts. Although that case was concerned with "knowing assistance" rather than "knowing receipt", I would find it very difficult, in the light of the current state of the authorities to which I have referred, to define the difference in the mental states required; and I doubt if there is one."

41. It would have been open to the judge to hold that Mr Leach was dishonest, in that he knew that he was transferring to Mr Yardley or to one of his companies monies which were subject to an undertaking that they would be applied solely for the acquisition of property and that the monies would not be so applied. But the experienced judge who was observing Mr Leach being cross-examined at length found that Mr Leach, although misguided, was not dishonest in carrying out his client's instructions.

42. The judge did not give reasons for this finding or state what test he applied to determine dishonesty, but I think it probable that he applied the combined test and I infer that he considered that Mr Leach did not realise that in acting on his client's instructions in relation to the monies he was acting in a way which a responsible and honest solicitor would regard as dishonest. The judge may also have been influenced by the consideration that as he did not find that Mr Sims' undertaking created a trust Mr Leach would not have realised that he was dealing with trust property.

43. It is only in exceptional circumstances that an appellate court should reverse a finding by a trial judge on a question of fact (and particularly on the state of mind of a party) when the judge has had the advantage of seeing the party giving evidence in the witness box. Therefore I do not think that it would have been right for the Court of Appeal in this case to have come to a different conclusion from the judge and to have held that Mr Leach was dishonest in that when he transferred the monies to Mr Yardley he knew that his conduct was dishonest by the standards of responsible and honest solicitors.

44. This was the view taken by the Court of Appeal in *Mortgage Express Ltd v Newman & Co* [2000] Lloyds Rep PN 745 where the issue before the court was not dissimilar to the issue in the present case. In that case it was alleged that the defendant, a solicitor, had dishonestly taken part in a mortgage fraud. In the High Court [2000] PNLR 298 the judge found that the defendant had not consciously suspected a mortgage fraud. Nevertheless he found that she had deliberately refrained from making enquiries and giving advice which an ordinary honest and competent solicitor would have made and given in all the circumstances, and that she had no excuse for doing so other than the fact that she had taken a highly restricted and blinkered view of the duties that she owed to her clients. The judge considered that the explanation for this behaviour was to be found in what she had been told by an insurance and mortgage broker, Mr Baruch, at the outset of the whole transaction, which was that a particular client was not the kind of client who required to be advised of the matters of which a purchaser would normally be advised. The judge found that the solicitor had not been dishonest. He said, at pp 321 and 322:

> "Her fault thus lay in her grossly defective appreciation of the nature of the duties she owed to Mortgage Express and a determination *at the outset* not to concern herself with any matters which were not strictly within the tunnel of her vision. If she honestly believed that it was proper for her to take such a restricted view of her duties, and did not in fact come to suspect that a mortgage fraud was being committed, then in my judgment, however gross the negligence she was not guilty of a dishonest or fraudulent omission within the meaning of rule 14(f). I have

concluded that, unreasonable as it was for her to hold it, the view that she held of the very restricted ambit of her duties to Mortgage Express was honestly held ….

My conclusion is that her whole approach to this problem was from the outset both naïve and well below the standards which should be expected of her profession, but was not dishonest."

45. The Court of Appeal held that the judge's finding that the defendant's conduct was explained by instructions given to her by Mr Baruch was not one which he could have come to on the pleadings and the evidence and that therefore his judgment must be set aside. The plaintiff had submitted that in the absence of a conclusion as to the Baruch instructions, it was clear that the judge would have held that the defendant had been dishonest. Therefore the plaintiff submitted that the Court of Appeal should so hold. The Court of Appeal acknowledged the logic of this submission but observed that it did not take into account the important fact that the judge had concluded that the defendant had not been dishonest after having seen her cross-examined over one and a half days, and Aldous LJ (with whose judgment Tuckey and Mance LLJ agreed) stated, at p 752, para 38:

"It would not be right for this court to conclude that Ms Newman was dishonest when the judge had concluded to the contrary, albeit upon a basis which I have held to be flawed. A conclusion as to whether Ms Newman acted honestly can only be reached after seeing Ms Newman give her evidence."

46. However, in the present case, the Court of Appeal considered that it was entitled to differ from the judge and to find that Mr Leach had been dishonest on the ground that the judge had deliberately refrained from considering a particular aspect of the case, namely "Nelsonian" dishonesty. In his judgment, at p 68, Carnwath J cited the following passage from the judgment of Lord Nicholls in *Royal Brunei* [1995] 2 AC 378, 389:

"an honest person does not participate in a transaction if he knows it involves a misapplication of trust assets to the detriment of the beneficiaries. Nor does an honest person in such a case deliberately close his eyes and ears, or deliberately not ask questions, lest he learn something he would rather not know, and then proceed regardless."

Later in his judgment at page 73 after holding that the undertaking did not create a trust the judge continued with the passage which I have already set out under the heading:

"Were any of the defendants knowing recipients or accessories?"

47. Delivering the judgment of the Court of Appeal and after referring to the passage in the judgment of Carnwath J, at p 68 citing Lord Nicholls, Potter LJ stated [1999] Lloyd's Rep Bank 438, 462 para 102:

"Bearing in mind the inclusion within Lord Nicholl's definition of dishonesty of the position where a party deliberately closes his eyes and ears, it can only be assumed that at that point, when the judge referred to Mr Leach as 'not dishonest', he was referring to the state of conscious, as opposed to 'Nelsonian', dishonesty, and it is plain that he deliberately refrained from resolving the latter question on the basis that it was unnecessary to do so.

103. Had the judge undertaken that task, Mr Tager submits that he could only have been driven to one conclusion, namely that Nelsonian dishonesty was established."

48. At the conclusion of a detailed and careful consideration of the submissions advanced by the respective counsel Potter LJ concluded the portion of the judgment relating to Mr Leach by stating, at

p 465, para 109,:

> "It seems to me that, save perhaps in the most exceptional circumstances, it is not the action of an honest solicitor knowingly to assist or encourage another solicitor in a deliberate breach of his undertaking. At the very least it seems to me that Mr Leach's conduct amounted, in the words of Lord Nicholls to 'acting in reckless disregard of others' rights or possible rights [which] can be a tell-tale sign of dishonesty'.
>
> 110. I do not consider that the points taken by Mr Jackson are sufficient to negative that tell-tale sign in this case. I have already dealt with his submissions (1) and (3). So far as his submission (2) is concerned, for reasons already given it does not seem to me that the fact that Mr Leach was acting for Mr Yardley can of itself excuse the former's refusal to consider the rights or possible rights of Twinsectra which came to his notice. Nor do I consider that the question whether Mr Leach acted dishonestly in the Nelsonian sense depends on whether he appreciated that what was anticipated was a 'mere' breach of undertaking or that it constituted a breach of trust. In such a case the vice seems to me to rest in deliberately closing his eyes to the rights of Twinsectra, whether legal or equitable, as the beneficiary of the undertaking, and his deliberate failure to follow matters up or take advice for fear of embarrassment or disadvantage."

49. I agree with Lord Hoffmann that it is unfortunate that Carnwath J referred to Mr Leach deliberately shutting his eyes to the problems and to the implications of the undertaking, but like Lord Hoffmann I do not think it probable that having cited the passage from the judgment of Lord Nicholls at [1995] 2 AC 378, 389 F the judge then overlooked the issue of Nelsonian dishonesty in finding that Mr Leach was not dishonest. I also consider, as Lord Millett has observed, that this was not a case where Mr Leach deliberately closed his eyes and ears, or deliberately did not ask questions, lest he learned something he would rather not know - he already knew all the facts, but the judge concluded that nevertheless he had not been dishonest. I also think that Potter LJ applied too strict a test when he stated at page 465:

> "It seems to me that, save perhaps in the most exceptional circumstances, it is not the action of an honest solicitor knowingly to assist or encourage another solicitor in a deliberate breach of his undertaking."

This test does not address the vital point whether Mr Leach realised that his action was dishonest by the standards of responsible and honest solicitors. In the light of the judge's finding, based as it clearly was, on an assessment of Mr Leach's evidence in cross-examination in the witness box before him, I consider the Court of Appeal should not have substituted its own finding of dishonesty.

50. As I have stated, Carnwath J did not give reasons for his finding that Mr Leach was not dishonest and did not state the test which he applied to determine dishonesty. Therefore the question arises whether a new trial should be ordered. An argument of some force can be advanced that there should be a retrial, and in *Mortgage Express Ltd v Newman & Co* [2000] Lloyd's Rep PN 745 the Court of Appeal ordered a new trial, although with considerable reluctance. However the present case can be distinguished from Mortgage Express on the ground that in that case the judge appears to have based his decision on a factual matter (Mr Baruch's instructions) which was not before him in evidence. In the present case the evidence was fully deployed before the judge and he saw Mr Leach rigorously cross-examined at length as to his state of mind. Whilst the judge did not define the test of dishonesty which he applied, I think it probable, as I have stated, that he applied the right test, ie the combined test, and did not apply a purely subjective test. In these circumstances I consider that it would not be right to order a retrial. Whilst the decision whether a new trial should be ordered will largely depend on the facts of the particular case, I find support for this view in the judgment of the House in *Automatic Wood-Turning Co Ltd v Stringer* [1957] AC 544, 555. In that case the Court of Appeal had ordered a new trial on the issue of negligence, but the order was set aside and Lord Morton of Henryton stated:

"My Lords, I cannot think that this order would have been made if the Court of Appeal had fully appreciated that Oliver J, after hearing all the evidence, had expressed his view that the appellants had not been guilty of negligence at common law. There is no indication in the record that the learned judge had not fully considered the evidence when he expressed this view."

51. For the reasons which I have given I would allow Mr Leach's appeal and set aside the judgment of the Court of Appeal.

LORD MILLETT

52. There are two issues in this appeal. The first is concerned with the nature of the so-called "*Quistclose* trust" and the requirements for its creation. The second arises only if the first is answered adversely to the appellant. It is whether his conduct rendered him liable for having assisted in a breach of trust. This raises two questions of some importance. One concerns the extent of the knowledge of the existence of a trust which is required before a person can be found civilly liable for having assisted in its breach. In particular, is it sufficient that he was aware of the arrangements which created the trust or must he also have appreciated that they did so? The other, which has led to a division of opinion among your Lordships, is whether, in addition to knowledge, dishonesty is required and, if so, the meaning of dishonesty in this context. For reasons which will appear a third question, concerned with the ingredients of the equitable claim tendentiously described as being in respect of the "knowing receipt" of trust property, is no longer alive. The much needed rationalisation of this branch of the law must, therefore, await another occasion.

(1) *The facts*

53. The appellant Mr Leach is a solicitor. At the material time he was in sole practice. In October 1992 he was instructed by a Mr Yardley to act in the purchase of residential land at Apperley Bridge, Bradford. The terms of the sale required the payment of £950,000 on exchange of contracts. Exchange took place on 23 December 1992 with the use of moneys obtained from Barclay's Bank.

54. Mr Yardley was an entrepreneur with a number of irons in the fire. He was involved in several on-going property transactions besides the purchase of the site at Apperley Bridge, but his interests were not confined to the purchase and development of property. He carried on business through a series of one-man companies.

55. Delays occurred in securing the necessary finance from Barclay's Bank, and by December 1992 Mr Yardley was actively seeking an alternative source of funds. In due course he obtained an offer of a short term loan of £1 million from the respondent Twinsectra Ltd.

56. Twinsectra was only prepared to make the loan if repayment was secured by a solicitor's personal undertaking, a most unusual requirement. Mr Leach refused to give such an undertaking. Mr Yardley then approached another solicitor, a Mr Sims, who was a member of a two-partner firm. Mr Sims had been involved in some dealings on his own behalf with Mr Yardley as a result of which he owed Mr Yardley $1.5 million. He agreed to give the requisite undertaking.

57. By this time Barclays Bank had agreed to provide the finance for Apperley Bridge, and the loan from Twinsectra was no longer needed. Mr Yardley and Mr Sims decided to proceed with it nevertheless. They agreed between themselves that Mr Sims would take up the loan on his own account and use it to repay his personal indebtedness to Mr Yardley. Mr Sims' undertaking to repay the loan, originally

intended to be by way of guarantee of Mr Yardley's liability to repay the money he was borrowing from Twinsectra, would (as between himself and Mr Yardley) be given by Mr Sims as principal debtor. Mr Yardley knew that if Twinsectra were told of the change the loan would be at risk. The judge found that his failure to tell Twinsectra was dishonest but that he was not liable in deceit for falsely holding Mr Sims out as his solicitor. In the judge's view the representation was essentially true, since Mr Sims had authority to act as Mr Yardley's agent to conclude the loan agreement on his behalf. The Court of Appeal reversed this finding because it did not meet the gravamen of Twinsectra's complaint. This was not that it was misled about the extent of Mr Sims' authority to bind Mr Yardley to the contract of loan. It was that it would not have made the loan if it had known that Mr Sims was no longer acting for Mr Yardley as his client in a property transaction, for in those circumstances he could not properly give a solicitor's undertaking: see *United Bank of Kuwait Ltd v Hammoud* [1988] 1 WLR 1051. The judge found that on this aspect of the case Mr Leach, too, was not dishonest, but that he was "certainly misguided."

58. The undertaking was drafted by Twinsectra's solicitors and was signed by Mr Sims on 24 December. It was in the following terms:

> "Dear Sirs,
>
> In consideration of your providing a loan in the sum of £1,000,000 (one million pounds) to a client of this firm for the purpose of temporary bridging finance in the acquisition of property to be acquired by such client, we hereby personally and irrevocably undertake that:
>
> 1. The loan monies will be retained by us until such time as they are applied in the acquisition of property on behalf of our client.
>
> 2. The loan monies will be utilised *solely* for the acquisition of property on behalf of our client *and for no other purpose.*
>
> 3. We will repay to you the said sum of £1,000,000.00 together with interest calculated at the rate of £657.53 per day from the date you instruct your bankers to transfer the loan monies to our client account, such repayment to be made on the earlier of: (a) the expiry of four calendar months from the date upon which you instruct your bankers to transfer the loan monies to our client account or (b) the seventh day following our giving written notice to your solicitors of intention to make such repayment.
>
> 4. We will pay to your solicitors upon receipt by us of the loan monies their charges in connection with the loan in the sum of £1,000.00 plus VAT and disbursements.
>
> We confirm that this undertaking is given by us in the course of our business as solicitors and in the context of an underlying transaction on behalf of our clients which is part of our usual business as solicitors." (Emphasis added).

59. The judge found that the letter was fundamentally untrue. Mr Sims was not acting for any client in any relevant property transaction and there was no "underlying transaction on behalf of their clients" still less one which was "part of the usual business of solicitors". While Mr Sims obviously knew this, however, it cannot be assumed that Mr Leach did so. The judge found that Mr Leach "should have been aware" of it if he had thought about it at all (though even this seems somewhat speculative); but he did not find that he was.

60. Mr Sims had previously on 23 December forwarded a draft of the proposed undertaking to Mr Leach which Mr Leach placed on his file. It did not differ from the final version in any respect material to these proceedings, which are based exclusively on paragraphs 1 and 2 of the undertaking. Those

paragraphs were unchanged in the final version, the only substantive amendments being to paragraph 3.

61. In the letter which accompanied the draft undertaking Mr Sims sought Mr Leach's confirmation on a number of points. These included the following:

> "The matter that concerns me is paragraph 1 which strictly means that my firm has to retain this sum until another property has been acquired. Is the £1,000,000 to be used for another purchase?"

Mr Sims' concern arose from the fact that, by pre-arrangement with Mr Leach, he intended to pay the money as soon as it was received to Mr Leach as Mr Yardley's solicitor, and realised that this would put him in breach of paragraph 1 of the undertaking. He evidently thought that this would not matter so long as the money was applied in the acquisition of property. Mr Leach clearly understood the reason for Mr Sims' concern, even if (as may be the case) he knew nothing of the arrangement by which Mr Sims had agreed with Mr Yardley that the payment would be treated as discharging his own personal debt.

62. Mr Leach spoke to Mr Sims by telephone and discussed the proposed undertaking. He told Mr Sims that he would obtain confirmation from Mr Yardley as to the purpose of the loan. As for Mr Sims' undertaking to retain the money, "that was a matter for him" and he "appreciated his difficulty". He told Mr Sims that the moneys would be held by his firm in a separate account "until they are required by Mr Yardley". It was, however, for Mr Sims to decide as he was giving the undertaking and must be satisfied with its wording.

63. Mr Leach then spoke to Mr Yardley and was told that the money would be used in connection with property acquisitions at Stourport, Apperley Bridge and Droitwich. Mr Leach duly faxed Mr Sims and told him that he had spoken to Mr Yardley and could confirm that the money was to be used for the purchase of property. Mr Leach sent a copy of the fax to Mr Yardley and asked for his instructions to be confirmed by fax. He told Mr Yardley that he would notify him as soon as the moneys were received "so that the funds may be utilised in connection with the purchase of the property you have notified to me". Mr Yardley faxed his confirmation.

64. All this took place on 23 December before the undertaking was finally signed by Mr Sims on the following day. On the same day, and in anticipation of the receipt of the money from Twinsectra, Mr Sims gave the necessary instructions to his bank to make telegraphic transfers of the bulk of the money to Mr Leach's firm. They were implemented on 29 December.

65. Mr Leach received £949,985 on 29 December 1992 and a further sum of £14,810 on 19 January 1993. The money was credited to a client account. Over a period between 29 December 1992 and 31 March 1993 the money was disbursed in accordance with the instructions of Yardley or one of his co-directors. Three of the payments totalling £580,875 were applied in the acquisition of property at Stourbridge, Droitwich and Apperley Bridge. The judge held that these payments were within the spirit if not the letter of the undertaking and his finding was upheld by the Court of Appeal. It has not been challenged before us. Three sums totalling £22,000 were retained by Mr Leach in payment of his conveyancing fees. These were the subject of a claim in "knowing receipt". Other sums totalling £357,720.11 were applied on Mr Yardley's instructions otherwise than in connection with the acquisition of property and in breach of paragraph 2 of the undertaking. These were the subject of a claim for "dishonest assistance."

(2) *The judgments below*

66. The judge found that the undertaking did not create a trust and accordingly dismissed the action. As a result he did not need to make a specific finding of Mr Leach's state of mind in relation to the disbursements. But in summarising his conclusions he stated that he had found that "he was not dishonest, but that he did deliberately shut his eyes to the implications of the undertaking".

67. The Court of Appeal allowed Twinsectra's appeal. They held that paragraphs 1 and 2 of the undertaking created a *Quistclose* trust or a trust analogous thereto (which they described as "an express purpose trust") and upheld a tracing claim for proprietary relief against Mr Yardley's companies, which were in administration. They reversed the judge's conclusion that Mr Leach had not been dishonest, holding that the judge's conclusions were consistent only with a finding of what they described as "Nelsonian dishonesty", and gave judgment against him for £379,720.11 and interest.

(3) *Was there a Quistclose trust?*

68. Money advanced by way of loan normally becomes the property of the borrower. He is free to apply the money as he chooses, and save to the extent to which he may have taken security for repayment the lender takes the risk of the borrower's insolvency. But it is well established that a loan to a borrower for a specific purpose where the borrower is not free to apply the money for any other purpose gives rise to fiduciary obligations on the part of the borrower which a court of equity will enforce. In the earlier cases the purpose was to enable the borrower to pay his creditors or some of them, but the principle is not limited to such cases.

69. Such arrangements are commonly described as creating "a Quistclose trust", after the well-known decision of the House in *Quistclose Investments Ltd v Rolls Razor Ltd* [1970] AC 567 in which Lord Wilberforce confirmed the validity of such arrangements and explained their legal consequences. When the money is advanced, the lender acquires a right, enforceable in equity, to see that it is applied for the stated purpose, or more accurately to prevent its application for any other purpose. This prevents the borrower from obtaining any beneficial interest in the money, at least while the designated purpose is still capable of being carried out. Once the purpose has been carried out, the lender has his normal remedy in debt. If for any reason the purpose cannot be carried out, the question arises whether the money falls within the general fund of the borrower's assets, in which case it passes to his trustee-in-bankruptcy in the event of his insolvency and the lender is merely a loan creditor; or whether it is held on a resulting trust for the lender. This depends on the intention of the parties collected from the terms of the arrangement and the circumstances of the case.

70. In the present case Twinsectra contends that paragraphs 1 and 2 of the undertaking which Mr Sims signed on 24 December created a *Quistclose* trust. Mr Leach denies this and advances a number of objections to the existence of a trust. He says that Twinsectra lacked the necessary intention to create a trust, and relies on evidence that Twinsectra looked exclusively to Mr Sims' personal undertaking to repay the loan as its security for repayment. He says that commercial life would be impossible if trusts were lightly inferred from slight material, and that it is not enough to agree that a loan is to be made for a particular purpose. There must be something more, for example, a requirement that the money be paid into a segregated account, before it is appropriate to infer that a trust has been created. In the present case the money was paid into Mr Sims' client account, but that is sufficiently explained by the fact that it was not Mr Sims' money but his client's; it provides no basis for an inference that the money was held in trust for anyone other than Mr Yardley. Then it is said that a trust requires certainty of objects and this was lacking, for the stated purpose "to be applied in the purchase of property" is too uncertain to be enforced. Finally it is said that no trust in favour of Twinsectra could arise prior to the

failure of the stated purpose, and this did not occur until the money was misapplied by Mr Yardley's companies.

Intention

71. The first two objections are soon disposed of. A settlor must, of course, possess the necessary intention to create a trust, but his subjective intentions are irrelevant. If he enters into arrangements which have the effect of creating a trust, it is not necessary that he should appreciate that they do so; it is sufficient that he intends to enter into them. Whether paragraphs 1 and 2 of the undertaking created a *Quistclose* trust turns on the true construction of those paragraphs.

72. The fact that Twinsectra relied for its security exclusively on Mr Sims' personal liability to repay goes to Twinsectra's subjective intention and is not relevant to the construction of the undertaking, but it is in any case not inconsistent with the trust alleged. Arrangements of this kind are not intended to provide security for repayment of the loan, but to prevent the money from being applied otherwise than in accordance with the lender's wishes. If the money is properly applied the loan is unsecured. This was true of all the decided cases, including the *Quistclose* case itself.

The effect of the undertaking

73. A *Quistclose* trust does not necessarily arise merely because money is paid for a particular purpose. A lender will often inquire into the purpose for which a loan is sought in order to decide whether he would be justified in making it. He may be said to lend the money for the purpose in question, but this is not enough to create a trust; once lent the money is at the free disposal of the borrower. Similarly payments in advance for goods or services are paid for a particular purpose, but such payments do not ordinarily create a trust. The money is intended to be at the free disposal of the supplier and may be used as part of his cash-flow. Commercial life would be impossible if this were not the case.

74. The question in every case is whether the parties intended the money to be at the free disposal of the recipient: *In re Goldcorp Exchange Ltd* [1995] 1 AC 74, 100 per Lord Mustill. His freedom to dispose of the money is necessarily excluded by an arrangement that the money shall be used *exclusively* for the stated purpose, for as Lord Wilberforce observed in the *Quistclose* case [1970] AC 567, 580:

> "A necessary consequence from this, by a process simply of interpretation, must be that if, for any reason, [the purpose could not be carried out,] the money was to be returned to [the lender]: the word 'only' or 'exclusively' can have no other meaning or effect."

In the *Quistclose* case a public quoted company in financial difficulties had declared a final dividend. Failure to pay the dividend, which had been approved by the shareholders, would cause a loss of confidence and almost certainly drive the company into liquidation. Accordingly the company arranged to borrow a sum of money "on condition that it is used to pay the forthcoming dividend". The money was paid into a special account at the company's bank, with which the company had an overdraft. The bank confirmed that the money

> "will only be used for the purpose of paying the dividend due on 24 July 1964".

The House held that the circumstances were sufficient to create a trust of which the bank had notice, and that when the company went into liquidation without having paid the dividend the money was repayable to the lender.

75.

In the present case paragraphs 1 and 2 of the undertaking are crystal clear. Mr Sims undertook that the money would be used *solely* for the acquisition of property *and for no other purpose;* and was to be retained by his firm until so applied. It would not be held by Mr Sims simply to Mr Yardley's order; and it would not be at Mr Yardley's free disposition. Any payment by Mr Sims of the money, whether to Mr Yardley or anyone else, otherwise than for the acquisition of property would constitute a breach of trust.

76.

Mr Leach insisted that such a payment would, no doubt, constitute a breach of contract, but there was no reason to invoke equitable principles merely because Mr Sims was a solicitor. But Mr Sims' status as a solicitor has nothing to do with it. Equity's intervention is more principled than this. It is unconscionable for a man to obtain money on terms as to its application and then disregard the terms on which he received it. Such conduct goes beyond a mere breach of contract. As North J explained in *Gibert v Gonard* (1884) 54 LJ Ch 439, 440:

> "It is very well known law that if one person makes a payment to another for a certain purpose, and that person takes the money knowing that it is for that purpose, he must apply it to the purpose for which it was given. He may decline to take it if he likes; but if he chooses to accept the money tendered for a particular purpose, it is his duty, and there is a legal obligation on him, to apply it for that purpose."

The duty is not contractual but fiduciary. It may exist despite the absence of any contract at all between the parties, as in *Rose v Rose* (1986) 7 NSWLR 679; and it binds third parties as in the *Quistclose* case itself. The duty is fiduciary in character because a person who makes money available on terms that it is to be used for a particular purpose only and not for any other purpose thereby places his trust and confidence in the recipient to ensure that it is properly applied. This is a classic situation in which a fiduciary relationship arises, and since it arises in respect of a specific fund it gives rise to a trust.

The nature of the trust

77.

The latter two objections cannot be so easily disposed of. They call for an exploration of the true nature of the *Quistclose* trust, and in particular the location of the beneficial interest while the purpose is still capable of being carried out.

78.

This has been the subject of much academic debate. The starting point is provided by two passages in Lord Wilberforce's speech in the *Quistclose* case [1970] AC 567. At p 580, he said:

> "That arrangements of this character for the payment of a person's creditors by a third person, give rise to a relationship of a fiduciary character or trust, in favour, as a primary trust, of the creditors, and secondarily, if the primary trust fails, of the third person, has been recognised in a series of cases over some 150 years."

Later, at p 581, he said:

> "[W]hen the money is advanced, the lender acquires an equitable right to see that it is applied for the primary designated purpose (see *In re Rogers* [(1891)] 8 Morr 243 where both Lindley LJ and Kay LJ recognised this)."

79.

These passages suggest that there are two successive trusts, a primary trust for payment to identifiable beneficiaries, such as creditors or shareholders, and a secondary trust in favour of the lender arising on the failure of the primary trust. But there are formidable difficulties in this analysis, which has little academic support. What if the primary trust is not for identifiable persons, but as in the present case to

carry out an abstract purpose? Where in such a case is the beneficial interest pending the application of the money for the stated purpose or the failure of the purpose? There are four possibilities: (i) in the lender; (ii) in the borrower; (iii) in the contemplated beneficiary; or (iv) in suspense.

80.
(i). *The lender.* In "The Quistclose Trust: Who Can Enforce It?" (1985) 101 LQR, 269, I argued that the beneficial interest remained throughout in the lender. This analysis has received considerable though not universal academic support: see for example Priestley J "The Romalpa Clause and the Quistclose Trust" in *Equity and Commercial Transactions,* ed Finn (1987) 217, 237; and Professor M Bridge "The Quistclose Trust in a World of Secured Transactions" (1992) 12 OJLS 333, 352; and others. It was adopted by the New Zealand Court of Appeal in *General Communications Ltd v Development Finance Corporation of New Zealand Ltd*; [1990] 3 NZLR 406 and referred to with apparent approval by Gummow J in *In re Australian Elizabethan Theatre Trust* (1991) 102 ALR 681. Gummow J saw nothing special in the *Quistclose* trust, regarding it as essentially a security device to protect the lender against other creditors of the borrower pending the application of the money for the sated purpose.

81.
On this analysis, the *Quistclose* trust is a simple commercial arrangement akin (as Professor Bridge observes) to a retention of title clause (though with a different object) which enables the borrower to have recourse to the lender's money for a particular purpose without entrenching on the lender's property rights more than necessary to enable the purpose to be achieved. The money remains the property of the lender unless and until it is applied in accordance with his directions, and insofar as it is not so applied it must be returned to him. I am disposed, perhaps pre-disposed, to think that this is the only analysis which is consistent both with orthodox trust law and with commercial reality. Before reaching a concluded view that it should be adopted, however, I must consider the alternatives.

82.
(ii). *The borrower*. It is plain that the beneficial interest is not vested unconditionally in the borrower so as to leave the money at his free disposal. That would defeat the whole purpose of the arrangements, which is to prevent the money from passing to the borrower's trustee-in-bankruptcy in the event of his insolvency. It would also be inconsistent with all the decided cases where the contest was between the lender and the borrower's trustee-in-bankruptcy, as well as with the *Quistclose* case itself: see in particular *Toovey v Milne* (1819) 2 B & A 683; *In re Rogers, Ex p Holland and Hannen* (1891) 8 Morr 243 (supra).

83.
The borrower's interest pending the application of the money for the stated purpose or its return to the lender is minimal. He must keep the money separate; he cannot apply it except for the stated purpose; unless the terms of the loan otherwise provide he must return it to the lender if demanded; he cannot refuse to return it if the stated purpose cannot be achieved; and if he becomes bankrupt it does not vest in his trustee in bankruptcy. If there is any content to beneficial ownership at all, the lender is the beneficial owner and the borrower is not.

84.
In the present case the Court of Appeal adopted a variant, locating the beneficial interest in the borrower but subject to restrictions. I shall have to return to this analysis later.

85.
(iii). *In the contemplated beneficiary.* In the *Quistclose* case itself [1970] AC 567, as in all the reported cases which preceded it, either the primary purpose had been carried out and the contest was between the borrower's trustee-in bankruptcy or liquidator and the person or persons to whom the borrower had paid the money; or it was treated as having failed, and the contest was between the borrower's trustee-in-bankruptcy and the lender. It was not necessary to explore the position while the primary purpose was still capable of being carried out and Lord Wilberforce's observations must be read in that light.

86.

The question whether the primary trust is accurately described as a trust for the creditors first arose in *In re Northern Developments Holdings Ltd* (unreported) 6 October 1978, where the contest was between the lender and the creditors. The borrower, which was not in liquidation and made no claim to the money, was the parent company of a group one of whose subsidiaries was in financial difficulty. There was a danger that if it were wound up or ceased trading it would bring down the whole group. A consortium of the group's banks agreed to put up a fund of more than £500,000 in an attempt to rescue the subsidiary. They paid the money into a special account in the name of the parent company for the express purpose of "providing money for the subsidiary's unsecured creditors over the ensuing weeks" and for no other purpose. The banks' object was to enable the subsidiary to continue trading, though on a reduced scale; it failed when the subsidiary was put into receivership at a time when some £350,000 remained unexpended. Relying on Lord Wilberforce's observations in the passages cited above, Sir Robert Megarry V-C held that the primary trust was a purpose trust enforceable (inter alios) by the subsidiaries' creditors as the persons for whose benefit the trust was created.

87.

There are several difficulties with this analysis. In the first place, Lord Wilberforce's reference to *In re Rogers* 8 Morr 243 makes it plain that the equitable right he had in mind was not a mandatory order to compel performance, but a negative injunction to restrain improper application of the money; for neither Lindley LJ nor Kay LJ recognised more than this. In the second place, the object of the arrangements was to enable the subsidiary to continue trading, and this would necessarily involve it in incurring further liabilities to trade creditors. Accordingly the application of the fund was not confined to existing creditors at the date when the fund was established. The company secretary was given to understand that the purpose of the arrangements was to keep the subsidiary trading, and that the fund was "as good as share capital". Thus the purpose of the arrangements was not, as in other cases, to enable the debtor to avoid bankruptcy by paying off existing creditors, but to enable the debtor to continue trading by providing it with working capital with which to incur fresh liabilities. There is a powerful argument for saying that the result of the arrangements was to vest a beneficial interest in the subsidiary from the start. If so, then this was not a *Quistclose* trust at all.

88.

In the third place, it seems unlikely that the banks' object was to benefit the creditors (who included the Inland Revenue) except indirectly. The banks had their own commercial interests to protect by enabling the subsidiary to trade out of its difficulties. If so, then the primary trust cannot be supported as a valid non-charitable purpose trust: see *In re Grant's Will Trusts* [1980] 1 WLR 360 and cf *In re Denley's Trust Deed* [1969] 1 Ch 373.

89.

The most serious objection to this approach is exemplified by the facts of the present case. In several of the cases the primary trust was for an abstract purpose with no one but the lender to enforce performance or restrain misapplication of the money. In *Edwards v Glyn* (1859) 2 E & E the money was advanced to a bank to enable the bank to meet a run. In *In re EVTR, Gilbert v Barber* [1987] BCLC 646 it was advanced "for the sole purpose of buying new equipment". In *General Communications Ltd v Development Finance Corporation of New Zealand Ltd* [1990] 3 NZLR 406 the money was paid to the borrower's solicitors for the express purpose of purchasing new equipment. The present case is another example. It is simply not possible to hold money on trust to acquire unspecified property from an unspecified vendor at an unspecified time. There is no reason to make an arbitrary distinction between money paid for an abstract purpose and money paid for a purpose which can be said to benefit an ascertained class of beneficiaries, and the cases rightly draw no such distinction. Any analysis of the *Quistclose* trust must be able to accommodate gifts and loans for an abstract purpose.

90.

(iv) *In suspense.* As Peter Gibson J pointed out in *Carreras Rothmans Ltd v Freeman Matthews Treasure Ltd* [1985] Ch 207, 223 the effect of adopting Sir Robert Megarry V-C's analysis is to leave

the beneficial interest in suspense until the stated purpose is carried out or fails. The difficulty with this (apart from its unorthodoxy) is that it fails to have regard to the role which the resulting trust plays in equity's scheme of things, or to explain why the money is not simply held on a resulting trust for the lender.

91. Lord Browne-Wilkinson gave an authoritative explanation of the resulting trust in *Westdeutsche Landesbank Girpcentrale v Islington Borough Council* [1996] AC 669, 708C and its basis has been further illuminated by Dr R Chambers in his book *Resulting Trusts* published in 1997. Lord Browne-Wilkinson explained that a resulting trust arises in two sets of circumstances. He described the second as follows:

> "Where A transfers property to B *on express trusts*, but the trusts declared do not exhaust the whole beneficial interest."

The *Quistclose* case [1970] AC 567 was among the cases he cited as examples. He rejected the argument that there was a resulting trust in the case before him because, unlike the situation in the present case, there was no transfer of money on express trusts. But he also rejected the argument on a wider and, in my respectful opinion, surer ground that the money was paid and received with the intention that it should become the absolute property of the recipient.

92. The central thesis of Dr Chambers' book is that a resulting trust arises whenever there is a transfer of property in circumstances in which the transferor (or more accurately the person at whose expense the property was provided) did not intend to benefit the recipient. It responds to the absence of an intention on the part of the transferor to pass the entire beneficial interest, not to a positive intention to retain it. Insofar as the transfer does not exhaust the entire beneficial interest, the resulting trust is a default trust which fills the gap and leaves no room for any part to be in suspense. An analysis of the *Quistclose* trust as a resulting trust for the transferor with a mandate to the transferee to apply the money for the stated purpose sits comfortably with Dr Chambers' thesis, and it might be thought surprising that he does not adopt it.

93. (v). *The Court of Appeal's analysis*. The Court of Appeal were content to treat the beneficial interest as in suspense, or (following Dr Chambers' analysis) to hold that it was in the borrower, the lender having merely a contractual right enforceable by injunction to prevent misapplication. Potter LJ put it in these terms [1999] Lloyd's Rep Bank 438 , 456, para 75:

> "The purpose imposed at the time of the advance creates an enforceable restriction on the borrower's use of the money. Although the lender's right to enforce the restriction is treated as arising on the basis of a 'trust', the use of that word does not enlarge the lender's interest in the fund. The borrower is entitled to the beneficial use of the money, subject to the lender's right to prevent its misuse; the lender's limited interest in the fund is sufficient to prevent its use for other than the special purpose for which it was advanced."

This analysis, with respect, is difficult to reconcile with the court's actual decision insofar as it granted Twinsectra a proprietary remedy against Mr Yardley's companies as recipients of the misapplied funds. Unless the money belonged to Twinsectra immediately before its misapplication, there is no basis on which a proprietary remedy against third party recipients can be justified.

94. Dr Chambers' "novel view" (as it has been described) is that the arrangements do not create a trust at all; the borrower receives the entire beneficial ownership in the money subject only to a contractual right in the lender to prevent the money being used otherwise than for the stated purpose. If the purpose fails, a resulting trust in the lender springs into being. In fact, he argues for a kind of

restrictive covenant enforceable by negative injunction yet creating property rights in the money. But restrictive covenants, which began life as negative easements, are part of our land law. Contractual obligations do not run with money or a chose in action like money in a bank account.

95. Dr Chambers' analysis has attracted academic comment, both favourable and unfavourable. For my own part, I do not think that it can survive the criticism levelled against it by Lusina Ho and P St J Smart: "Reinterpreting the Quistclose Trust: A Critique of Chambers' Analysis″ (2001) 21 OJLS 267. It provides no solution to cases of non-contractual payment; is inconsistent with Lord Wilberforce's description of the borrower's obligation as fiduciary and not merely contractual; fails to explain the evidential significance of a requirement that the money should be kept in a separate account; cannot easily be reconciled with the availability of proprietary remedies against third parties; and while the existence of a mere equity to prevent misapplication would be sufficient to prevent the money from being available for distribution to the creditors on the borrower's insolvency (because the trustee-in-bankruptcy has no greater rights than his bankrupt) it would not prevail over secured creditors. If the bank in the *Quistclose* case [1970] AC 567 had held a floating charge (as it probably did) and had appointed a receiver, the adoption of Dr Chambers' analysis should have led to a different outcome.

96. Thus all the alternative solutions have their difficulties. But there are two problems which they fail to solve, but which are easily solved if the beneficial interest remains throughout in the lender. One arises from the fact, well established by the authorities, that the primary trust is enforceable by the lender. But on what basis can he enforce it? He cannot do so as the beneficiary under the secondary trust, for if the primary purpose is fulfilled there is no secondary trust: the pre-condition of his claim is destructive of his standing to make it. He cannot do so as settlor, for a settlor who retains no beneficial interest cannot enforce the trust which he has created.

97. Dr Chambers insists that the lender has merely a right to prevent the misapplication of the money, and attributes this to his contractual right to specific performance of a condition of the contract of loan. As I have already pointed out, this provides no solution where the arrangement is non-contractual. But Lord Wilberforce clearly based the borrower's obligation on an equitable or fiduciary basis and not a contractual one. He was concerned to justify the co-existence of equity's exclusive jurisdiction with the common law action for debt. Basing equity's intervention on its auxiliary jurisdiction to restrain a breach of contract would not have enabled the lender to succeed against the bank, which was a third party to the contract. There is only one explanation of the lender's fiduciary right to enforce the primary trust which can be reconciled with basic principle: he can do so because he is the beneficiary.

98. The other problem is concerned with the basis on which the primary trust is said to have failed in several of the cases, particularly *Toovey v Milne* 2 B & A 683 and the *Quistclose* case itself [1970] AC 567. Given that the money did not belong to the borrower in either case, the borrower's insolvency should not have prevented the money from being paid in the manner contemplated. A man cannot pay some only of his creditors once he has been adjudicated bankrupt, but a third party can. A company cannot pay a dividend once it has gone into liquidation, but there is nothing to stop a third party from paying the disappointed shareholders. The reason why the purpose failed in each case must be because the lender's object in making the money available was to save the borrower from bankruptcy in the one case and collapse in the other. But this in itself is not enough. A trust does not fail merely because the settlor's purpose in creating it has been frustrated: the trust must become illegal or impossible to perform. The settlor's motives must not be confused with the purpose of the trust; the frustration of the former does not by itself cause the failure of the latter. But if the borrower is treated as holding the money on a resulting trust for the lender but with power (or in some cases a duty) to carry out the lender's revocable mandate, and the lender's object in giving the mandate is frustrated, he is entitled to revoke the mandate and demand the return of money which never ceased to be his beneficially.

99. There is a further point which is well brought out in the judgment of the Court of Appeal. On a purchase of land it is a commonplace for the purchaser's mortgagee to pay the mortgage money to the purchaser's solicitor against his undertaking to apply it in the payment of the purchase price in return for a properly executed conveyance from the vendor and mortgage to the mortgagee. There is no doubt that the solicitor would commit a breach of trust if he were to apply it for any other purpose, or to apply it for the stated purpose if the mortgagee countermanded his instructions: see *Bristol and West Building Society v Mothew* [1998] Ch 1, 22. It is universally acknowledged that the beneficiary of the trust, usually described as an express or implied trust, is the mortgagee. Until paid in accordance with the mortgagee's instructions or returned it is the property of the mortgagee in equity, and the mortgagee may trace the money and obtain proprietary relief against a third party: *Boscawen v Bajwa* [1996] 1 WLR 328. It is often assumed that the trust arises because the solicitor has become the mortgagee's solicitor for the purpose of completion. But that was not the case in *Barclays Bank Plc v Weeks Legg and Dean* [1999] QB 309, 324, where the solicitor's undertaking was the only communication passing between the mortgagee and the solicitor. I said:

> "The function of the undertaking is to prescribe the terms upon which the solicitor receives the money remitted by the bank. Such money is trust money which belongs in equity to the bank but which the solicitor is authorised to disburse in accordance with the terms of the undertaking but not otherwise. Parting with the money otherwise than in accordance with the undertaking constitutes at one and the same time a breach of a contractual undertaking and a breach of the trust on which the money is held."

The case is, of course, even closer to the present than the traditional cases in which a *Quistclose* trust has been held to have been created. I do not think that subtle distinctions should be made between "true" *Quistclose* trusts and trusts which are merely analogous to them. It depends on how widely or narrowly you choose to define the *Quistclose* trust. There is clearly a wide range of situations in which the parties enter into a commercial arrangement which permits one party to have a limited use of the other's money for a stated purpose, is not free to apply it for any other purpose, and must return it if for any reason the purpose cannot be carried out. The arrangement between the purchaser's solicitor and the purchaser's mortgagee is an example of just such an arrangement. All such arrangements should if possible be susceptible to the same analysis.

100. As Sherlock Holmes reminded Dr Watson, when you have eliminated the impossible, whatever remains, however improbable, must be the truth. I would reject all the alternative analyses, which I find unconvincing for the reasons I have endeavoured to explain, and hold the *Quistclose* trust to be an entirely orthodox example of the kind of default trust known as a resulting trust. The lender pays the money to the borrower by way of loan, but he does not part with the entire beneficial interest in the money, and insofar as he does not it is held on a resulting trust for the lender from the outset. Contrary to the opinion of the Court of Appeal, it is the borrower who has a very limited use of the money, being obliged to apply it for the stated purpose or return it. He has no beneficial interest in the money, which remains throughout in the lender subject only to the borrower's power or duty to apply the money in accordance with the lender's instructions. When the purpose fails, the money is returnable to the lender, not under some new trust in his favour which only comes into being on the failure of the purpose, but because the resulting trust in his favour is no longer subject to any power on the part of the borrower to make use of the money. Whether the borrower is obliged to apply the money for the stated purpose or merely at liberty to do so, and whether the lender can countermand the borrower's mandate while it is still capable of being carried out, must depend on the circumstances of the particular case.

Certainty

101.

After this over-long exposition, it is possible to dispose of the remaining objections to the creation of a *Quistclose* trust very shortly. A trust must have certainty of objects. But the only trust is the resulting trust for the lender. The borrower is authorised (or directed) to apply the money for a stated purpose, but this is a mere power and does not constitute a purpose trust. Provided the power is stated with sufficient clarity for the court to be able to determine whether it is still capable of being carried out or whether the money has been misapplied, it is sufficiently certain to be enforced. If it is uncertain, however, then the borrower has no authority to make any use of the money at all and must return it to the lender under the resulting trust. Uncertainty works in favour of the lender, not the borrower; it cannot help a person in the position of Mr Leach.

When the trust in favour of the lender arises

102. Like all resulting trusts, the trust in favour of the lender arises when the lender parts with the money on terms which do not exhaust the beneficial interest. It is not a contingent reversionary or future interest. It does not suddenly come into being like an eighteenth century use only when the stated purpose fails. It is a default trust which fills the gap when some part of the beneficial interest is undisposed of and prevents it from being "in suspense".

Conclusion

103. In my opinion the Court of Appeal were correct to find that the terms of paragraphs 1 and 2 of the undertaking created a *Quistclose* trust. The money was never at Mr Yardley's free disposal. It was never held to his order by Mr Sims. The money belonged throughout to Twinsectra, subject only to Mr Yardley's right to apply it for the acquisition of property. Twinsectra parted with the money to Mr Sims, relying on him to ensure that the money was properly applied or returned to it. Mr Sims act in paying the money over to Mr Leach was a breach of trust, but it did not in itself render the money incapable of being applied for the stated purpose. Insofar as Mr Leach applied the money in the acquisition of property, the purpose was achieved.

(4) *Knowing (or dishonest) assistance*

104. Before turning to the critical questions concerning the extent of the knowledge required and whether a finding of dishonesty is a necessary condition of liability, I ought to say a word about the distinction between the "knowing receipt" of trust money and "knowing (or dishonest) assistance" in a breach of trust; and about the meaning of "assistance" in this context.

105. Liability for "knowing receipt" is receipt-based. It does not depend on fault. The cause of action is restitutionary and is available only where the defendant received or applied the money in breach of trust for his own use and benefit: see *Agip (Africa) Ltd v Jackson* [1990] Ch 265, 291-*2; Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378, 386. There is no basis for requiring actual knowledge of the breach of trust, let alone dishonesty, as a condition of liability. Constructive notice is sufficient, and may not even be necessary. There is powerful academic support for the proposition that the liability of the recipient is the same as in other cases of restitution, that is to say strict but subject to a change of position defence.

106. Mr Leach received sums totalling £22,000 in payment of his costs for his own use and benefit, and Twinsectra seek their repayment on the ground of knowing receipt. But he did not receive the rest of the money for his own benefit at all. He never regarded himself as beneficially entitled to the money. He held it to Mr Yardley's order and paid it out to Mr Yardley or his companies. Twinsectra cannot and

does not base its claim in respect of these moneys in knowing receipt, not for want of knowledge, but for want of the necessary receipt. It sues in respect of knowing (or dishonest) assistance.

107.
The accessory's liability for having assisted in a breach of trust is quite different. It is fault-based, not receipt-based. The defendant is not charged with having received trust moneys for his own benefit, but with having acted as an accessory to a breach of trust. The action is not restitutionary; the claimant seeks compensation for wrongdoing. The cause of action is concerned with attributing liability for misdirected funds. Liability is not restricted to the person whose breach of trust or fiduciary duty caused their original diversion. His liability is strict. Nor is it limited to those who assist him in the original breach. It extends to everyone who consciously assists in the continuing diversion of the money. Most of the cases have been concerned, not with assisting in the original breach, but in covering it up afterwards by helping to launder the money. Mr Leach's wrongdoing is not confined to the assistance he gave Mr Sims to commit a breach of trust by receiving the money from him knowing that Mr Sims should not have paid it to him (though this is sufficient to render him liable for any resulting loss); it extends to the assistance he gave in the subsequent misdirection of the money by paying it out to Mr Yardley's order without seeing to its proper application.

The ingredients of accessory liability

108.
The classic formulation of this head of liability is that of Lord Selborne LC in *Barnes v Addy* (1874) LR 9 Ch App 244, 251. Third parties who were not themselves trustees were liable if they were found

> "either making themselves trustees de son tort, or actually participating in any fraudulent conduct of the trustee to the injury of the cestui que trust".

In the next passage of his judgment, at p 252, he amplified this by referring to those who

> "assist with knowledge in a dishonest and fraudulent design on the part of the trustees".

109.
There were thus two conditions of liability: the defendant must have assisted (i) with knowledge (ii) in a fraudulent breach of trust. The second condition was discarded in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378. Henceforth, it was sufficient that the defendant was accessory to any breach of trust whether fraudulent or not. The question for present decision is concerned with the first condition. Since that case it has been clear that actual knowledge is necessary; the question is whether it is sufficient, or whether there is an additional requirement of dishonesty in the subjective sense in which that term is used in criminal cases.

110.
Prior to the decision in *Royal Brunei Airlines Sdn Bhd v Tan* the equitable claim was described as "knowing assistance". It gave a remedy against third parties who knowingly assisted in the misdirection of funds. The accessory was liable if he knew all the relevant facts, in particular the fact that the principal was not entitled to deal with the funds entrusted to him as he had done or was proposing to do. Unfortunately, the distinction between this form of fault-based liability and the liability to make restitution for trust money received in breach of trust was not always observed, and it was even suggested from time to time that the requirements of liability should be the same in the two cases. Authorities on one head of liability were applied in cases which concerned the other, and judges embarked on sophisticated analyses of the kind of knowledge required to found liability.

111.
Behind the confusion there lay a critical issue: whether negligence alone was sufficient to impose liability on the accessory. If so, then it was unnecessary to show that he possessed actual knowledge of the relevant facts. Despite a divergence of judicial opinion, by 1995 the tide was flowing strongly in

favour of rejecting negligence. It was widely thought that the accessory should be liable only if he actually knew the relevant facts. It should not be sufficient that he ought to have known them or had the means of knowledge if he did not in fact know them.

112. There was a gloss on this. It is dishonest for a man deliberately to shut his eyes to facts which he would prefer not to know. If he does so, he is taken to have actual knowledge of the facts to which he shut his eyes. Such knowledge has been described as "Nelsonian knowledge", meaning knowledge which is attributed to a person as a consequence of his "wilful blindness" or (as American lawyers describe it) "contrived ignorance". But a person's failure through negligence to make inquiry is insufficient to enable knowledge to be attributed to him: see *Agip (Africa) Ltd v Jackson* [1990] Ch 265, 293.

113. In his magisterial opinion in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378, every word of which merits close attention, Lord Nicholls firmly rejected negligence as a sufficient condition of accessory liability. The accessory must be guilty of intentional wrongdoing. But Lord Nicholls did not, in express terms at least, substitute intentional wrongdoing as the condition of liability. He substituted dishonesty. Dishonesty, he said, was a necessary and sufficient ingredient of accessory liability. "Knowingly" was better avoided as a defining ingredient of the principle, and the scale of knowledge accepted in *Baden v Sociétié Générale pour Favoriser le Developpement du Commerce et de l'Industrie en France SA* [1993] 1 WLR 509 was best forgotten. His purpose, as he made clear, was to get away from the refinements which had been introduced into the concept of knowledge in the context of accessory liability.

The meaning of dishonesty in this context

114. In taking dishonesty to be the condition of liability, however, Lord Nicholls used the word in an objective sense. He did not employ the concept of dishonesty as it is understood in criminal cases. He explained the sense in which he was using the word at [1995] 2 AC 378, 389 as follows:

> "Whatever may be the position in some criminal or other contexts (see, for instance, *R v Ghosh* [1982] QB 1053) in the context of the accessory liability principle acting dishonestly, or with a lack of probity, which is synonymous, means simply not acting as an honest person would in the circumstances. This is an objective standard. At first sight this may seem surprising. Honesty has a connotation of subjectivity, as distinct from the objectivity of negligence. Honesty, indeed, does have a strong subjective element in that it is a description of a type of conduct assessed in the light of what a person actually knew at the time, as distinct from what a reasonable person would have known or appreciated. Further, honesty and its counterpart dishonesty are mostly concerned with advertent conduct, not inadvertent conduct. Carelessness is not dishonesty. Thus for the most part dishonesty is to be equated with conscious impropriety. However, these subjective characteristics of honesty do not mean that individuals are free to set their own standards of honesty in particular circumstances. The standard of what constitutes honest conduct is not subjective. Honesty is not an optional scale, with higher or lower values according to the moral standards of each individual. If a person knowingly appropriates another's property, he will not escape a finding of dishonesty simply because he sees nothing wrong in such behaviour. In most situations there is little difficulty in identifying how an honest person would behave. Honest people do not intentionally deceive others to their detriment. Honest people do not knowingly take others' property. Unless there is a very good and compelling reason, an honest person does not participate in a transaction if he knows it involves a misapplication of trust assets to the detriment of the beneficiaries. Nor does an honest person in such a case deliberately close his eyes and ears, or deliberately not ask questions, lest he learn something he would rather not know, and then proceed regardless."

Dishonesty as a state of mind or as a course of conduct?

115. In *R v Ghosh* [1982] QB 1053 Lord Lane CJ drew a distinction between dishonesty as a state of mind and dishonesty as a course of conduct, and held that dishonesty in section 1 of the Theft Act 1968 referred to dishonesty as a state of mind. The question was not whether the accused had in fact acted dishonestly but whether he was aware that he was acting dishonestly. The jury must first of all decide whether the conduct of the accused was dishonest according to the ordinary standards of reasonable and honest people. That was an objective test. If he was not dishonest by those standards, that was an end of the matter and the prosecution failed. If it was dishonest by those standards, the jury had secondly to consider whether the accused was aware that what he was doing was dishonest by those standards. That was a subjective test. Given his actual (subjective) knowledge the accused must have fallen below ordinary (objective) standards of honesty and (subjectively) have been aware that he was doing so.

116. The same test of dishonesty is applicable in civil cases where, for example, liability depends upon intent to defraud, for this connotes a dishonest state of mind. *Aktieselskabet Dansk Skibsfinansiering v Brothers* [2001] 2 BCLC 324 was a case of this kind (trading with intent to defraud creditors). But it is not generally an appropriate condition of civil liability, which does not ordinarily require a guilty mind. Civil liability is usually predicated on the defendant's conduct rather than his state of mind; it results from his negligent or unreasonable behaviour or, where this is not sufficient, from intentional wrongdoing.

117. A dishonest state of mind might logically have been required when it was thought that the accessory was liable only if the principal was guilty of a fraudulent breach of trust, for then the claim could have been regarded as the equitable counterpart of the common law conspiracy to defraud. But this requirement was discarded in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] .2 AC 378

118. It is, therefore, not surprising that Lord Nicholls rejected a dishonest state of mind as an appropriate condition of liability. This is evident from the opening sentence of the passage cited above, from his repeated references both in that passage and later in his judgment to the defendant's conduct in "acting dishonestly" and "advertent conduct", and from his statement that "for the most part" (ie not always) it involves "conscious impropriety". "Honesty", he said, "is a description of a type of conduct assessed in the light of what a person actually knew at the time." Usually ("for the most part"), no doubt, the defendant will have been guilty of "conscious impropriety"; but this is not a condition of liability. The defendant, Lord Nicholls said, at p 390E, was "required to act honestly"; and he indicated that Knox J had captured the flavour of dishonesty in *Cowan de Groot Properties Ltd v Eagle Trust Plc* [1992] 4 All ER 700, 761 when he referred to a person who is "guilty of commercially unacceptable conduct in the particular context involved." There is no trace in Lord Nicholls' opinion that the defendant should have been aware that he was acting contrary to objective standards of dishonesty. In my opinion, in rejecting the test of dishonesty adopted in *R v Ghosh* [1982] QB 1053, Lord Nicholls was using the word to characterise the defendant's conduct, not his state of mind.

119. Lord Nicholls had earlier drawn an analogy with the tort of procuring a breach of contract. He observed, at p 387 B-C, that a person who knowingly procures a breach of contract, or who knowingly interferes with the due performance of a contract, is liable in damages to the innocent party. The rationale underlying the accessory's liability for a breach of trust, he said, was the same. It is scarcely necessary to observe that dishonesty is not a condition of liability for the common law cause of action. This is a point to which I must revert later; for the moment, it is sufficient to say that procuring a breach of contract is an intentional tort, but it does not depend on dishonesty. Lord Nicholls was not of

course confusing knowledge with dishonesty. But his approach to dishonesty is premised on the belief that it is dishonest for a man consciously to participate in the misapplication of money.

120. This is evident by the way in which Lord Nicholls dealt with the difficult case where the propriety of the transaction is doubtful. An honest man, he considered, would make appropriate enquiries before going ahead. This assumes that an honest man is one who would not knowingly participate in a transaction which caused the misapplication of funds. But it is most clearly evident in the way in which Lord Nicholls described the conduct of the defendant in the case under appeal. The question was whether he was personally liable for procuring or assisting in a breach of trust committed by his company. The trust was created by the terms of a contract entered into between the company, which carried on the business of a travel agency, and an airline. The contract required money obtained from the sale of the airline's tickets to be placed in a special trust account. The company failed to pay the money into a special account but used it to fund its own cash flow. Lord Nicholls described the defendant's conduct, at p 393:

> "In other words, he caused or permitted his company to apply the money in a way he knew was not authorised by the trust of which the company was trustee. Set out in these bald terms, the defendant's conduct was dishonest."

There was no evidence and Lord Nicholls did not suggest that the defendant realised that honest people would regard his conduct as dishonest. Nor did the plaintiff put its case so high. It contended that the company was liable because it made unauthorised use of trust money, and that the defendant was liable because he caused or permitted his company to do so despite his knowledge that its use of the money was unauthorised. This was enough to make the defendant liable, and for Lord Nicholls to describe his conduct as dishonest.

121. In my opinion Lord Nicholls was adopting an objective standard of dishonesty by which the defendant is expected to attain the standard which would be observed by an honest person placed in similar circumstances. Account must be taken of subjective considerations such as the defendant's experience and intelligence and his actual state of knowledge at the relevant time. But it is not necessary that he should actually have appreciated that he was acting dishonestly; it is sufficient that he was.

122. This is the way in which Lord Nicholls' use of the term "dishonesty" was understood by Mance LJ in *Grupo Torras SA v Al-Sabah* [1999] CLC 1469. It is also the way in which it has been widely understood by practitioners: see William Blair QC "Secondary Liability of Financial Institutions for the Fraud of Third Parties" (2000) 30 Hong Kong Law Journal 74; Jeremy Chan "Dishonesty and Knowledge" (2001) 31 Hong Kong Law Journal 283; Andrew Stafford QC "Solicitors' liability for knowing receipt and dishonest assistance in breach of trust" (2001) 17 Professional Negligence 3. Mr Blair QC, at p 83, welcomed the "more pragmatic and workable test of objective dishonesty". Mr Stafford QC, at p 14, invited your Lordships to

> "Reiterate that honesty is an objective standard and that individuals are not free to set their own standards of proper conduct;

"Direct that trial judges should reach specific conclusions as to whether an honest person, having the same knowledge, experience and attributes as the defendant, would have appreciated that what he was doing would be regarded as wrong or improper; "Direct that if the hypothetical honest person would have appreciated that what he was doing was wrong or improper, then it is appropriate to conclude that the defendant acted dishonestly; "Deprecate attempts to over-refine degrees of knowledge and tests of dishonesty."

This is almost entirely objective. The only subjective elements are those relating to the defendant's knowledge, experience and attributes. The objective elements include not only the standard of honesty (which is not controversial) but also the recognition of wrongdoing. The question is whether an honest person would appreciate that what he was doing was wrong or improper, not whether the defendant himself actually appreciated this. The third limb of the test established for criminal cases in *R v Ghosh* [1982] QB 1053 is conspicuously absent. But there is no trace of it in Lord Nicholls' opinion in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378 either.

123.

Judges have frequently used the word dishonesty in civil cases in an objective sense to describe deliberate wrongdoing, particularly when handling equitable concepts such as concealed fraud. In *Beaman v ARTS Ltd* [1949] 1 KB 550 the defendants were sued for conversion. They had stored packages for the plaintiff. The plaintiff found herself stranded in enemy occupied Europe during the war and was unable to communicate with the defendants. The defendant's manager, who was about to be called up and was anxious to close the business down for the duration, opened the packages. Finding their contents to be of little or no value, he considered himself justified in giving them away to the Salvation Army, though he kept one package for himself. The trial judge (Denning J) expressly acquitted the manager of dishonesty or moral turpitude. Reversing the judge, Lord Greene MR described the defendant's conduct as reprehensible. They would, he said, at p 561:

> "no doubt be shocked to hear their conduct described as fraudulent. *That is, however, quite immaterial*. Mr Ingram, who misappropriated one of the plaintiff's cases for his own use, was no doubt shocked when counsel described his action as stealing. *No amount of self-deception can make a dishonest action other than dishonest*; nor does an action which is essentially dishonest become blameless because it is committed with a good motive" (emphasis added).

This is as clear a statement of principle as can be imagined. Neither an honest motive nor an innocent state of mind will save a defendant whose conduct is objectively dishonest. Mr Ingram was not criminally dishonest, since it never entered his head that other people would regard his conduct as dishonest. But equity looks to a man's conduct, not to his state of mind.

124.

The Law Commission must plead guilty of the same usage. In their Report on Limitation of Actions (Law Com No 270) they propose replacing the expression "deliberate concealment" in Section 32(1)(b) of the Limitation Act 1980 by "dishonest concealment". They explain this concept, at paragraph 3.137 of their Report as follows:

> "We are of the view that our proposals in relation to 'concealment' should only apply where the defendant has been guilty of 'unconscionable conduct' - *or in other words, if the concealment can be said to be 'dishonest' ... the claimant must show that the defendant was being dishonest in [concealing information].* We do not consider that the concealment could be described as 'dishonest' unless the person concealing it is aware of what is being concealed and does not wish the claimant to discover it … by covering up shallow foundations the builder . . . . cannot be said to have been guilty of 'dishonest concealment' unless he was aware that his work was defective or negligent, and does not want the claimant to discover this" (emphasis added).

In the context it is clear that the Law Commission are indicating requirements which are not only necessary but sufficient. It would be self-defeating to require the plaintiff to establish subjective dishonesty: many people would see nothing wrong, and certainly nothing dishonest, in seeking to avoid legal liability by refraining from disclosing their breach of duty to a potential plaintiff.

125.

The modern tendency is to deprecate the use of words like "fraud" and "dishonesty" as synonyms for moral turpitude or conduct which is morally reprehensible. There is much to be said for semantic reform, that is to say for changing the language while retaining the incidents of equitable liability; but

there is nothing to be said for retaining the language and giving it the meaning it has in criminal cases so as to alter the incidents of equitable liability.

Should subjective dishonesty be required?

126. The question for your Lordships is not whether Lord Nicholls was using the word dishonesty in a subjective or objective sense in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378. The question is whether a plaintiff should be required to establish that an accessory to a breach of trust had a dishonest state of mind (so that he was subjectively dishonest in the *R v Ghosh* sense); or whether it should be sufficient to establish that he acted with the requisite knowledge (so that his conduct was objectively dishonest). This question is at large for us, and we are free to resolve it either way.

127. I would resolve it by adopting the objective approach. I would do so because:

(1) consciousness of wrongdoing is an aspect of mens rea and an appropriate condition of criminal liability: it is not an appropriate condition of civil liability. This generally results from negligent or intentional conduct. For the purpose of civil liability, it should not be necessary that the defendant realised that his conduct was dishonest; it should be sufficient that it constituted intentional wrongdoing.

(2).The objective test is in accordance with Lord Selborne's statement in *Barnes v Addy* LR 9 Ch App 244 and traditional doctrine. This taught that a person who knowingly participates in the misdirection of money is liable to compensate the injured party. While negligence is not a sufficient condition of liability, intentional wrongdoing is. Such conduct is culpable and falls below the objective standards of honesty adopted by ordinary people.

(3) The claim for "knowing assistance" is the equitable counterpart of the economic torts. These are intentional torts; negligence is not sufficient and dishonesty is not necessary. Liability depends on knowledge. A requirement of subjective dishonesty introduces an unnecessary and unjustified distinction between the elements of the equitable claim and those of the tort of wrongful interference with the performance of a contract.

128. If Mr Sims' undertaking was contractual, as Mr Leach thought it was, then Mr Leach's conduct would have been actionable as a wrongful interference with the performance of the contract. Where a third party with knowledge of a contract has dealings with the contract breaker which the third party knows will amount to a breach of contract and damage results, he commits an actionable interference with the contract: see *D C Thomson & Co Ltd v Deakin* [1952] Ch 646 CA, 694; *Sefton v Tophams Ltd* [1965] Ch 1140, where the action failed only because the plaintiff was unable to prove damage.

129. In *British Motor Trade Association v Salvadori* [1949] Ch 556 the defendant bought and took delivery of a car in the knowledge that it was offered to him by the vendor in breach of its contract with its supplier. There is a close analogy with the present case. Mr Leach accepted payment from Mr Sims in the knowledge that the payment was made in breach of his undertaking to Twinsectra to retain the money in his own client account until required for the acquisition of property.

130. In *Sefton v Tophams Ltd* the defendant bought land in the knowledge that the use to which it intended to put the land would put the vendor in breach of his contractual obligations to the plaintiff. Again the analogy with the present case is compelling. Mr Leach knew that by accepting the money and placing it at Mr Yardley's free disposal he would put Mr Sims in breach of his contractual undertaking that it would be used only for the purpose of acquiring property.

131. In both cases the defendant was liable for any resulting loss. Such liability is based on the actual interference with contractual relations, not on any inducement to break them, so that it is no defence that the contract-breaker was a willing party to the breach and needed no inducement to do so. Dishonesty is not an ingredient of the tort.

132. It would be most undesirable if we were to introduce a distinction between the equitable claim and the tort, thereby inducing the claimant to attempt to spell a contractual obligation out of a fiduciary relationship in order to avoid the need to establish that the defendant had a dishonest state of mind. It would, moreover, be strange if equity made liability depend on subjective dishonesty when in a comparable situation the common law did not. This would be a reversal of the general rule that equity demands higher standards of behaviour than the common law.

133. If we were to reject subjective dishonesty as a requirement of civil liability in this branch of the law, the remaining question is merely a semantic one. Should we return to the traditional description of the claim as "knowing assistance", reminding ourselves that nothing less than actual knowledge is sufficient; or should we adopt Lord Nicholls' description of the claim as "dishonest assistance", reminding ourselves that the test is an objective one?

134. For my own part, I have no difficulty in equating the knowing mishandling of money with dishonest conduct. But the introduction of dishonesty is an unnecessary distraction, and conducive to error. Many judges would be reluctant to brand a professional man as dishonest where he was unaware that honest people would consider his conduct to be so. If the condition of liability is intentional wrongdoing and not conscious dishonesty as understood in the criminal courts, I think that we should return to the traditional description of this head of equitable liability as arising from "knowing assistance".

Knowledge

135. The question here is whether it is sufficient that the accessory should have actual knowledge of the facts which created the trust, or must he also have appreciated that they did so? It is obviously not necessary that he should know the details of the trust or the identity of the beneficiary. It is sufficient that he knows that the money is not at the free disposal of the principal. In some circumstances it may not even be necessary that his knowledge should extend this far. It may be sufficient that he knows that he is assisting in a dishonest scheme.

136. That is not this case, for in the absence of knowledge that his client is not entitled to receive it there is nothing intrinsically dishonest in a solicitor paying money to him. But I am satisfied that knowledge of the arrangements which constitute the trust is sufficient; it is not necessary that the defendant should appreciate that they do so. Of course, if they do not create a trust, then he will not be liable for having assisted in a breach of trust. But he takes the risk that they do.

137. The gravamen of the charge against the principal is not that he has broken his word, but that having been entrusted with the control of a fund with limited powers of disposal he has betrayed the confidence placed in him by disposing of the money in an unauthorised manner. The gravamen of the charge against the accessory is not that he is handling stolen property, but that he is assisting a person who has been entrusted with the control of a fund to dispose of the fund in an unauthorised manner. He should be liable if he knows of the arrangements by which that person obtained control of the money and that his authority to deal with the money was limited, and participates in a dealing with the money

in a manner which he knows is unauthorised. I do not believe that the man in the street would have any doubt that such conduct was culpable.

The findings below

138. Mr Leach's pleaded case was that he parted with the money in the belief, no doubt engendered by Mr Yardley's assurances, that it would be applied in the acquisition of property. But he made no attempt to support this in his evidence. It was probably impossible to do so, since he was acting for Mr Yardley in the acquisition of the three properties which had been identified to him on 23 December, and must have known that some of the payments he was making were not required for their acquisition. In his evidence he made it clear that he regarded the money as held by him to Mr Yardley's order, and that there was no obligation on his part to see that the terms of the arrangements between Twinsectra and Mr Sims were observed. That was Mr Sims' responsibility, not his.

139. The judge found that Mr Leach was not dishonest. But he also found as follows:

> "He was clearly aware of [the terms of the undertaking]. Indeed, his pleaded defence asserts … that he believed their 'substance ... to be that the advance would be applied in the acquisition of property' and that he had received them on the footing that they would be so applied. Yet, in evidence, he frankly admitted that he had regarded the money as held simply to the order of Mr Yardley, without restriction. Again, I have to conclude that he simply shut his eyes to the problems. As far as he was concerned, it was a matter solely for Mr Sims to satisfy himself whether he could release the money to Mr Yardley's account."

140. The Court of Appeal thought that the judge's two conclusions (i) that Mr Leach was not dishonest and (ii) that he "simply shut his eyes to the problems" (or, as he put it later in his judgment "deliberately shut his eyes to the implications") were inconsistent. They attempted to reconcile the two findings by saying that the judge had overlooked the possibility of wilful blindness. Potter LJ put it in these terms [1999] Lloyd's Rep 438, 465, para 108:

> "Mr Leach clearly appreciated (indeed he recorded) that an undertaking in the form proposed created difficulties for Mr Sims (as Mr Sims himself recognised) yet, as from that point … [he] deliberately closed his eyes to those difficulties in the sense that he treated them as a problem simply for Mr Sims and not for himself or his client."

Conclusion

141. I do not think that this was a case of wilful blindness, or that the judge overlooked the possibility of imputed knowledge. There was no need to impute knowledge to Mr Leach, for there was no relevant fact of which he was unaware. He did not shut his eyes to any fact in case he might learn the truth. He knew of the terms of the undertaking, that the money was not to be at Mr Yardley's free disposal. He knew (i) that Mr Sims was not entitled to pay the money over to him (Mr Leach), and was only prepared to do so against confirmation that it was proposed to apply the money for the acquisition of property; and (ii) that it could not be paid to Mr Yardley except for the acquisition of property. There were no enquiries which Mr Leach needed to make to satisfy himself that the money could properly be put at Mr Yardley's free disposal. He knew it could not. The only thing that he did not know was that the terms of the undertaking created a trust, still less a trust in favour of Twinsectra. He believed that Mr Sims' obligations to Twinsectra sounded in contract only. That was not an unreasonable belief; certainly not a dishonest one; though if true it would not have absolved him from liability.

142.

Yet from the very first moment that he received the money he treated it as held to Mr Yardley's order and at Mr Yardley's free disposition. He did not shut his eyes to the facts, but to "the implications", that is to say the impropriety of putting the money at Mr Yardley's disposal. His explanation was that this was Mr Sims' problem, not his.

143. Mr Leach knew that Twinsectra had entrusted the money to Mr Sims with only limited authority to dispose of it; that Twinsectra trusted Mr Sims to ensure that the money was not used except for the acquisition of property; that Mr Sims had betrayed the confidence placed in him by paying the money to him (Mr Leach) without seeing to its further application; and that by putting it at Mr Yardley's free disposal he took the risk that the money would be applied for an unauthorised purpose and place Mr Sims in breach of his undertaking. But all that was Mr Sims' responsibility.

144. In my opinion this is enough to make Mr Leach civilly liable as an accessory (i) for the tort of wrongful interference with the performance of Mr Sims' contractual obligations if this had been pleaded and the undertaking was contractual as well as fiduciary; and (ii) for assisting in a breach of trust. It is unnecessary to consider whether Mr Leach realised that honest people would regard his conduct as dishonest. His knowledge that he was assisting Mr Sims to default in his undertaking to Twinsectra is sufficient.

Knowing receipt

145. Each of the sums which Mr Leach received for his own benefit was paid in respect of an acquisition of property, and as such was a proper disbursement. He thus received trust property, but not in breach of trust. This was very properly conceded by counsel for Twinsectra before your Lordships.

Conclusion

146. I would reduce the sum for which judgment was entered by the Court of Appeal by £22,000, and subject thereto dismiss the appeal.
