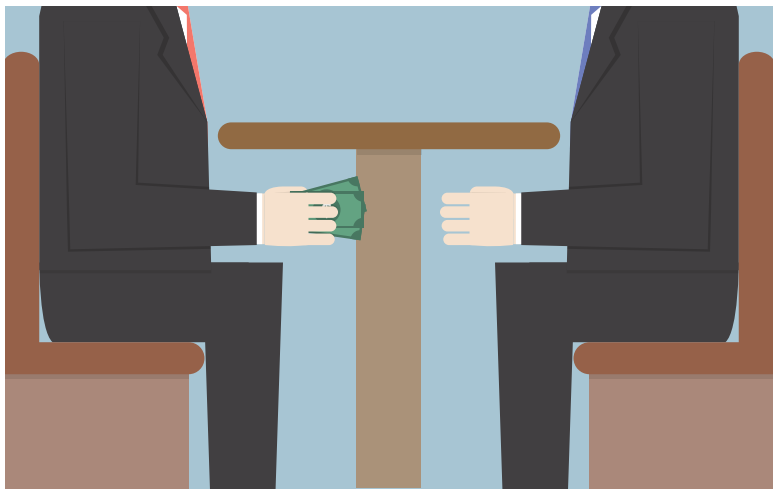
Focus BUSINESS LAW

Proving third party liability in fraud

Courts explore the three bases for recovery in breaches of trust

Anna Wong



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All frauds involve breaching people's trust. More often than not, sophisticated frauds are enabled by individuals and entities with varying degrees of connection to the fraudsters, such as banks, directors of corporate trustees, brokers, accountants and lawyers. Cognizant of this reality, equity permits recovery from third parties to a trust relationship on three *in personam* bases: (1) trustee *de son tort*; (2) knowing assistance; and (3) knowing receipt.

Strangers may be held liable as trustees *de son tort* if they intermeddle in the administration of a trust. Where it is proved that the stranger had possession and control of trust property and commits a breach of trust, he/she is liable. An agent or a delegate of the appointed trustee is not to be made a trustee *de son tort* unless he/she repudiates the role of agent and assumes the job of a trustee: *Air Canada v. M & L Travel Ltd.* [1993] S.C.J. No. 118.

Knowing assistance, as a type of accessory wrongdoing, and knowing receipt, which as its names suggests is receipt-based, each find their origin in Lord Selborne's dictum regarding constructive trustees in the English decision of *Barnes v. Addy* (1894) L.R. 9 Ch. App. 244. Strangers to a trust can be accountable as constructive trustees if they knowingly assisted in a dishonest and fraudulent design on the part of the trustee, or received and become chargeable with trust property.

In a trio of cases in the 1990s, the Supreme Court of Canada adopted *Barnes v. Addy* and clarified the elements of knowing assistance and knowing receipt. (See *Bank of China v. Fan* [2015] B.C.J. No. 703 for a recent recap.)

In *Air Canada*, the top court held that an action in knowing assistance requires (1) a fraudulent and dishonest breach of trust; and (2) subjective knowledge of the trust's existence and its breach (i.e., actual knowledge, recklessness or wilful blindness) on the part of the defendant.

While *Air Canada* made clear that dishonesty of the knowing assistant is not necessary, constructive knowledge will not amount to a want of probity. Notably, recent English jurisprudence has shifted the focus from knowledge to dishonesty, and accordingly renamed the claim "dishonest assistance." The test applied in England is an objective one, which asks whether the assistant acted dishonestly by ordinary standards of honest behaviour: *Barlow Clowes International Ltd. v. Eurotrust International Ltd.* [2005] UKPC 37; *Starglade Properties Ltd v Nash* [2010] EWCA Civ 1314. It need not be shown that the assistant was precisely aware of the existence of a trust relationship; it is sufficient that he/she suspected that other people's money was being misappropriated, and chose not to inquire.

In *Gold v. Rosenberg* [1997] S.C.J. No. 93, and *Citadel General Assurance Co. v. Lloyds Bank Canada* [1997] S.C.J. No. 92, the court laid down three requirements for knowing receipt: (1) the property is subject to a trust in favour of the plaintiff; (2) the defendant received the trust property for his/her own use and benefit; and (3) the defendant had actual or constructive knowledge of a breach of trust. The second requirement effectively excludes agents holding trust property for another, such as banks disbursing or receiving trust funds for customers. With respect to the third requirement, it suffices that the defendant knew of facts sufficient to put a reasonable person on inquiry and failed to do so. The requisite knowledge need not arise at the time of receipt: "Even if the property is received innocently, once the recipient learns of the fraud or breach of trust, whether actually or constructively, he is liable to return any of the property that he then still holds" (*Holmes v. Amlez International Inc.* [2009] O.J. No. 4513).

> "...[I]f knowing receipt, pared down to its core, is about 'who [as between the plaintiff and defendant] has a better claim to the disputed property' (Gold), then the question of who is better placed to stop the breach of trust should be relevant.
>
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The conceptual basis for knowing receipt is somewhat murky, which has important ramifications. In *Gold*, the Supreme Court noted that "unjust enrichment is the essence of a claim in knowing receipt." The requirement of knowledge, however, is inconsistent with the strict-liability nature of unjust enrichment. As a claim for unjust enrichment is concerned with restoring the principal's property or "giving back to someone something that has been taken from them" (*Citadel*), the defendant's knowledge of a breach of trust is superfluous. There is no reason why imposition of liability shouldn't be the same as in other cases of restitution — that is, strict but tempered by defences such as bona fide purchaser for value and change of position. Under a strict liability approach, the defendant's state of knowledge will be scrutinized only when considering the availability of the defences, with the onus of proof falling on the defendant. This view has garnered powerful support from the likes of Peter Birks, Mitchell McInnes, and Lord Nicholls.

Conversely, if knowing receipt, pared down to its core, is about "who [as between the plaintiff and defendant] has a better claim to the disputed property" (*Gold*), then the question of who is better placed to stop the breach of trust should be relevant. Because the winner stands to take all and the loser left with a worthless claim against the fraudster, fairness demands that the party who has a greater ability to halt the breach or raise alarm yet did nothing should bear the loss. The prevailing test for knowing receipt does not delve into this question.

Clarifying the conceptual basis on which to impose stranger liability is important, and will require a balancing of different policy considerations. Casting the liability net too wide has the potential to hinder commercial dealings while casting it too narrow fails to create adequate incentive to police illicit schemes and risks imposing the loss on the most innocent victims.

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Conflict: Lawyers can't represent two clients with adverse interests

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Conflicts of interest are like pornography — hard to define, but easy to recognize when you see one.

Factors that may signal a looming conflict include:

- The immediacy of the legal interests;
- Whether those interests are directly adverse;
- Whether the issue is substantive or procedural;
- The temporal relationship between the matters;
- The significance of the issue to the clients' immediate and long-term interests;
- The clients' reasonable expectations in retaining a lawyer in those matters.

As the code explains, "the bright line rule [articulated by the Supreme Court of Canada] prohibits a lawyer or law firm from representing one client whose legal interests are directly adverse to the immediate legal interests of another client even if the matters are unrelated unless the clients consent."

Conflicts can also develop over time so that new information or a change in circumstances may reveal a problem where none existed before.

A lawyer should consider whether a conflict exists not only at the outset of their dealings with the not-for-profit, but throughout the retainer.

Regardless of the role that is being played, lawyers that are assisting not-for-profits can never leave their ethical obligations at the door.

They need to be alert to the risks that flow from their dealings with the organization and its directors. They need to be realistic and reasonable in assessing their role. They need to effectively communicate the decisions they make and actions they take. Doing so will protect themselves and, of equal importance, the organizations they hope to assist.

Len Polsky is the manager, practice review, of the Law Society of Alberta, in Calgary. He gratefully acknowledges the contributions to this article made by Dan Ebner of Prather Ebner in Chicago.