KNOWING RECEIPT OF FRAUDULENT FUNDS & KNOWING ASSISTANCE IN BREACH OF TRUST IN ESTATES & TRUSTS

by Justin W. de Vries[1]

INTRODUCTION

In equity, a third party who receives money from a fiduciary, in breach of the fiduciary's trust obligations to a beneficiary, is liable in a personal action brought by the beneficiary.[2] The beneficiary does not need to show that the third party recipient committed fraud or was dishonest in acquiring the funds. The beneficiary must simply show that the third party recipient knew, or should have known, that the trustees were acting in breach of the terms of the trust when they made the transfer.[3] In other words, the beneficiary must show that the third party knowingly participated in the fraud.

The equitable basis for this action is the principle of unjust enrichment: there is no reason that the third party recipient should be enriched by the misappropriated property at the expense of the beneficiary. Where this occurs, the third party recipient may be compelled to return the misappropriated funds.[4] The ability to pursue a third party via the claim of unjust enrichment is a useful tool for wronged beneficiaries. It is especially important where the fraudulent trustee has disappeared or died and restitution cannot be obtained from him.

There are, of course, defences to the claim of unjust enrichment. Where the third party recipient does not receive notice of the trust, nor could he have otherwise known about the trust, then the

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[2] CED Restitution VI.2.(d) at §439.

[3] *Banton v CIBC Trust Corp.*, 2001 CarswellOnt 828, 53 OR (3d) 567 ["*Banton*"].

[4] *Banton* at para 26.

third party may escape liability. For example, where a third party innocently purchases a property held in trust for a beneficiary, the third party may not be compelled to return the trust property where the purchaser did not know and could not know that the purchase property was also trust property. This defence was raised in *Scorgie v. Scorgie*.[5] In that case, the court held that in order to avoid liability, the third party recipient needed to be a *bona fide* purchaser for value without notice.[6]

THIRD PARTY BREACH OF TRUST LIABILITY

Attracting Liability

In *Citadel General Assurance Co. v. Lloyds Bank Canada*, the Supreme Court of Canada established the three ways that a non-trustee could become a "constructive trustee" and therefore subject to the same responsibilities and liabilities as a duly appointed trustee.[7] The first category is a stranger to the trust who steps in to act as a trustee. Having assumed the responsibility for administering the trust, this person becomes a trustee *de son tort.* The second two categories relate to strangers to the trust who knowingly participate in a breach of trust committed by the trustee.[8]

1. Trustees *De Son Tort*

Trustees *de son tort* are a common occurrence in the estate context. Often, a family member or the person who was acting as attorney for property of the deceased before death will begin administering the deceased's estate even though the will names someone else as the deceased's

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[5] *Scorgie v Scorgie*, 1994 CarswellAlta 291, [1995] 3 WWR 417 (ABQB) ["*Scorgie*"]
[6] *Scorgie* at para 56.
[7] *Citadel General Assurance Co. v. Lloyds Bank Canada*, [1997] 3 S.C.R. 805, 1997 CarswellAlta 823 at para 19 ["*Citadel General*"].
[8] *Citadel General* at para 21.

personal representative. Any move to take possession of the trust property with the intention of administering it according to the terms of the trust (including a will) may be sufficient for a person to become a trustee *de son tort*[9] notwithstanding that the trust names someone else as trustee. Having assumed the role of (estate) trustee, that person becomes a trustee *de son tort* and gains all the attendant liability whether they like it or not. As a result, where a trustee *de son tort* commits a breach of trust, he or she will be held liable for the breach.

A party cannot be liable for a breach of trust merely because he or she acted as an agent of the trustees. In that case, the liability rests with the trustee who provided the agent with instructions. In order for a claim of breach of trust to be successful against a defendant, the defendant must have actually claimed to act for the benefit of the beneficiaries (and not to be acting as agent for the trustee) prior to the events giving rise to the claim.

2. Knowing Assistance

The second category is where the third party knowingly assisted the trustee commit fraud. Unlike the "knowing recipient" category (discussed further below), in this category, the stranger to the trust does not actually take receipt of the trust property, but rather assists the trustee in some way commit fraud.

In *Air Canada v M & L Travel Ltd.,* the Supreme Court of Canada held that in order to be found liable the third party must have had actual knowledge (or recklessness or wilful blindness) that the actions of the trustee breached the terms of the trust yet assisted the trustee's "dishonest and fraudulent design" regardless.[10] Constructive knowledge of the breach is not sufficient to find

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[9] *Air Canada v M & L Travel Ltd.,* 1993 CarswellOnt 568 (S.C.C.) at para 33 ["*Air Canada*"].
[10] *Air Canada* at 811.

the stranger to the trust liable for the breach.[11] The Court also determined that in order for the stranger to the trust to be liable for the breach the misapplication of trust property by the trustee must be dishonest and fraudulent.

What precisely constitutes a “dishonest and fraudulent design” is open to interpretation and will be determined on the facts of each case. However, the conduct must be “morally reprehensible” and involve nothing short of dishonesty[12]. Not surprisingly, morally reprehensible or dishonest behavior can be difficult to prove in the best of circumstances.

Given the high threshold, it is more difficult to find a third party liable in this category than in the “knowing receipt” category. Practically, this is the right standard because, were it not for the raised threshold, professionals and those who routinely provide services to trustees would be at a substantial risk of liability.[13]

3. Knowing Receipt or Dealing

The third and final way that a stranger to the trust can be found to be a “constructive trustee” and liable for a breach of trust is from “knowing receipt or dealing.”[14] “Knowing receipt or dealing” arises where trust property is dealt with in a manner inconsistent with the terms of the trust after the third party acquired knowledge of the trust. Within this category, there are two generally recognized subcategories. In both cases, there is no requirement to show that the breach of trust was fraudulent.[15]

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[11] *Citadel General* at para 23; *Gold v. Rosenberg*, 1997 CarswellOnt 3273, [1997] 3 S.C.R. 767 (S.C.C.) [“*Gold*”] .
[12] *Air Canada* at paras 42 – 45.
[13] See E.E. Gillese & M. Milcynski, *The Law of Trusts*, 2 ed. (Toronto: Irwin Law, 2005) at 126.
[14] *Air Canada* at 36.
[15] *Citadel General* at para 24.

1) "**Knowing dealing**": strangers to the trust, usually an agent of the trustees, received the trust property lawfully and not for their own benefit, but then deal with the trust property in a manner inconsistent with the trust.
2) "**Knowing receipt**": a stranger to the trust receives trust property for his or her own benefit, knowing that it was transferred in breach of trust. In this case, the recipient must receive the trust property in his or her personal capacity, and not as an agent of the trustees.

In the second subcategory, "knowing receipt," the court in *Citadel General* determine that there are two primary issues that the plaintiff must prove to succeed. First, that the recipient of the trust property was given the trust property for his or her own use or benefit.[16] At a minimum, the recipient must have taken the trust property into his or her possession.[17] A party need not have legal title to the property – physical control is sufficient.

Second, the court must be satisfied that the recipient has a sufficient degree of knowledge of the breach of trust. Actual knowledge, wilful blindness or reckless blindness would clearly suffice. "Actual knowledge" means actual knowledge both of the existence of the trust and that the transfer of property is in breach of the trust. Where a trust was created by contract or by testamentary document, "actual knowledge" will depend on the recipient's familiarity and involvement with the trust document.[18] Where the recipient received a benefit as a result of the breach of the trust, knowledge may be presumed.[19]

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[16] *Citadel General*
[17] *Gold* at 127.
[18] CED Restitution VI.2.(d) at §443
[19] *Air Canada*; *Alers-Hankey v. Solomon* (2000), 75 B.C.L.R. (3d) 232 (B.C. C.A.)

In *Citadel General*, the court extensively reviewed two lines of cases that differed on whether "constructive knowledge" could be considered a "knowing receipt." "Constructive knowledge" refers to any actual knowledge that would reasonability put someone on notice of the breach of trust. The Court held that since the party received the property for his or her own benefit, there should be a lower threshold of knowledge required as more is expected of the recipient. As a result, the Court held that "constructive knowledge" of the trust breach is sufficient. Therefore, a defendant who receives trust property *without* constructive or actual knowledge of the breach may indeed be innocent of the breach and entitled to keep the property.

AVAILABLE REMEDIES

The claim of "knowing receipt" is different, and more potent, than the traditional claim for constructive trust. The court will impose a constructive trust where if finds that the defendant holds property on trust for the plaintiff. In those cases, the action arises *in rem*[20] and the rights of the claimant is in the trust property itself.

In contrast, actions arising from knowing receipt of trust property in breach of a trust or fiduciary obligation are *in personam*[21]claims, and liability follows the person, not the trust property.[22] At the time the recipient received the trust property, the beneficiary may have had a claim for a constructive trust. But even if the recipient sold the trust property or otherwise disposed of it, he or she is still liable to the beneficiary for the wrongful conduct. In other words, the recipient is required to account to the beneficiary regardless of his or her actual dealings with the misappropriated trust property on the grounds that he or she is a "constructive trustee."

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[20] *In Rem* is Latin for "in the thing itself." A lawsuit against an item of property, not against a person (*in personam*). An action *in rem* is a proceeding that ignores the owner of the property, and determines title to the property.
[21] *In Personam* is Latin for "directed towards a particular person".
[22] D.W.M. Waters, *Waters' Law of Trusts in Canada*, 4th ed., at 11.I.E.1

Depending on the facts of the case, the Court may impose a constructive trust over the misappropriated trust and require that it be returned to the trust or the Court may require the recipient to pay damages.

COSTS

If the plaintiff fails to make out a fraudulent claim, alleging any type of fraud in a civil action often results in a higher cost award, including substantial indemnity costs. As such, a plaintiff should proceed with caution before alleging fraud and be satisfied that she has a firm footing or sound basis on which to allege knowing receipt of fraudulent funds or knowing assistance in a breach of trust. It is trite law that costs are designed to discourage frivolous or ill-considered lawsuits.

CONCLUSION

All is not lost where the trustee of a trust breaches his fiduciary obligation, misappropriates trust assets, and disappears. The defrauded beneficiaries are able to pursue strangers to the trust for damages or the return of the trust property. As canvassed above, there are three main circumstances in which a beneficiary can bring a claim against a stranger to the trust: (i) where the stranger purported to act as trustee (trustee *de son tort*), (ii) where the stranger participated in the fraud, or (iii) where the stranger received the misappropriated trust property having notice of the trust.

In all three cases, the beneficiary must first demonstrate that the stranger had knowledge of the trust (the standard of proving knowledge will depend on the circumstances of the claim) and/or of the breach of trust. Once knowledge is ascertained, the stranger is considered in equity to be a "constructive trustee," subject to the same duties and standards as a trustee duly appointed in law

or by deed. The beneficiary is then free to pursue the stranger for damages or recovery of the trust property.

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