



## **Does A Constructive Trust Trump the Bankruptcy and Insolvency Act?**

*Charles B. Wagner\**

In the words of the Court of Appeal at paragraph 34, "those funds should be the subject of a constructive trust in favour of DSLC Capital Corp. in order to prevent the unjust enrichment of Credifinance Securities Limited." But, this is the end of the story. Let's start at the beginning.

DSL Capital Corp. (DSL) sought to invest in Credifinance Securities Limited (Credifinance) thinking that it was a member in good standing with the Investment Industry Regulatory Organization of Canada (IIROC). DSL's plan was to become a part owner of Credifinance so that DSL could sell securities and other investments to its existing network of investors. Based on representations of Charles Bennaroch, the principal of Credifinance, DSL loaned Credifinance \$400,000 and, by share subscription agreement, proceeded to purchase a minority ownership interest in Credifinance.

The deal went sour when DSL discovered that Bennaroch misled them. In truth, Credifinance, Bennaroch, Glover and another employee of Credifinance were under investigation by IIROC for misconduct. IIROC accused Bennaroch of engaging in improper financial and business transactions with clients and providing untrue or misleading evidence to IIROC. Credifinance faced the possibility of significant fines and other penalties as well as the loss of its membership in IIROC. As well, Credifinance and Bennaroch personally were being sued for hundreds of millions of dollars in the United States. The IIROC investigation and the lawsuit in the United States were not disclosed in Credifinance's audited financial statements and were hidden from DSL.

In the initial court proceeding against Credifinance, Gregory Sidlofsky of Wagner Sidlofsky LLP, succeeded in freezing part of the proceeds of the loan. Thereafter, Credifinance declared bankruptcy with Bennaroch and another company that Bennaroch controlled allegedly being secured creditors seeking to recover the funds that DSL had frozen. Deloitte & Touche, Credifinance's Trustee in bankruptcy, dismissed DSL's claim that it had a constructive trust over the \$310,500 in Credifinance's account that had been frozen and which could be traced to the loan. The Trustee took the position that even if there was a fraudulent misrepresentation by Credifinance, it would not allow our client to bypass the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 (BIA) because the Trustee argued that there is no special status accorded to the victim of a fraud. In other words – victims of fraud are just like any other creditor. DSL appealed the Trustee's decision and the matter was heard by Justice Marrocco of the Superior Court of Justice.

Justice Marrocco found that DSLC was deceived by Georges Bennaroch and but for the deceit, it would not have entered into any agreement with nor lent Credifinance \$400,000, and Credifinance would not have had \$310,500 in its bank account. He imposed a constructive trust over the \$310,500 remaining in Credifinance's bank account that could be traced to the loan. Deloitte & Touch appealed Justice Marrocco's decision to the Ontario Court of Appeal

At the Court of Appeal, counsel for Deloitte & Touche argued that the allegations of fraudulent misrepresentation made by DSLC, even if they could be established, are incapable at law of elevating DSLC's subordinate unsecured claim to the status of a property claim with priority over the Trustee or other creditors of the bankrupt. The Trustee's position was that while constructive trust principles can be applied in bankruptcy proceedings, those principles are applied only in the most extraordinary cases. Mr. Sidlofsky argued, on behalf of DSLC, that the constructive trust granted by Justice Marrocco was just in the circumstances of this case and did not unjustly deprive creditors of their rights under the BIA. He argued that the fraud resulted in DSLC having a property interest in the remaining loan proceeds by way of constructive trust and that the trust should take priority over the defendants' alleged security interest. The Ontario Court of Appeal upheld Justice Marrocco's decision and dismissed Deloitte & Touche's appeal.

This case is interesting and may be relevant for those in the estate litigation bar who look for avenues to recover funds defalcated by a fraudster. In estate litigation, allegations that a deceased sheltered his/her assets by transferring them to other parties may give rise to disappointed creditors and or dependents seeking statutory or equitable remedies to trace the missing funds or assets. In the context of estate litigation, concerns about a bankrupt estate arise when a person who is already bankrupt dies or when the bankruptcy takes place after the deceased's demise. When a bankruptcy is involved, the statutory regime set out in the *BIA* complicates matters. Given the prevalent use of parties seeking the remedy of a constructive trust in the context of estate litigation the issues raised in *Credifinance Securities Ltd., Re*, 2011 CarswellOnt 1218, 2011 ONCA 160 (Ont. C.A. Mar 02, 2011) are of interest to those in the estate litigation bar.

In reviewing the decision there are a number of important conclusions of the OCA that may have a bearing on an estate litigator's practice.

1. There is no question that the remedy of constructive trust is expressly recognized in bankruptcy proceedings;
2. A constructive trust will ordinarily be imposed on property in the hands of a wrongdoer to prevent him or her from being unjustly enriched from his or her wrongful conduct;
3. In its role as arbiter of commercial morality, the bankruptcy court can rely on equitable principles even at the expense of the formulaic scheme of distribution of the BIA;
4. A constructive trust in bankruptcy proceedings can be used to remedy an injustice such as where permitting creditors to access the property of the bankrupt would result in an injustice;

5. A Trustee in bankruptcy is an officer of the court and must act in an equitable manner. The court will not allow a Trustee in bankruptcy to stand on his legal rights if to do so would offend natural justice;
6. This decision does not suggest that once a civil fraud by the bankrupt against a claimant is established that a constructive trust will always be imposed. It is a discretionary remedy. Importantly, in this case the only creditors who were impacted by this decision were the principal of the corporate defendant and his lawyers who were also creditors of the bankrupt estate.

This decision does not mean that every victim of fraud can successfully obtain a constructive trust over money taken from him by the bankrupt. Imposing a constructive trust is discretionary and the court will consider all of the circumstances including who will be impacted by a constructive trust. But what is clear is that the remedy of constructive trust is a viable argument in bankruptcy cases that can, in appropriate circumstances, trump other creditor's claims.

\* *Charles B. Wagner, Wagner Sidlofsky LLP*