TAB 8

2017 ABCA 58
Alberta Court of Appeal

Easy Loan Corp. v. Wiseman

2017 CarswellAlta 185, 2017 ABCA 58, [2017] 5 W.W.R. 419, [2017] A.W.L.D. 1270, [2017] A.W.L.D. 1335, [2017] W.D.F.L. 1348, 275 A.C.W.S. (3d) 478, 412 D.L.R. (4th) 155, 45 C.B.R. (6th) 3, 45 Alta. L.R. (6th) 209

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)

Ronald Berger, Patricia Rowbotham, J.D. Bruce McDonald JJ.A.

Heard: December 6, 2016
Judgment: February 13, 2017
Docket: Calgary Appeal 1601-0044-AC

Proceedings: affirming *Easy Loan Corp. v. Base Mortgage & Investments Ltd.* (2016), 33 C.B.R. (6th) 288, 2016 CarswellAlta 174, 2016 ABQB 77, 27 Alta. L.R. (6th) 270, [2016] 8 W.W.R. 191, (sub nom. *Base Mortgage & Investments Ltd. (Receivership), Re)* 613 A.R. 384, K.D. Yamauchi J. (Alta. Q.B.)

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Subject: Corporate and Commercial; Estates and Trusts; Family; Insolvency; Property

Related Abridgment Classifications

Bankruptcy and insolvency
VIII Property of bankrupt
VIII.5 Trust property
VIII.5.d Tracing

Headnote

Bankruptcy and insolvency --- Property of bankrupt — Trust property — Tracing
Investors invested funds with defendant BF Ltd., allegedly in Ponzi scheme — Alberta Securities Commission issued order freezing BF Ltd.'s bank account in which funds were deposited — On application by respondent, court appointed receiver over BF Ltd.'s assets — Investors applied for order that funds in frozen bank account were held in trust for them — Constructive trust was imposed over funds in bank account for benefit of investors and other defrauded investors who did not take part in application — Logical, just, equitable and convenient approach for distributing bank account was pro rata sharing based on tracing or lowest intermediate balance rule (LIBR) was approach to be used when distributing bank account — Respondent appealed — Appeal dismissed — Cases said LIBR was fairest rule absent two exceptions, unworkability or

contrary intention of beneficiaries, which did not apply — LIBR was general rule for allocating funds among innocent beneficiaries when there was shortfall in trust account or in account that had been impressed with constructive trust by operation of law — Nothing in evidence suggested that investors intended there be any particular distribution method, therefore LIBR applied — Investors knew their investments would be pooled or comingled, however contract appeared to contemplate something less than full pooling or commingling because investor beneficiaries were entitled to return of their capital at time of their choosing, or at maturity date of their investment — Nothing could be cleaned by contract about investors' intentions as to which distribution method to use.

Table of Authorities

Cases considered:

Boughner v. Greyhawk Equity Partners Limited Partnership (Millenium) (2013), 2013 ONCA 26, 2013 CarswellOnt 510, 5 C.B.R. (6th) 113 (Ont. C.A.) — considered

Brookfield Bridge Lending Fund Inc. v. Vanquish Oil & Gas Corp. (2009), 2009 ABCA 99, 2009 CarswellAlta 682, 5 Alta. L.R. (5th) 1, [2009] 7 W.W.R. 1, 454 A.R. 162, 455 W.A.C. 162 (Alta. C.A.) — followed

Canson Enterprises Ltd. v. Boughton & Co. (1991), [1992] 1 W.W.R. 245, 9 C.C.L.T. (2d) 1, 39 C.P.R. (3d) 449, 131 N.R. 321, 85 D.L.R. (4th) 129, 61 B.C.L.R. (2d) 1, 6 B.C.A.C. 1, 13 W.A.C. 1, [1991] 3 S.C.R. 534, 43 E.T.R. 201, 1991 CarswellBC 269, 1991 CarswellBC 925 (S.C.C.) — followed

Elliott, Re (2002), 2002 ABQB 1122, 2002 CarswellAlta 1686, [2003] 5 W.W.R. 275, 30 C.P.C. (5th) 320, 11 Alta. L.R. (4th) 358, 333 A.R. 39 (Alta. Q.B.) — considered

Hallett's Estate, Re (1880), 13 Ch. D. 696, [1874-1880] All E.R. Rep. 793 (Eng. C.A.) — considered

Kretschmer v. Terrigno (2012), 2012 ABCA 345, 2012 CarswellAlta 2064, 539 A.R. 212, 561 W.A.C. 212, 77 Alta. L.R. (5th) 300, [2013] 6 W.W.R. 701, 26 R.F.L. (7th) 296 (Alta. C.A.) — considered

Law Society of Upper Canada v. Toronto Dominion Bank (1998), 1998 CarswellOnt 4757, 169 D.L.R. (4th) 353, 116 O.A.C. 24, 42 O.R. (3d) 257, 44 B.L.R. (2d) 72 (Ont. C.A.) — followed

Ontario (Securities Commission) v. Greymac Credit Corp. (1986), 55 O.R. (2d) 673, 17 O.A.C. 88, 23 E.T.R. 81, 30 D.L.R. (4th) 1, 34 B.L.R. 29, 1986 CarswellOnt 158 (Ont. C.A.) — considered

Ontario (Securities Commission) v. Greymac Credit Corp. (1988), 31 E.T.R. 1, (sub nom. *Greymac Trust Co. v. Ontario (Securities Comm.))* [1988] 2 S.C.R. 172, 52 D.L.R. (4th) 767, 29 O.A.C. 217, 87 N.R. 341, 65 O.R. (2d) 479, 1988 CarswellOnt 597, 1988 CarswellOnt 964 (S.C.C.) — considered

R. v. Mazzucco (2012), 2012 ONCJ 333, 2012 CarswellOnt 6948 (Ont. C.J.) — considered

Sawchuk v. Bourne (2005), 2005 ABCA 382, 2005 CarswellAlta 1997, 17 C.B.R. (5th) 39, 14 B.L.R. (4th) 9 (Alta. C.A.) — considered

Soulos v. Korkontzilas (1997), 1997 CarswellOnt 1489, 212 N.R. 1, 9 R.P.R. (3d) 1, 46 C.B.R. (3d) 1, 32 O.R. (3d) 716 (headnote only), 146 D.L.R. (4th) 214, 100 O.A.C. 241, 17 E.T.R. (2d) 89, [1997] 2 S.C.R. 217, 1997 CarswellOnt 1490, 32 O.R. (3d) 716, 32 O.R. (3d) 716 (note) (S.C.C.) — considered

306440 Ontario Ltd. v. 782127 Ontario Ltd. (2014), 2014 ONCA 548, 324 O.A.C. 21, 2014 CarswellOnt 19018, 384 D.L.R. (4th) 278, 8 E.T.R. (4th) 1, 3 P.P.S.A.C. (4th) 159 (Ont. C.A.) — followed

Statutes considered:

Bankruptcy Code, 11 U.S.C.
Chapter 7 — referred to

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3
s. 67(1)(a) — considered

APPEAL by respondent of judgment reported at *Easy Loan Corp. v. Base Mortgage & Investments Ltd.* (2016), 2016 ABQB 77, 2016 CarswellAlta 174, 27 Alta. L.R. (6th) 270, 33 C.B.R. (6th) 288, [2016] 8 W.W.R. 191, 613 A.R. 384 (Alta. Q.B.), granting application for constructive trust over certain funds and directing that funds be distributed according to specific tracing scheme.

***Per curiam*:**

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 Corp. v. Base Mortgage & Investments Ltd.*, 2016 ABQB 77, 613 A.R. 384 (Alta. Q.B.), (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 (Ont. C.J.) at para 9, (2012), 101 W.C.B. (2d) 651 (Ont. C.J.) 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 S.C.R. 217, 146 D.L.R. (4th) 214 (S.C.C.) 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.*, 2014 ONCA 548 (Ont. C.A.) 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 (Ont. C.A.) 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. Vanquish Oil & Gas Corp.*, 2009 ABCA 99 (Alta. C.A.) at paras 11, 13 and 15, (2009), 454 A.R. 162 (Alta. C.A.). 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 *Hallett's Estate, Re* (1880), 13 Ch. D. 696 (Eng. C.A.) (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 S.C.R. 534, 85 D.L.R. (4th) 129 (S.C.C.) 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 O.R. (2d) 673, 17 O.A.C. 88 (Ont. C.A.) at para 48, affirmed [1988] 2 S.C.R. 172 (S.C.C.).

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, *Elliott, Re*, 2002 ABQB 1122, 333 A.R. 39 (Alta. Q.B.) 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 A.C.W.S. (3d) 12 (Alta. C.A.); *Kretschmer v. Terrigno*, 2012 ABCA 345, 539 A.R. 212 (Alta. C.A.) 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 O.R. (3d) 257, 116 O.A.C. 24 (Ont. C.A.) ("*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. The lender agrees that its sole remedies with respect to default by the borrowers shall be against the demised premises and the borrowers.
>
> 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 or impose any liability as such on either of them.

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 dismissed.