Air Canada *v.* M & L Travel Ltd., [1993] 3 S.C.R. 787

Ross Valliant *Appellant*

v.

Air Canada *Respondent*

Indexed as: Air Canada *v.* M & L Travel Ltd.

File No.: 22416.

1993: April 26; 1993: October 21.

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

on appeal from the court of appeal for ontario

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 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 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.

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 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 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 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. Glatt* (1979), 25 O.R. (2d) 567; *Scott v. Riehl* (1958), 15 D.L.R. (2d) 67.

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

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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.

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

IACOBUCCI J. -- 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 general questions of the personal liability of directors for the acts of the corporation.

I. Background

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.

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.

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 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.

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.

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, Valliant's personal loan payments, and Martin's salary were all paid out of this account.

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.

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.

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 & 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.)

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.

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.)

Griffiths J.A. began by noting that it was not contested that there was a trust relationship 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.

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.

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.); and *Andrea Schmidt Construction Ltd. v. Glatt* (1979), 25 O.R. (2d) 567 (H.C.).

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. . . .
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> . . .
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> 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. . . .

Griffiths J.A. concluded that *Wawanesa v. Chalmers, Henry Electric Ltd. v. Farwell* and *Andrea Schmidt Construction Ltd.* could not be distinguished 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.

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 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.

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

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*

In this Court, the appellant initially argued that the relationship between M & L and the respondent 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.

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.

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.

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 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.

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.

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 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.

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.

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*.

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 Penn. Central Transportation Co.*, 328 F.Supp. 1278 (E.D.Pa. 1971); Scott on Trusts § 12.2 (3d ed.).

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.

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.

2. *Personal Liability of the Directors as Constructive Trustees*

(a) General Principles

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.

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 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.

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."

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 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.

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".

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 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.

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

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 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.

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.

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 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

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 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.

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.

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

> . . . 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.

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).

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.

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" (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.

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, 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.

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 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.

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. Therefore, he was personally liable for his breach of trust.

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 by reduction of his personal liability on his guarantee to the bank in respect of the Farwell company loan.

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."

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 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.

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. 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.

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.

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 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.

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. . . ."

Generally, there are good reasons for requiring participation in a fraudulent and dishonest breach 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.

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. It is unnecessary, therefore, to find that the appellant himself acted in bad faith or dishonestly.

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.

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, Delvaux*, *supra*,; *Scott v. Riehl*, *supra*. Therefore, the breach of trust by M & L was dishonest and fraudulent from an equitable standpoint.

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.

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 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

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

The following are the reasons delivered by

MCLACHLIN J. -- 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.

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 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.

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.

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 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.

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.

I would dismiss the appeal.

Appeal dismissed with costs.

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