AN EXAMINATION OF CONSTRUCTIVE TRUSTS IN THE INSOLVENCY CONTEXT

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INTRODUCTION

Constructive trusts. The mere thought can make secured creditors and their lawyers shudder. After all, imagine having valid, perfected, first-ranking security defeated by a claim that the debtor holds the secured property in trust for another person, absent any formal trust arrangements! The horror! But it does happen. It could happen to your clients. And although not preventable, understanding what constructive trusts are, and how they could be claimed, will help you advise your clients in the event they do arise.

BACKGROUND

The constructive trust is a judicial construct that is often used as a remedy in cases of unjust enrichment. In the circumstances where it is employed, specific property that is owned or possessed by the defendant is alleged to be impressed with a trust in favour of the constructive beneficiary, thereby removing that property from the defendant's estate.

Problems arise in the insolvency context where parties may be unaware of someone's subsequent claim of constructive trust, which may reorder the priorities in a bankruptcy. In the relatively certain distribution scheme set out in the *Bankruptcy and Insolvency Act,* R.S.C. 1985, c. B-3, as amended (the "**BIA**") this can wreak havoc with other creditors' expected recovery. Constructive trusts can also cause problems in restructurings under the BIA or *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (the "**CCAA**"), where proposals or plans can be affected or even unsuccessful if based on a scenario that changes as a result of a successful constructive trust claim.

THE EVOLUTION OF CANADIAN CONSTRUCTIVE TRUST CASES

The starting point with respect to an examination of constructive trusts in Canada must start with *Pettkus v. Becker,* [1980] S.C.J. No. 103.

As an aside, there has been much scholarly debate as to whether this case clarified the use of constructive trusts generally in Canada, or whether it simply addressed remedial constructive trusts. Such a discussion is outside the scope of this paper.

In any event, in *Pettkus*, Pettkus and Becker had a successful bee keeping business which operated on two Ontario properties. Although unmarried, the parties lived together as husband and wife for almost 20 years. When the relationship terminated, Ms. Becker brought an application alleging a constructive trust, seeking an entitlement to one-half interest in lands owned by Mr. Pettkus, and a share in the bee keeping business. The Supreme Court of Canada held that Mr. Pettkus held the

property on constructive trust for Ms. Becker. The Court held that a constructive trust can be applied in the cases of unjust enrichment, and that unjust enrichment can be established if there is an enrichment of one party and a corresponding deprivation of the other party, in the absence of juristic reason for the enrichment.

The next major case in Canada that dealt with constructive trusts was *Lac Minerals Ltd. v. International Corona Resources Ltd.,* [1989] S.C.J. No. 63. In this well-known case, International Corona Resources Ltd. ("**Corona**"), a junior mining company, carried out exploration on certain property known as the Williams property, and subsequently made attempts to acquire that property. Representatives from a senior mining company, Lac Minerals ("**Lac**"), arranged to visit the Williams property. Corona showed the Lac representatives confidential geographic findings and discussed the Williams property with Lac. Lac thereafter acquired the Williams property but never informed Corona of its intention to acquire the property. Corona sued Lac. The trial judge found that although there had not been a binding contract between Lac and Corona, Lac was nonetheless liable for breach of confidence and breach of fiduciary duty, and determined that the appropriate remedy with respect to breach of fiduciary duty would be the return of the Williams property to Corona. This finding was affirmed by the Court of Appeal which also confirmed that a finding of constructive trust was an appropriate remedy for breach of confidence and breach of fiduciary duty. This finding was upheld by the Supreme Court of Canada which determined that a constructive trust was the only just remedy in the circumstances regardless of whether the remedy was based on breach of confidence or breach of fiduciary duty.

The *Lac Minerals* decision was important in the development of the application of constructive trusts in Canada as previously Canadian courts had refused to impose a constructive trust absent a "special" relationship as between the parties. In this case, because of the disclosure of the information by Corona to Lac, and the corresponding loss as a result of that disclosure, Lac became bound as a fiduciary duty to Corona. This finding of constructive trust despite the absence of a clear-cut relationship between the parties shows how a claim of constructive trust may very well come "out of the blue" as it were and surprise and defeat other creditors.

In 1993, the Supreme Court of Canada again considered the issue of constructive trusts in *Peter v. Beblow,* [1993] 1 S.C.R. 980. In that case, there was a common law relationship between Ms. Peter and Mr. Beblow which had lasted for 12 years. Ms. Peter did the domestic work of the household and raised the children without compensation. It was determined by the court that a constructive trust was established arising from the unjust enrichment of Mr. Beblow. The Court held that a constructive trust is available where monetary damages are inadequate, and there is a link between the contribution that founds the action, and the property. The court further determined that a direct link

between the contribution and the property is essential for a constructive trust to arise whether the situation at hand is commercial or familial. In other words, there are no special rules for family cases. Further, the court held that the test for the absence of juristic reason is flexible and in every case the fundamental concern is the legitimate expectation of the parties.

The Canadian constructive trust case that appears to be the most controversial is *Soulos v. Korkontzilas* (1997), 146 D.L.R. (4th) 214 (S.C.C.). In that case, a real estate broker acted for a potential purchaser of commercial property. The purchaser made an offer for that property, it was rejected, and then the owner told the broker what it would accept for the property. Instead of telling the purchaser this, the broker arranged for the purchase of the property in his wife's name. The purchaser sued and alleged damages and alternatively, claimed breach of fiduciary duty and remedial constructive trust. The claim for damages was abandoned (because the property had actually declined in value since the date of purchase) but the purchaser still sought a return of the property based on constructive trust. The trial judge found a breach of fiduciary duty but also found that the purchaser was not entitled to a constructive trust, as it was an alternative to damages, and the purchaser had not suffered any damage (due to the decline in the value of the property). This decision was overturned at the Court of Appeal, and the broker appealed. The Supreme Court dismissed the appeal. Madam Justice McLachlin (as she then was) said that a constructive trust is an appropriate mechanism to condemn wrongful acts committed by fiduciaries and to maintain the integrity of trust relationships. She called this type of constructive trust "real" or "institutional" vs. "remedial" as found in *Pettkus*, *supra*. In other words, this decision appears to have broadened the availability of constructive trusts, relying on the amorphous concept of "good conscience", to base a finding of constructive trust. Justices Sopinka and Iacobucci wrote strong dissents in this decision, finding, among other things, that because there was no loss and no enrichment, a remedy of constructive trust was inappropriate in the circumstances.

CONSTRUCTIVE TRUSTS IN THE INSOLVENCY CONTEXT

Given the priority over other people and creditors that a constructive trust beneficiary would enjoy, its not surprising that allegations of constructive trust are frequently made in the insolvency context.

Baltman v. Melnitzer (Trustee of), [1996] O.J. No. 3963 (O.C.J.), extended the principle of constructive trust into the insolvency context. This case gives an excellent overview of the relevant case law, and contains a helpful consideration of juristic reason. In this case, upon the bankruptcy of Mr. Melnitzer, it was determined that a line of credit with RBC was opened on the basis of fraudulent misrepresentation. Mr. Melnitzer had purchased some artwork using the line of credit. Ms. Baltman, Mr. Melnitzer's wife, claimed ownership of the artwork on the basis that it had been given to her as a

gift. RBC claimed ownership of the artwork on the basis of unjust enrichment, and thereby claimed a constructive trust. In this case, the court found that the first two requirements for a finding of constructive trust, namely, enrichment and a consequential deprivation, existed. However, the bank's claim would ultimately fail based on a finding by the Court that there was a juristic reason for the deprivation. The court found that although there was a fraud in establishing the line of credit, there still remained a contractual relationship between Mr. Melnitzer and the bank, which provided sound juristic reason. The court further found that the bank could not establish that it had a reasonable expectation to acquire a proprietary interest in the subject paintings. The court determined that a court must consider the competing equitable interests and decide whether a proprietary or monetary remedy is appropriate. In this case, the court determined that a monetary remedy was appropriate.

In *Ellingsen (Trustee of) v. Hallmark Ford Sales Ltd.* (2000), 190 D.L.R. (4th) 47 (B.C.C.A.), Mr. Ellingsen purchased a truck from the respondent car dealership; part of the purchase price was to be financed through a bank. The dealer transferred ownership to Mr. Ellingsen prior to financing being confirmed, although blank conditional sales documentation was signed. The financing arrangements were delayed, and before the arrangements were finalized the purchaser assigned himself into bankruptcy. The trustee in bankruptcy sought a declaration that the truck vested in it free and clear of any claims by the dealer. The Court of Appeal held that the dealer did not retain a security interest, and that there was no enforceable interest on which to sue. However, the court determined that it was appropriate to impose a constructive trust in favour of the dealer to prevent an unjust outcome. The court determined that the dealer was entitled to the constructive trust as it did not stand on the same footing as the general creditors. It is worth noting that Chief Justice McEachern (as he then was) dissented and stated that he felt that the dealer ought to have registered a financing statement under the provincial personal property regime.

The decision in *Melnitzer* and the dissent by McEachern C.J.A. in *Ellingsen* mirrors the substantial debate that has occurred in cases and scholarly articles as to the whether parties to a commercial relationship can have available to them a constructive trust. Many feel that the existence of a contractual relationship creates a juristic reason for the deprivation, and should therefore preclude the finding of a constructive trust.

Certainly, in *Caterpillar Financial Services Ltd. v. 360networks corp.*, [2007] B.C.J. No. 22 (C.A.), the Court of Appeal found that Caterpillar could not make a successful claim for a constructive trust when it had failed to perfect registration of its security interests.

A finding of constructive trust was made in *Ascent Ltd. (Re),* [2006] O.J. No. 89 (O.C.J.), however, the court found that a prior commercial relationship was over-ridden by an intervening judicial event. In

Ascent, Cafco financed the acquisition by Ascent of an insurance policy for the benefit of Ascent. Ascent defaulted on payments under the policy, which had been assigned to Cafco pursuant to a Payment Installment Contract ("**PIC**"). Ascent thereafter filed a Notice of Intention to make a proposal, and its proposal was ultimately rejected, resulting in its bankruptcy. Cafco argued that the creditors of Ascent were unjustly enriched by the insurance premium that was unearned. In this case, the issue squarely before the court was: "What is unjust enrichment, and can it form the basis for the use of the constructive trust in a commercial insolvency to provide an appropriate remedy?"

The court in *Ascent* determined that the three requirements of constructive trust were present. In turning to the discussion of whether there was a juristic reason for the enrichment and corresponding deprivation, the court determined that a decision of the trial court, during proposal proceedings, that the unearned premium was to be held in trust for Cafco dramatically changed the creditor landscape. It would be interesting to know what the court might have decided had it not been for that intervening court decision.

Ascent is an interesting case as the court also considered the impact of a finding of constructive trust on the distribution scheme laid out under the BIA. The court commented that it was satisfied that, "… it is, in certain cases appropriate to do injustice to the BIA in order to do justice to commercial morality." Further, the court found "… no offence in equity intervening, even at the expense of the formulaic aspects of the BIA scheme of distribution." (at para. 17).

In *New Solutions Financial Corp. v. 952339 Ontario Ltd*. 2007 CarswellOnt 46 (O.C.J.), an interim receiver appointed under the BIA operated an insolvent school. Parents of students of that school sought a refund of tuition and other fees they had made as advance payments before the school ceased to operate. The court found that the secured creditor had priority to the payments made by the parents since the parents failed on the third prong of the constructive trust test: they could not establish an absence of juristic reason for the enrichment of the school. Of note was the Admission Agreement that was signed by the parents in which they acknowledged that the fees must be paid whether or not the services are actually provided to the student.

The most recent case in the insolvency context dealing with constructive trusts is *Melchior v. Cable (Trustee of)*, [2007] B.C.J. No. 158 (S.C.). This case involved an application by Ms. Melchoir, Mr. Cable's common law spouse for a remedial constructive trust in relation to certain patents arising out of a business that Mr. Cable (a bankrupt) owned and operated. The business was also a bankrupt. Of note is that there had been no relationship breakdown; Mr. Cable and Ms. Melchoir were still co-habitating at the time of the application. The Court found that Ms. Melchoir did nothing to contribute to the creation of the patents, and that she received a salary from the business at the

operative times. The court relied on the decision in *Ellingsen* and determined that a remedial constructive trust will not be imposed without taking into account the interests of others who may be affected by the remedy. Ms. Melchoir's claim was thereby dismissed.

ANALYSIS

An examination of the case law discussed above shows clearly that all courts in Canada, with reference to constructive trusts, are in agreement that in order to make a finding of constructive trust there must be:

(1) an unjust enrichment;

(2) a corresponding deprivation; and

(3) no juristic reason for the deprivation.

These three conditions must be met regardless of whether the relationship is familial or commercial, and whether the parties are solvent or insolvent. All of the above considerations are based on a general overall theme of "good conscience", pursuant to which the court will look to the expectation of the parties, and also, consider the impact of a finding on constructive trust on the interests of others who may be affected by the finding of a constructive trust.

Should constructive trusts exist in the insolvency context? Because a constructive trust can be found to exist some time after bankruptcy, such a trust can prove problematic to affected creditors, who can do nothing to protect their interests in the case of any unknown constructive trust. However, what makes constructive trusts problematic in the insolvency context is that even after a finding of constructive trust, the court is called upon to look at its effect on creditors. This is where scholars tend to feel that constructive trusts are problematic, because such a consideration takes the finding of a constructive trust out of the realm of pure fact, and into the more treacherous realm of judicial discretion. Does this make a constructive trust inappropriate in a bankruptcy?

While concerning, discretion and equity already have a strong foothold in Canadian insolvency law. There is never complete certainty in the classification of, and the priority of payment to, creditors, due to the fact that a bankruptcy court is a court of equity. Further, if applied in a principled manner, a constructive trust would only give priority over other creditors when there was a legitimate reason for subordinating certain creditor's rights. This application of discretion already exists in insolvency law

in Canada, and although troubling, the existence of constructive trusts does not expand the danger for creditors from that which exists already.

So what can secured creditors do to protect themselves from constructive trusts? Frankly, not very much, since they are situation based, and often, the facts giving rise to such claims would be unknown to creditors. However, a thorough understanding of how constructive trusts arise, and how to analyze them when they do, is likely the best defense.

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