

CONSTRUCTIVE TRUSTS IN INSOLVENCY: A CANADIAN PERSPECTIVE

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In Canada and the United States, the constructive trust is a proprietary remedy awarded mainly to prevent unjust enrichment or to deter wrongdoing. The remedy gives the plaintiff an equitable proprietary interest in the disputed asset, as opposed to simply a money claim for the value of the asset. This feature of the constructive trust is particularly important if the defendant is insolvent or, by extension, if there is a substantial risk that the defendant may become insolvent before the judgment is satisfied. A constructive trust in insolvency is analogous to a security interest: it allows the plaintiff to take the disputed asset out of the defendant's estate, with the result that the plaintiff recovers in full on its claim. This is at the expense of the estate, which is correspondingly depleted, and the claims of the defendant's unsecured creditors which are, as a result, diminished. The Canadian case law on the availability of constructive trust relief in the defendant's insolvency is unsettled, and there is confusion in both the case law and the literature as to the doctrinal basis of the remedy and the relevant policy considerations. It is commonly argued that a key policy consideration is, or should be, whether the plaintiff voluntarily accepted the risk of the defendant's insolvency. But while popular in restitution circles, this approach is deeply problematic from a bankruptcy perspective. This article examines the current state of the case law in Canada, identifies and critically analyzes the main theoretical arguments in the literature and suggests the basis on which courts should approach cases of this kind.

Au Canada et aux États-Unis, la fiducie par interprétation est une réparation fondée sur le droit de propriété principalement octroyée afin de prévenir l'enrichissement injustifié ou un acte répréhensible. Cette réparation fournit au demandeur un intérêt en equity dans la propriété du bien en litige plutôt qu'une simple revendication pécuniaire de la valeur du bien. Cet aspect de la fiducie par interprétation est particulièrement important si le défendeur est insolvable ou s'il existe un risque important que ce dernier le devienne avant que le jugement ne soit satisfait. Dans le cadre de l'insolvabilité, une fiducie par interprétation est analogue à une garantie en ce qu'elle permet au demandeur de retirer le bien en litige du patrimoine du défendeur, de telle sorte que le demandeur

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recouvre l'intégralité de sa demande. Ce recouvrement se fait aux dépens du patrimoine, qui se retrouve ainsi appauvri, et des revendications des créanciers non garantis du défendeur qui sont, comme résultat, réduites. La jurisprudence canadienne portant sur la possibilité de recourir à la fiducie par interprétation comme moyen de réparation dans les cas d'insolvabilité du défendeur n'est pas établie et il y a confusion tant dans les décisions que dans les écrits juridiques relativement aux fondements doctrinaux de la réparation et les considérations de principe applicables. Plusieurs ont fait valoir qu'une considération de principe essentielle est, ou devrait être, de vérifier si le demandeur a volontairement accepté le risque de l'insolvabilité du défendeur. Cette notion est bien reçue sur le plan de la restitution, mais elle pose d'énormes problèmes en droit de la faillite. L'auteur examine l'état actuel de la jurisprudence canadienne en la matière, cerne et analyse, d'un point de vue critique, les principaux arguments théoriques mis de l'avant dans la doctrine, et donne des suggestions quant au fondement sur lequel les tribunaux devraient s'appuyer dans ce genre d'affaires.

I. Introduction

In Canada and the United States, the constructive trust is a proprietary remedy awarded mainly to prevent unjust enrichment or to deter wrongdoing (such as breach of fiduciary obligation). The remedy is a proprietary one in the sense that it gives the plaintiff an equitable proprietary interest in the disputed asset, as opposed to simply a money claim for the value of the asset. This feature of the constructive trust is particularly important if the defendant is insolvent or if there is a substantial risk that the defendant may become insolvent before the judgment is satisfied. A constructive trust in insolvency is analogous to a security interest: it allows the plaintiff to take the disputed asset out of the defendant's estate, with the result that the plaintiff recovers in full on its claim. This is at the expense of the estate, which is correspondingly depleted, and the claims of the defendant's unsecured creditors which are, as a result, diminished.

The Canadian case law on the availability of constructive trust relief in the defendant's insolvency is unsettled and there is confusion, in both the case law and the literature, as to the doctrinal basis of the remedy and the relevant policy considerations. The leading journal article on the topic,¹ which is cited regularly by the courts,² proposes a theory of constructive

¹ David M Paciocco, "The Remedial Constructive Trust: A Principled Basis for Priorities Over Creditors" (1989) 68:2 *Canadian Bar Review* 315 [Paciocco].

² See, e.g., *KPMG (Trustee in Bankruptcy of Ellingsen) v Hallmark Ford Sales Ltd*, 2000 BCCA 458 (*sub nom Ellingsen (Trustee of) v Hallmark Ford Sales Ltd*) at paras 32 (Donald JA), 59 (Lambert JA), 190 DLR (4th) 47 [Ellingsen]; *Caterpillar Financial Services v 360networks Corp et al*, 2007 BCCA 14 at para 61, 279 DLR (4th) 701, Kirkpatrick JA

trust relief which, while popular in restitution circles, is deeply problematic from a bankruptcy perspective. The article is more than twenty-five years old and there have been significant developments in the case law since it was written. The aims of this article are to survey the current state of the case law in Canada, identify and critically analyze the main theoretical arguments in the literature, and suggest the basis on which courts should approach cases of this kind.

As indicated above, the constructive trust remedy may be imposed for a variety of purposes, including the prevention of unjust enrichment and the avoidance of wrongdoing. In the interests of manageability, the focus in this article will be on the constructive trust to prevent unjust enrichment, though the constructive trust to prevent wrongdoing raises many interesting issues as well.³ In Canada, the law governing the constructive trust to prevent unjust enrichment developed in the context of property disputes arising on the breakdown of *de facto* relationships.⁴ Despite some statements in the cases to the contrary,⁵ there are strong grounds for arguing that the considerations governing constructive trusts in the family context are different from those which apply in commercial cases.⁶ Again in the interests of manageability, this article will focus on commercial cases. Even within the commercial context, there is a wide variety of factual circumstances in which a plaintiff might ask for constructive trust relief and various reasons why the plaintiff might prefer a constructive trust remedy to just a money claim. As indicated above, one important consideration is that a constructive trust remedy will be more beneficial to the plaintiff than a money claim if the defendant is insolvent. But the plaintiff may also want a constructive trust remedy in order to pursue a tracing claim (as where the defendant has exchanged the disputed asset for other property and the plaintiff wants to claim the other property).⁷ Or again, the plaintiff may want constructive trust relief because

[*Caterpillar Financial Services*]; *Alternas Savings and Credit Union Limited v Norman*, 2006 CanLII 3466 at para 36, 2006 CarswellOnt 720 (SC), Cameron J; *Tracy v Instalcoans Financial Solutions Centres (BC) Ltd*, 2010 BCCA 357 at para 37, 320 DLR (4th) 577, Newbury JA.

³ See, e.g., Anthony Duggan, “Gain-Based Remedies and the Place of Deterrence in the Law of Fiduciary Obligations” in Andrew Robertson & Tang Hang Wu, eds, *The Goals of Private Law* (Oxford: Hart Publishing, 2009) 365.

⁴ See the line of cases starting with *Pettkus v Becker*, [1980] 2 SCR 834, 117 DLR (3d) 257 [*Pettkus*] and concluding, for now, with *Kerr v Baranow*, 2011 SCC 10, [2011] 1 SCR 269 [*Kerr*].

⁵ See, e.g. *Peter v Beblow* [1993] 1 SCR 980 at 996–97 (McLachlin J) contra 1022–23 (Cory J), 101 DLR (4th) 621 [*Peter v Beblow*].

⁶ Lionel Smith, “The State of the Law of Unjust Enrichment in Common Law Canada” (2015) 57:1 Can Bus LJ 39 at 48–51 [Smith]. See also Paciocco, *supra* note 1 at 325–28.

⁷ See, e.g., *Attorney-General for Hong Kong v Reid*, [1994] 1 AC 324, [1994] 1 All ER 1.

the disputed asset holds special value for him which would probably not be captured by a money award⁸ or, relatedly, because the disputed asset is hard to value and there is a significant risk that, in assessing damages, the court may get the calculations wrong.⁹

Once again, for reasons of manageability, this article will focus on cases where the defendant's insolvency is the reason for the constructive trust claim.¹⁰ The discussion will be organized around two cases: *Baltman v Melnitzer*¹¹ and *i Trade Finance Inc v Bank of Montreal*.¹² In both cases, a loan contract was induced by the borrower's fraud, the borrower used the loan money to purchase other property and the plaintiff claimed a constructive trust over the property as proceeds of the loan. In *Baltman*, the claim was against the borrower's trustee in bankruptcy. In *i Trade*, the claim was against a third party creditor which held a competing interest in the disputed property. Although *i Trade* was not litigated in an insolvency context, the case raises both doctrinal issues and policy considerations which have clear insolvency implications.

The balance of the article is organized as follows. Part 2, below, provides an overview of the Canadian law governing unjust enrichment claims. Part 3 provides an account of the two cases, *Baltman* and *i Trade*. Part 4 identifies three perspectives on the availability of proprietary remedies in insolvency, each representing a different point on the policy spectrum and using the cases discussed in Part 3 as the focal point for a broader analysis. Part 5 is the conclusion.

2. The Canadian Law of Unjust Enrichment

In *Pettkus v Becker*, Chief Justice Dickson articulated a three-part test of unjust enrichment: (1) there must be proof that the defendant was enriched; (2) there must be proof that the plaintiff was correspondingly deprived; and (3) there must be no juristic reason to justify the defendant's enrichment.¹³

⁸ See, e.g. *Soulos v Korkontzilas*, [1997] 2 SCR 217, 32 OR (3d) 716 [*Soulos*].

⁹ See, e.g., *LAC Minerals Ltd v International Corona Resources Ltd*, [1989] 2 SCR 574, 69 OR (2d) 287 [*LAC Minerals Ltd*].

¹⁰ For a comprehensive account of the constructive trust remedy, covering both commercial and non-commercial cases and cases both inside and outside insolvency, see Mitchell McInnes, *The Canadian Law of Unjust Enrichment and Restitution* (Toronto: LexisNexis Canada, 2014) at 1306–64 [McInnes, *Unjust Enrichment and Restitution*]. See also Peter D Maddaugh & John D McCamus, *The Law of Restitution* (Toronto: Canada Law Book, 2014) (loose-leaf), ch 5 at 200 [Maddaugh & McCamus].

¹¹ (1996), 43 CBR (3d) 33, 1996 CarswellOnt 4337 (WL Can) (*sub nom Baltman v Coopers & Lybrand Ltd*) (Ct J (Gen Div [Bankruptcy])) [*Baltman*].

¹² 2011 SCC 26, [2011] 2 SCR 360 [*i Trade SCC*].

¹³ *Supra* note 2 at 848.

In *Garland v Consumers' Gas Co*¹⁴ the Supreme Court refined the third part of the test, holding that there are two stages to the juristic reasons analysis. At the first stage, the plaintiff has the burden of proving that there is no justification in law for the defendant to keep the enrichment (for example the enrichment cannot be explained by a contract, a gift, a disposition of law or the like). If the plaintiff can manage this hurdle, she becomes *prima facie* entitled to a remedy. At the second stage of the analysis, the burden shifts to the defendant of rebutting the plaintiff's *prima facie* entitlement by pointing to some other reason to justify the enrichment. Factors relevant at this second stage of the inquiry include the parties' reasonable expectations and public policy considerations.¹⁵

In *Pettkus*, it was held that once the plaintiff has established the requirements for relief on the grounds of unjust enrichment, the court must decide, as a matter of discretion, whether a constructive trust remedy is appropriate. Factors relevant to the exercise of this discretion include: (1) the adequacy of a money remedy; (2) the continued identifiability of the disputed asset; (3) a clear and substantial connection between the disputed asset and the unjust enrichment; (4) the parties' reasonable expectations; and (5) the effect a proprietary remedy might have on third party claims to the disputed asset.¹⁶ In *Garland*, the plaintiff's claim was for a money judgment, not constructive trust relief, and so the court did not have to undertake the remedial stage of the inquiry. But later, in *Kerr v Baranow*, the court made it clear that the constructive trust to reverse unjust enrichment remains a discretionary remedy to be awarded sparingly.¹⁷ In other words, the remedial stage of the inquiry remains alive and well post-*Garland*.

Unfortunately, developments in the case law after *Garland* have led to confusion surrounding the proper basis for restitutionary claims in Canada. In *BMP Global Distribution Inc v Bank of Nova Scotia*,¹⁸ the plaintiff bank sued its customer for recovery of money it had paid out on a forged cheque. The court held that the plaintiff was entitled to recover on the principle of payments made under a mistake of fact, namely that the payor is entitled to recovery unless: (1) the payor intended the payee to have the money; (2) the payment was made for good consideration; or (3) the payee has

¹⁴ 2004 SCC 25, [2004] 1 SCR 629 [*Garland*].

¹⁵ *Ibid* at para 46, Iacobucci J. See also *Kerr*, *supra* note 4 at paras 43,117–22, Cromwell J.

¹⁶ For a useful summary of the cases in point, see AH Oosterhoff, Robert Chambers & Mitchell McInnes, eds, *Oosterhoff on Trusts*, 8th ed (Toronto: Carswell, 2014) at 748–57 [Oosterhoff, Chambers & McInnes, 8th ed]. For a fuller account, see McInnes, *supra* note 10 at 1320–45.

¹⁷ *Supra* note 4 at para 47 *per* Cromwell J: “The first remedy to consider is always a monetary award [...] In most cases, it will be sufficient to remedy the unjust enrichment.”

¹⁸ 2009 SCC 15, [2009] 1 SCR 504 [*BMP*].

changed its position on the strength of the payment. There was no mention in the judgment of the cause of action for unjust enrichment as articulated in *Pettkus* and developed in *Garland*, much less any indication of how the cause of action in the *BMP* case relates to the cause of action in unjust enrichment.

This has led to a vigorous debate in the literature. According to one school of thought, *Garland* is an exhaustive statement of the Canadian principles governing unjust enrichment and the *BMP* case was an aberration. According to the other school of thought, *Garland* applies only to novel cases and the established common law causes of action otherwise continue to apply.¹⁹ Lionel Smith, echoing Isaiah Berlin's famous distinction between thinkers who are hedgehogs and thinkers who are foxes,²⁰ argues that the debate is understandable and inevitable, because the *Garland* expansionists are by inclination hedgehogs, while the *Garland* contractionists are foxes. Smith goes on to suggest that, in cases like *BMP*, the Supreme Court has revealed itself to be a fox and that there is no point in Canadian legal commentators being hedgehogs if the country's highest court is a fox. But his claim implies either that the court has deliberately chosen to be a hedgehog or that it is naturally inclined that way and there is nothing, at least in the *BMP* case itself, to suggest any such commitment. A perhaps more plausible, though certainly more prosaic, take on the *BMP* case is that the judgment simply responds to how the case was argued and that counsel either chose not to rely on *Garland* or overlooked the case.²¹ On this view, neither *Garland* nor *BMP* tells us much about the court's likely response in future cases. Fortunately, the issue is not central to the present inquiry. Whatever the appropriate cause of action for the recovery of mistaken payments and the like, the plaintiff has the option of asking for a constructive trust remedy and, if it does so, the factors guiding the exercise of the court's discretion should be the same.²²

¹⁹ John D McCamus, "Mistake, Forged Cheques and Unjust Enrichment: Three Cheers for *BMP Global*" (2009) 48:1 Can Bus LJ 76; John D McCamus, "Unjust Enrichment, 'Existing Categories' and *Kerr v. Baranow*: A Reply to Professor McInnes" (2012) 52:3 Can Bus LJ 390; Mitchell McInnes, "Revising the Reason for Restitution: *Garland* Ten Years After" (2015) 57:1 Can Bus LJ 1; Smith, "State of the Law", *supra* note 6.

²⁰ Isaiah Berlin, *The Hedgehog and The Fox: An Essay on Tolstoy's View of History* (New York: Simon & Schuster, 1953): Hedgehogs look for one big idea to explain a subject, whereas foxes prefer multiple, overlapping explanations.

²¹ Something like this happened in *i Trade* SCC, *supra* note 12 at paras 18–21: counsel expressly disavowed unjust enrichment (*Garland*, *supra* note 14) as the basis of *i Trade*'s claim, and instead relied on *BMP*, *supra* note 18.

²² It is true, as the following analysis will show, that if the case is pleaded in unjust enrichment, the court has room for discretion at the unjust enrichment stage of the analysis as well as the remedial stage, whereas if the case is pleaded on one or other of the traditional grounds, the discretion arises largely at the remedial stage. But this difference should not

The above discussion points to confusion in the cases as to how an action for recovery in unjust enrichment should be framed. There is further confusion at the remedial stage as to the relevance of the defendant's bankruptcy in deciding whether to award a constructive trust. Some cases suggest that the defendant's bankruptcy is a factor supporting the remedy, given that if the plaintiff is awarded only a money judgment, it may not recover in full or at all, in the defendant's bankruptcy distribution.²³ Other cases suggest that the defendant's bankruptcy should count against a constructive trust remedy because it would allow the plaintiff to recover its claim in full, ahead of the defendant's other unsecured creditors and in violation of the *pari passu* (rateable sharing) principle governing bankruptcy distributions.²⁴ As the following discussion will show, the trend in the more recent cases is to reject the argument that the defendant's bankruptcy is a sufficient reason for constructive trust relief and to be cautious when considering a constructive trust remedy against an insolvent defendant.²⁵

3. The Cases

A) *Baltman v Melnitzer*

The facts of the case were that Royal Bank opened an \$8 million line of credit in Melnitzer's favour, taking various kinds of security in support of Melnitzer's repayment obligations. Melnitzer drew on the line of credit and used the money to buy paintings. He went bankrupt, owing the bank roughly \$2.5 million, and the bank's security \$2.5 million and the bank's security was insufficient to cover the debt. It turned out that when Melnitzer was negotiating with the bank for the line of credit, he made false representations about his creditworthiness. The bank brought an action in unjust enrichment claiming a constructive trust over the paintings as proceeds of the advances. The case pre-dated *Garland*, and the bank's argument was based on the unreconstructed test of unjust enrichment articulated in *Pettkus*. Specifically,

affect the availability or otherwise of a constructive trust remedy: either the court denies the remedy because it finds that there is no unjust enrichment and therefore no basis for relief at all, or it denies the remedy because while it finds that the cause of action has been made out, it concludes that a constructive trust would be inappropriate.

²³ See e.g. *Tracy*, *supra* note 2 at para 35, citing McLachlin J in *Peter v Beblow*, *supra* note 5 at para 31; *LAC Minerals Ltd*, *supra* note 9 at 677, La Forest J; *Phoenix Assurance Company of Canada v Corporation of the City of Toronto*, 35 OR (2d) 16, 1981 CanLII 1790 (SC).

²⁴ See e.g. *Ellingsen*, *supra* note 2 at para 36, Donald JA, citing *Barnabe v Touhey*, 26 OR (3d) 477 at 479, 1995 CanLII 1672 (CA); *Canada (AG) v Confederation Life Insurance Co* (1995), 24 OR (3d) 717 at 771, 8 ETR (2d) 72 (Ct J (Gen Div)), Blair J.

²⁵ See Paciocco, *supra* note 1 at 338–39 criticizing the view stated in the text at note 23. See also McInnes, *Unjust Enrichment and Restitution*, *supra* note 10 at 1337–40 and see especially at 1340.

it argued that: (1) Melnitzer was enriched by the loan moneys; (2) the bank was correspondingly deprived because it had not been repaid; and (3) there was no juristic reason for the enrichment because the contract under which the advances were made was void on account of Melnitzer's fraud.

The court rejected this argument on the ground that a contract induced by fraud is not void *ab initio*, but simply voidable at the option of the defrauded party and that, at the date the bank paid out the advances, it had not elected to avoid the contract. The court also held that the parties' reasonable expectations were relevant to the juristic reasons inquiry and that, at the time of making the advances, the bank "had no expectation whatsoever that it would or could acquire a proprietary interest in the paintings."²⁶ The bank "was content with its credit-line arrangements and the collateral it had received."²⁷ And for good measure, the court added that "it is patently absurd to attempt to twist the unjust enrichment principle like a warm pretzel and employ it on these facts."²⁸

The end result is that the bank failed in its cause of action for unjust enrichment. But the court went on to consider whether a constructive trust remedy would be appropriate, in case it was wrong in dismissing the bank's unjust enrichment claim. It held that a constructive trust remedy would be inappropriate for the following reasons: (1) the commercial nature of the relationship between Melnitzer and the bank; (2) the bank did take security over certain collateral, but chose not to take a security interest in the paintings; (3) the bank had its normal contractual remedies against Melnitzer; (4) the bank had the right to claim as a creditor in Melnitzer's bankruptcy; (5) the bank's loss was due to its own negligence, lack of investigation and breach of its own credit-granting rules in its dealings with Melnitzer; and (6) the bank's aim, in asking for a constructive trust remedy, was to "jump the queue" over other unsecured creditors in the bankruptcy.²⁹ In elaboration of the last point, the court said:

this is a case where a large and sophisticated commercial enterprise entered a loan contract with a person it was anxiously and almost desperately courting and chose to dictate the terms and conditions of the arrangement. Now, having been burned [...] the Bank is attempting to re-write [the] contract and, after the fact, obtain new security at the expense of other creditors[.]³⁰

The case was decided pre-*Garland*, but it is hard to believe that the outcome today would be any different. Post-*Garland*, the bank might argue at the

²⁶ *Baltman*, *supra* note 11 at para 27, Killeen J.

²⁷ *Ibid* at para 43.

²⁸ *Ibid* at para 44.

²⁹ *Ibid* at para 48.

³⁰ *Ibid* at para 49.

first stage of the juristic reasons inquiry that the contract, though still on foot at the date of the advances, was tainted by Melnitzer's fraud and is therefore not a juristic reason for the enrichment.³¹ Alternatively, the bank might argue that the enrichment occurred, not when it made the advances, but when it rescinded the loan contract. At that point, Melnitzer and, by extension his trustee, were enriched by retention of the loan money, the bank was correspondingly deprived and, the contract having been rescinded, there is no juristic reason for the enrichment. But even if the court was prepared to accept one or other of these arguments, the bank would still probably founder at the remedial discretion stage: the court would almost certainly deny constructive trust relief for much the same reasons as those given in the case itself.³²

B) i Trade Finance Inc v Bank of Montreal

In this case, i Trade made a loan to a company, Webworx, on the strength of fraudulent misrepresentations made by Ablacksingh ("A"), who controlled Webworx. A and his spouse helped themselves to the loan proceeds and used the money to buy shares. They subsequently pledged the shares to the bank as security for their credit card obligations. The bank was unaware of the fraud. When i Trade discovered the fraud, it sued Webworx and A for recovery of the loan funds. The shares were sold pursuant to a court order and the proceeds were placed on trust, pending the outcome of the dispute. i Trade obtained summary judgment against these defendants on 6 September 2006. Justice Belobaba found them liable for conspiracy, deceit, fraudulent misrepresentation and breach of trust and awarded damages against them. He also made an order declaring that the defendants held all property purchased with the loan funds as constructive trustees for i Trade and granted i Trade a tracing order. The terms of the tracing order excluded property in the hands of a *bona fide* purchaser for value and they allowed i Trade to elect between: (1) "a constructive trust and/or an equitable lien"; and (2) pursuing its personal remedy against any party liable.³³

i Trade also sued the bank and judgment in those proceedings was delivered on 14 October 2008. Justice Belobaba's order was never challenged and so the share sale proceeds were clearly held on constructive

³¹ See Paciocco, *supra* note 1 at 344.

³² See e.g. *Pacific Shores Resort & Spa Ltd (Re)*, 2013 BCSC 480 at paras 33, 75, 14 BLR (5th) 53, Fitzpatrick J, citing (and referring with approval to the reasoning in) *Baltman*, *supra* note 11. As an alternative to pleading unjust enrichment, the bank might base its claim on *BMP*, *supra* note 18. In that event, it might succeed in establishing a right to recovery, but it would probably founder at the remedial discretion stage.

³³ *i Trade v Bank of Montreal* (5 September 2006) Toronto (ONSC), Belobaba J [unreported]. A summary of Belobaba J's order appears in *i Trade SCC*, *supra* note 12 at para 7.

trust for i Trade pursuant to the terms set out in the order. It follows that the sole question in i Trade's action against the bank should have been whether i Trade could enforce its constructive trust entitlement against the bank. But for reasons which are not explained in any of the reports, i Trade brought a claim against the bank for unjust enrichment which was apparently framed as follows: (1) A and Webworx had been unjustly enriched at i Trade's expense; (2) as a result of the earlier proceedings, A and Webworx held the shares and their sale proceeds on trust for i Trade; and (3) under the terms of the earlier order, i Trade could assert its constructive trust claim against a third party other than a *bona fide* purchaser for value. The motion judge confirmed i Trade's right to constructive trust relief on this basis and she found that the bank was not a *bona fide* purchaser for value. On this basis, i Trade's claim to the shares and their sale proceeds prevailed over the bank.³⁴

The Ontario Court of Appeal reversed this decision, holding that: (1) the motion judge focused on whether A and Webworx had been unjustly enriched at i Trade's expense, when the focus should have been on the bank and i Trade; and (2) as between the bank and i Trade, even assuming that the bank's enrichment corresponded with i Trade's deprivation, the bank's security agreement with A, entered into without knowledge of A's fraud, was a sufficient juristic reason for the enrichment. The court did not refer to *Garland*, but these considerations might have been applied at either the first or second stage of the *Garland* juristic reasons inquiry. i Trade argued in the alternative before the Court of Appeal that it held an "equitable lien" in the loan funds and their traceable proceeds.³⁵ The details of this argument are not spelled out in the judgment, but the claim seems to have been that: (1) as a consequence of A's fraud i Trade was entitled to rescind the loan contract; (2) the right had not been exercised at the date the bank acquired its interest in the shares; but (3) i Trade's as yet unexercised right of rescission gave it an equitable proprietary interest which prevailed over the bank's claim.³⁶ The court held, contrary to the motion judge, that the bank was a *bona fide* purchaser for value and so, under the terms of the original court order, i Trade could not assert its claim against the bank. This conclusion made it unnecessary to inquire further into the basis of i Trade's "equitable lien".

³⁴ *i Trade v Bank of Montreal* (14 October 2008), Toronto 03-CV-246248CM4 (ONSC), Kiteley J: summarized in the Court of Appeal's judgment, *Bank of Montreal v i Trade Finance Inc*, 2009 ONCA 615 at para 6, 96 OR (3d) 561 [*i Trade* ONCA]; and in the affirming judgment, *i Trade SCC*, *supra* note 12 at paras 8–11.

³⁵ *i Trade* ONCA, *ibid* at para 15.

³⁶ The cases in support of this argument are not referred to in the judgment but see e.g. Richard Calnan, *Proprietary Rights and Insolvency* (Oxford: Oxford University Press, 2009) at 4.48–4.93 [Calnan]; Peter Watts, "Constructive Trusts and Insolvency" (2009) 3 *Journal of Equity* 250 at 265–70 [Watts].

There are some misconceptions in the Court of Appeal's judgment, apparently flowing from the way the case was pleaded. In the first place, the court seems to have mischaracterized i Trade's unjust enrichment claim. As was to become clear in the subsequent Supreme Court proceedings, i Trade's claim in unjust enrichment was against A and Webworx, not the bank; its claim against the bank was based on Justice Belobaba's constructive trust order against A and Webworx.³⁷ In other words, its claim against the bank was not that the bank was directly enriched at i Trade's expense, but rather that it was entitled to relief against the bank based on Webworx's unjust enrichment. So on this point, at least, it seems the motion judge was right all along. The court's mistake does not affect its conclusion on the unjust enrichment point because, given its finding that the bank was a *bona fide* purchaser for value, the bank was going to win anyway. But in the bigger picture, the mistake matters because the failure to understand that an unjust enrichment claim might be framed against a third party either directly or indirectly may prejudice the plaintiff's case. Secondly, and more broadly, the Court of Appeal overlooked the point that there was no obvious need for i Trade to plead unjust enrichment in its action against the bank; it already had a constructive trust remedy from its action against A and Webworx and the only question was whether this could be enforced against the bank. In other words, the court's extended discussion of the unjust enrichment issue seems to have been beside the point.

Thirdly, the court made no reference to the case law in support of i Trade's claim to an "equitable lien". If it had done so, it would have become apparent that the claim involved a misuse of terminology. An equitable lien is a security interest arising by operation of law to secure performance of a monetary or other obligation. For example, as an alternative to granting constructive trust relief, the court might award damages secured by an equitable lien over the disputed property. An equitable lien may be worth more to the plaintiff than a constructive trust if the disputed property has depreciated in value.³⁸ By contrast, the equitable interest that arises from an unexercised right of rescission is not typically described as a "lien" but instead is referred to as a "trust" or a "mere equity".³⁹ Either way, it is different from an equitable lien because it gives the holder an outright

³⁷ See *i Trade SCC*, *supra* note 12 at para 18, reporting i Trade counsel's disavowal of any intention to assert "a direct remedy for unjust enrichment against BMO."

³⁸ This seems to have been the thinking behind Belobaba J's order allowing i Trade to elect between "a constructive trust and/or an equitable lien" (see *supra* note 33). Regarding the distinction between constructive trusts and equitable liens, see Donovan WM Waters, Mark Gillen & Lionel Smith, eds, *Waters' Law of Trusts in Canada*, 4th ed (Toronto: Carswell, 2012) at 502–03, 1341 [Waters, Gillen & Smith]; Maddaugh & McCamus, *supra* note 10 at ch 5 at 300.

³⁹ Robert Chambers, "Resulting Trusts in Canada" (2000) 38:2 *Alta L Rev* 378 at 409 [Chambers, "Resulting Trusts"].

equitable interest in the disputed property, not just a security interest.⁴⁰ This mistake made no difference to the analysis in the *i Trade* case itself but it may cause confusion in future cases over the different types of proprietary remedy open to unjust enrichment claimants.

The precise nature of *i Trade*'s claim against the bank was still in issue when the case reached the Supreme Court. In response to a question from the court, counsel confirmed that *i Trade* was not asserting "a direct remedy for unjust enrichment against BMO", although the Court of Appeal's reasons suggested otherwise.⁴¹ Before the Supreme Court, *i Trade*'s argument seems to have been based on the *BMP* case, in contrast to its unjust enrichment claim at first instance.⁴² The court held that the claim could not succeed on this basis because the *BMP* case only applies where the action is between the payor and the payee, but it recognized correctly that *i Trade* had a claim to the disputed funds deriving from the terms of Justice Belobaba's original order.⁴³ This ruling confirms the point made earlier that *i Trade*'s unjust enrichment claim against the bank appears to have been misconceived. The ruling also meant that the only question the Supreme Court had to decide was whether *i Trade*'s claim prevailed over the bank and, on this point, it found for the bank on the ground that it was a *bona fide* purchaser for value.

Given how the case played out in the Supreme Court, there was no need for the court to address the relationship between the *BMP* case and the action in unjust enrichment which had been front and centre in the courts below. The court referred several times to the *BMP* case without mentioning *Garland*. But not too much can be read into this, given that it was not required to address the two cases. Since the court found that the bank was a *bona fide* purchaser, it also ended up not being required to discuss the basis on which Justice Belobaba made his constructive trust order or to explore what he meant when he gave *i Trade* the option of an equitable lien. So, unfortunately, the judgment is unhelpful on the distinction between equitable liens and constructive trusts mentioned above.

C) Discussion

The factual substratum in *Baltman* and *iTrade* was the same. In both cases, a financial institution was tricked by the borrower's fraud into making a loan; the borrower used the funds to purchase property; a third party acquired an interest in the property (the trustee in *Baltman* and the bank in *i Trade*); and the financial institution, having discovered the fraud, claimed a proprietary interest in the property which, it argued, had priority over

⁴⁰ *Ibid* at 403.

⁴¹ *Supra* note 12 at para 18.

⁴² *Ibid* at paras 21, 29.

⁴³ *Ibid* at para 29.

the third party's claim. In *Baltman*, the plaintiff (the bank) tried to assert a constructive trust claim as the basis for its proprietary interest, while in *i Trade*, the Supreme Court accepted, more or less without argument, either that the disputed funds were held on constructive trust for the plaintiff (*i Trade*) or, alternatively, that *i Trade* was entitled to an "equitable lien" over the disputed funds.

In the end, *i Trade* turned out not to be an unjust enrichment case after all, but there are lessons that can be drawn from it which are relevant in the unjust enrichment context. In particular, it follows from the discussion of *i Trade* above, that there are two additional arguments the bank might have made in *Baltman*. First, it might have claimed recovery from Melnitzer of the outstanding loan funds secured by an equitable lien on the paintings. Section 71 of the *Bankruptcy and Insolvency Act*⁴⁴ provides that the debtor's property vests in the trustee subject to "the rights of secured creditors"; section 136(1) provides, in effect, that unsecured creditors' claims in a bankruptcy distribution are "subject to the rights of secured creditors"; and the definition of "secured creditor" in section 2 extends beyond consensual security interests to a security interest arising by operation of law, such as an equitable lien. It seems to follow that the outcome in *Baltman* might have been different if the bank had claimed an equitable lien over the paintings rather than a constructive trust. But the bank's claim was unmeritorious for all the reasons the trial judge gave and so, in principle, it should not more be entitled to relief on a claim for an equitable lien than it was on its constructive trust claim. The logical response would be for the court to say that: the bank's claim depends on its right to trace its interest in the loan funds into the paintings; this is an equitable tracing claim and therefore it is subject to the court's discretion; and, since the claim is unmeritorious, it should be disallowed.⁴⁵

The other approach open to the bank would have been to argue that its right to rescind the loan contract gave it an equitable interest in the loan funds and a corresponding interest in the paintings as proceeds. In *i Trade*, this type of interest was referred to in both the Court of Appeal and the Supreme Court as an "equitable lien". But, as explained above, an equitable lien is a security interest imposed to secure a monetary or other obligation,

⁴⁴ RSC 1985, c B-3 [BIA].

⁴⁵ See Waters, Gillen & Smith, *supra* note 38 at 510–11, referring to authors who have suggested that the tracing remedy should lie within the discretion of the court, but also noting that the case law, as it presently stands, does not support this proposition. See also Waters, Gillen & Smith, *ibid* at 1342: "[w]hether the claim is at common law or in equity, it is important that the plaintiff cannot make a proprietary claim where he has run a credit risk—a risk of another person's solvency—and that risk has materialized" (citing *Baltman*). This passage implies support in principle for the view that the tracing remedy should be discretionary.

whereas a right of rescission gives the plaintiff an outright equitable interest in the disputed property, not merely a security interest. The interest is usually characterized as a trust, or at least as analogous to an interest arising under a trust.⁴⁶ On this basis, the governing *BIA* provision is section 67(1)(a), which excludes property held on trust from the bankrupt's estate. But the courts' response to this argument should be the same as before: the bank's claim depends on its ability to trace its interest in the loan funds into the paintings and the court may disallow tracing on the ground that the bank's claim to the paintings is unmeritorious.⁴⁷

Let us change the facts in *i Trade* by taking the bank out of the picture and substituting a trustee in bankruptcy. In other words, what happens after A purchases the shares is that, instead of pledging them to the bank, he goes into bankruptcy. Assuming all other facts stay the same, the case is now on all fours with *Baltman*. Can *i Trade* claim the share sale proceeds ahead of the trustee in bankruptcy? In *i Trade* itself, the Court of Appeal denied the constructive trust claim on the ground that there was a juristic reason for the bank's enrichment at *i Trade*'s expense. But, as explained above, this conclusion wrongly assumes that *i Trade* was claiming unjust enrichment directly against the bank. The Supreme Court correctly characterized the claim as lying directly against A and Webworx and only indirectly against the bank, but it characterized the direct claim as being based on the *BMP* case, not unjust enrichment. As a result, neither court's judgment is helpful to the present inquiry. None of the *i Trade* judgments explore the circumstances surrounding *i Trade*'s loan to Webworx, but on the basis of the available facts it is hard to see how *i Trade*'s claim to the share sale proceeds was any more meritorious than the bank's claim in *Baltman*. Therefore, its hypothetical claim against A's trustee in bankruptcy would fail for the same reasons the bank's claim failed in *Baltman*.

4. Competing policy perspectives

A) Introduction

The following discussion deals with three perspectives on constructive trusts in insolvency, each representing different points on the policy spectrum. Robert Chambers is at one end of the spectrum.⁴⁸ Chambers

⁴⁶ See Chambers, "Resulting Trusts", *supra* note 39 at 409.

⁴⁷ See text excerpted *supra* note 45.

⁴⁸ Chambers, "Resulting Trusts", *supra* note 39; Robert Chambers, "Constructive Trusts in Canada" (1999) 37 *Alta L Rev* 173; Robert Chambers, *Resulting Trusts* (Oxford: Clarendon Press, 1997); Robert Chambers, "Is There a Presumption of Resulting Trust?" in Charles Mitchell, ed, *Constructive and Resulting Trusts* (Oxford: Hart Publishing, 2009) at 267; Robert Chambers, "The Presumption of Resulting Trust: *Nishi v. Rascal Trucking Ltd.*" (2014) 51:3 *Alta L Rev* 667.

has a novel take on the nature of the plaintiff's entitlement in cases like *Baltman* and *i Trade*, the implication of which seems to be that the plaintiff has a proprietary claim almost as a matter of course. Richard Calnan is at the opposite end of the spectrum.⁴⁹ Calnan's view is that proprietary remedies undermine the *pari passu* principle which governs bankruptcy distributions and that they should rarely, if ever, be recognized in insolvency proceedings. David Paciocco, who is the author of the leading Canadian contribution to the debate, occupies the middle ground.⁵⁰ He argues that the availability of constructive trust relief in bankruptcy should turn on discretionary considerations, in particular whether the plaintiff can be said to have voluntarily accepted the risk of the defendant's insolvency.

B) *Chambers*

In both *Baltman* and *i Trade*, the discussion was couched in terms of constructive trust relief. This is consistent with the conventional wisdom that the constructive trust is the law's response to unjust enrichment in cases where a proprietary remedy is called for. By contrast, Chambers argues that the trust which arises in such cases is a voluntary transfer resulting trust, not a constructive trust. The doctrine of resulting trusts applies to resolve disputes over unexplained transfers, in other words where A transfers property to B and there is no clear evidence that A intended to benefit B. In order to break the evidentiary impasse in cases where A and B are strangers, the courts apply a presumption of resulting trust with the result that B is taken to hold the disputed property on trust back for A unless B leads sufficient evidence to rebut the presumption. The cases typically involve voluntary transfers, where B provides no consideration in return for the disputed property. But Chambers argues that the same principles apply in any case where A makes the transfer with no intention to benefit B. For example, in *Chase Manhattan Bank NA v Israel-British Bank (London) Ltd*,⁵¹ the plaintiff bank transferred a payment to the defendant bank by mistake; the defendant became insolvent before repaying the money, but while the funds were still identifiable in its accounts; and the court declared a constructive trust over the funds in the plaintiff's favour. Chambers argues that the trust should have been characterized as a resulting trust, not a constructive trust. He sees no material difference between a case like this and a case where the transfer is voluntary and the transferor did not intend to benefit the transferee: (1) the plaintiff bank made the payment because it mistakenly believed that it was owing to the defendant bank; (2) the plaintiff bank's intention to benefit the defendant bank was vitiated by its mistake; and (3) therefore the

⁴⁹ Calnan, *supra* note 36.

⁵⁰ Paciocco, *supra* note 1 at 334.

⁵¹ (1979), [1981] Ch 105 (Ch Div), [1979] 3 All ER 1025 [*Chase Manhattan Bank NA*].

defendant bank held the disputed funds on resulting trust for the plaintiff bank.

Chambers' argument is important because it suggests a substantially enlarged role for the doctrine of resulting trusts, which would apply not only in the case of voluntary transfers, but in any case where A's intention to benefit B is either non-existent or impaired (for example, by mistake, misrepresentation or undue influence). His position is summarized as follows in the seventh edition of *Oosterhoff on Trusts*, a leading Canadian student text:

the possibility that the applicable trust is resulting, rather than constructive, draws [...] support from the fact that the circumstances of *Chase Manhattan* are similar to (and perhaps indistinguishable from) those that underlie the classic gratuitous transfer resulting trust. And indeed, [...] while the issue has not yet been entertained by Canadian courts, it may be that every trust to reverse an unjust enrichment ought to be classified as resulting.⁵²

This argument is especially important in the Canadian context, where the constructive trust is a remedy available at the courts' discretion. The resulting trust, by contrast, is not a remedy, but arises as a matter of course once the plaintiff has established the necessary facts.⁵³ If Chambers is right then, in a case like *Baltman*, the bank could argue that: (1) its intention to benefit Melnitzer was impaired by Melnitzer's fraud; (2) therefore, Melnitzer held the loan funds on resulting trust for the bank; and (3) Melnitzer's trustee in bankruptcy holds the paintings, as proceeds of the loan, on resulting trust for the bank. The doctrine of resulting trusts appears to leave little, if any, room for the courts to avoid this outcome even though, for the reasons explained in the judgment, the bank's claim to the paintings was unmeritorious.

⁵² AH Oosterhoff, Robert Chambers, Mitchell McInnes & Lionel Smith, eds, *Oosterhoff on Trusts*, 7th ed (Toronto: Carswell, 2009) at 791 [Oosterhoff et al, 7th ed]. This passage is replaced in the 8th edition with a somewhat more extensive account of Chambers' position (*supra* note 16 at 757–59) which is described as “compelling” though “contrary to precedent”: *ibid* at 758 and 791. In the latter connection, Chambers' position has been contested in the academic literature on doctrinal grounds. See e.g. John Mee, “Presumed Resulting Trusts, Intention and Declaration” (2014) 73:1 Cambridge LJ 86, arguing that: (1) the doctrine of voluntary transfer resulting trusts applies only if there is a basis for finding or presuming that the transferor intended the transferee to hold the disputed property on trust for the transferor; and (2) contrary to Chambers' reading of the case law, the doctrine does not apply simply because, at the date of the transfer, the transferor did not intend to benefit the transferee or the transferor's intention was impaired. Contrast McInnes, *Unjust Enrichment and Restitution*, *supra* note 10 at 1353–54, describing Chambers' approach as “principled and largely persuasive.”

⁵³ Smith, “State of the Law”, *supra* note 19 at 54. See also McInnes, *Unjust Enrichment and Restitution*, *supra* note 10 at 1354.

Chambers downplays the implications of his approach for competing third party claims. He argues that outside bankruptcy, third parties are sufficiently protected by the *bona fide* purchaser defence,⁵⁴ while inside bankruptcy “if a defendant is unjustly enriched because he or she has received an asset at the plaintiff’s expense, there is no reason why the defendant’s creditors should be entitled to that asset.”⁵⁵ While, as *i Trade* demonstrates, the first of these statements may be true, at least if the competing claim is a legal interest, *Baltman* raises concerns about the second statement. Furthermore, even in the context of perhaps less egregious cases like *Chase Manhattan*, from a bankruptcy law perspective the statement apparently begs the question as to why an unjust enrichment claimant should receive more favourable treatment than other creditors in the defendant’s bankruptcy, particularly given the detailed statutory distribution rules set out in the bankruptcy laws.⁵⁶ Oosterhoff acknowledges this point, at least obliquely, in a statement which appears just one page further on from the passage quoted above:

when formulating the rules governing proprietary restitution, the courts should [...] look beyond the immediate parties and have regard for other interests. General creditors will clearly be concerned by any order which reduces the pool of assets that is available for the satisfaction of debts in the event of the debtor’s insolvency. So, too the legislature may oppose judicially created trusts on the ground that they disrupt statutory schemes that were carefully crafted to address the issue of insolvency.⁵⁷

C) *Paciocco*

Paciocco argues that the availability of the constructive trust remedy in insolvency should turn on an inquiry into whether or not the plaintiff voluntarily accepted the risk of the defendant’s insolvency or, in other words, whether the plaintiff qualifies as an “involuntary creditor”. The plaintiff’s status as an involuntary creditor provides a justification for preferring its claim over voluntary creditors who have, by definition, accepted the risk of

⁵⁴ *Chambers*, “Resulting Trusts”, *supra* note 39 at 413.

⁵⁵ *Ibid* at 414.

⁵⁶ Contrast *Watts*, *supra* note 36 at 272–74, arguing that there is no basis for preferring mistaken payors and the like in insolvency proceedings and, in particular, disputing the argument that other creditors would receive a windfall if the plaintiff’s proprietary claim is disallowed, see *Watts*, *ibid* at 273: “windfalls are intrinsic to insolvency. Hence, if at one stage of the insolvency of the bankrupt there were only enough assets to give creditors, say, 30 cents in the dollar, but at the very last minute a further valuable asset comes in permitting 60 cents in the dollar, then the supplier of that asset has enriched the other creditors. There is, however, no rule of ‘last in, first out’.”

⁵⁷ Oosterhoff et al, 7th ed *supra* note 52 at 792; Oosterhoff, *Chambers & McInnes*, 8th ed, *supra* note 16 at 748.

the defendant's insolvency and have, or at least could have, compensated themselves *ex ante* by adjusting the terms on which they were prepared to do business with the defendant. But a restitution claimant should be entitled to constructive trust relief only if there is a close and substantial connection between the disputed property and the plaintiff's claim and the disputed property or its proceeds remains identifiable in the defendant's hands.⁵⁸ This statement is supported by Supreme Court cases decided in the family context, and Paciocco's justification for importing the requirement into the commercial context is that it avoids arbitrariness in the selection of the trust subject-matter.⁵⁹ Others have supported a similar limitation to avoid arbitrariness in a different sense, namely discrimination between different classes of involuntary creditor. Other involuntary creditors, for example, tort claimants and pre-paying consumers, do not qualify for preferential treatment in the debtor's insolvency and the identifiability requirement provides an intuitively plausible basis for distinguishing the restitution claimant from these other cases.⁶⁰ Other writers, in Canada and elsewhere, have picked up on the "involuntary creditor" or "voluntary acceptance of risk" theory,⁶¹ while Paciocco himself is frequently cited in Canada.⁶² Furthermore, the involuntary creditor test has been adopted and applied in a number of cases.⁶³

But despite its apparent widespread acceptance, the voluntary acceptance of risk theory has troubling implications for the administration of insolvency proceedings. The main concern lies in its uncertain application. For example, in cases like *Baltman* and *i Trade*, it could plausibly be argued that the plaintiff was an involuntary creditor because the borrower's fraud negated the plaintiff's consent to the loan contract. On the other hand, it could just as plausibly be argued that the risk of fraud is an incident of contracting and, while fraud justifies a remedy, it does not justify giving the plaintiff priority in the defendant's bankruptcy. Paciocco himself acknowledges this

⁵⁸ Paciocco, *supra* note 1 at 331–36 criticizing *Atlas Cabinets and Furniture Limited v National Trust Co Ltd*, (1988) 24 BCLR (2d) 389, 39 DLR (4th) 159 (SC) and other cases on this score.

⁵⁹ See e.g. *Sorachan v Sorachan*, [1986] 2 SCR 38, 29 DLR (4th) 1; Paciocco, *supra* note 1 at 333. Contrast Maddaugh & McCamus, *supra* note 10 at ch 5 at 38.1–38.3.

⁶⁰ See e.g. Emily Sherwin, "Constructive Trusts in Bankruptcy" 1989:2 U Ill L Rev 297 at 298 [Sherwin]. Contrast Watts, *supra* note 36 at 272–74.

⁶¹ See e.g. Waters, Gillen & Smith, *supra* note 38 at 1342, Maddaugh & McCamus, *supra* note 10 at 5.32–5.33 (Canada); Sherwin, *supra* note 60, *Restatement (Third) of Restitution and Unjust Enrichment* s.55 at comment d, Andrew Kull, "Restitution in Bankruptcy: Reclamation and Constructive Trust" (1998) 72:3 Am Bank LJ 265 [Kull] (United States); Andrew Burrows, "Proprietary Restitution: Unmasking Unjust Enrichment" (2001) 117:3 *Law Q Rev* 412, Sarah Worthington, "Property, Obligation and Insolvency Policy: Cutting the Gordian Knot" (2005) 20:4 J Intl Banking & Finance L 100 (England).

⁶² See the cases cited *supra* note 2.

⁶³ *Ellingsen*, *supra* note 2; *Caterpillar Financial Services Ltd*, *supra* note 2.

point, arguing that in cases involving a contract which is void or voidable, the appropriateness of constructive trust relief should turn on whether the defect “vitiates the voluntariness of the transaction” before going on to admit that “whether voluntariness is vitiated by the ineffectiveness of a transaction is a difficult question.”⁶⁴ Emily Sherwin suggests that the question engages a number of variables, including the nature of the fraud and the level of the plaintiff’s commercial sophistication, concluding that “the constructive trust claimant’s position is a question of degree.”⁶⁵ But such inquiries promote litigation because the answers are unpredictable and unpredictability inhibits settlements. Furthermore, case-by-case inquiries of this nature increase the length and complexity of trials, the costs of which come out of the estate, reducing the pool of assets available for distribution among the creditors at large.

Hallmark v Ellingsen, a leading Canadian case, offers a good illustration of the problem.⁶⁶ The case involved a dispute over the sale and delivery of a truck subject to finance. The purchaser went into bankruptcy without having arranged finance and while still in possession of the truck. The British Columbia Court of Appeal held by a majority that the dealer was entitled to recover the truck from the purchaser’s trustee in bankruptcy.⁶⁷ On the assumption that title in the truck had passed to the purchaser, the majority declared that the purchaser (or his trustee in bankruptcy) held the truck on constructive trust for the dealer.⁶⁸ Justice Donald, citing Paciocco, held that a constructive trust remedy was appropriate because the dealer was an involuntary creditor: “Hallmark never intended to grant credit to Ellingsen and so there is no justification for placing Hallmark in a class of general creditors.”⁶⁹ He then said:

Hallmark was imprudent in allowing the truck to leave the lot as it did, but it accepted the risk in the interest of good customer relations that it may have to take back a used truck if financing fell through, and in that event it would not be able to cover the depreciation. Ellingsen induced Hallmark to believe that he would be able to meet the Bank’s cash requirements for the loan and so Hallmark waited the three months before bankruptcy occurred.⁷⁰

⁶⁴ *Supra* note 1 at 344.

⁶⁵ Sherwin, *supra* note 60 at 352.

⁶⁶ *Supra* note 2.

⁶⁷ *Ibid* at para 41.

⁶⁸ See Jacob Ziegel, “The Unwelcome Intrusion of the Remedial Constructive Trust in Personal Property Security Law: *Ellingsen (Trustee of) v. Hallmark Ford Sales Ltd.*” (2001) 34:3 Can Bus LJ 460 (arguing that, contrary to the court’s assumption, title had not passed to Ellingsen and that Hallmark had a remedy in detinue and under *BIA*, s 81 and that therefore, there was no need for a constructive trust).

⁶⁹ *Ellingsen*, *supra* note 2 at para 34.

⁷⁰ *Ibid* at para 35.

In other words, the only risk Hallmark accepted was the risk of loss through depreciation if the deal fell through. It did not voluntarily accept the risk of Ellingsen's insolvency because Ellingsen lulled it into a false sense of security. But this view of the facts is contentious. Another judge might just as readily conclude that Ellingsen's conduct did not vitiate Hallmark's consent, that Hallmark was a relatively sophisticated commercial player and that, in releasing the truck to Ellingsen, it must be assumed to have accepted the insolvency risk. Of course, this view of the facts is no more necessarily correct than Justice Donald's version. The point is simply that, in advance of the case, it will be difficult for the parties to predict which way the court might jump.

Justice Lambert, the other majority judge, took a somewhat different approach. He also cited Paciocco with approval, but went on to say that, in the exercise of its remedial discretion, the court should not impose a constructive trust "without taking into account the interests of others who may be affected by the granting of the remedy."⁷¹ In this connection, he referred to the list of secured and general creditors set out in the debtor's Statement of Affairs and observed that there was nothing in the materials to indicate that any of the creditors transacted with the debtor on the assumption that Ellingsen owned the truck.⁷² This line of inquiry is subject to the same concern as Justice Donald's approach; like the voluntary acceptance of risk test, it makes outcomes dependent on case-by-case inquiries and so it is likely to increase litigation costs. The test may have been reasonably easy to apply in this particular case because Ellingsen's bankruptcy was a small one and there were only a few creditors. But in larger commercial insolvency proceedings, where there are multiple creditors, the court may have trouble knowing whether creditors relied on the disputed asset or not. This is especially so because creditors may be tempted to provide self-serving testimony, asserting that the debtor's ownership of the disputed asset was important to them, and the courts may have trouble telling self-serving statements from the truth.

*Re Omegas Group Inc*⁷³ is another interesting case in point. There the claimant paid the debtor in advance for computers the debtor was to purchase from IBM on the claimant's behalf. The debtor became bankrupt and the claimant, arguing that the payments were induced by the debtor's fraudulent misrepresentations, claimed a constructive trust over the disputed funds in the debtor's hands. Andrew Kull argues that the question the court should have asked, but did not, is whether the claimant had been

⁷¹ *Ibid* at para 71, citing McLachlin J in *Soulos*, *supra* note 8 at para 34.

⁷² *Ellingsen*, *supra* note 2 at para 73.

⁷³ 16 F (3d) 1443 (6th Cir 1994) (CA) [*Omega*].

“so far deceived about the risks it was running that in advancing funds to [the debtor] it did not act voluntarily.”⁷⁴ This is a close call:

On the one hand, late-period transactions of this kind occur closer in time to the bankruptcy, inspiring the claim that the debtor has made (implicitly or otherwise) fraudulent representations of solvency. On the other hand, a late-period seller—by comparison with creditors of longer standing—is likely to have dealt with the debtor on the basis of a higher appraisal of the risk of insolvency. Any perceived decline in the debtor’s creditworthiness will have been compensated for by more favorable terms.⁷⁵

In *Omega* itself, it seems there was evidence to support the latter hypothesis, but in other cases the indications may be less clear and it may not be so easy for the court to arrive at the correct interpretation of the facts or for the parties to predict in advance of the case what the court’s decision might be.⁷⁶

D) *Calnan*

Richard Calnan is at the opposite end of the policy spectrum from Chambers, arguing that the courts should be sparing in their administration of proprietary remedies in insolvency because of the impact a proprietary claim may have on the *pari passu* principle which governs bankruptcy distributions. He identifies the *pari passu* principle as one of two fundamental principles underpinning insolvency law. The other is what might be called the “property of the estate” principle, which says that the property of an insolvent person’s estate is limited to assets the person owned at the date of the insolvency and does not include assets belonging to third parties. The objective is to avoid the expropriation of a third party’s property in insolvency proceedings. The *pari passu* principle and the property of the estate principle are in tension with one another. The property of the estate principle allows a claimant to obtain full recovery at the expense of the estate and other creditors while, conversely, a too rigorous application of the *pari passu* principle may defeat legitimately preferential claims. Calnan favours the *pari passu* principle in the resolution of this tension, conceding that it does not provide perfect justice, but arguing that it facilitates the “distribution of the assets of the debtor amongst his creditors in a reasonably fair and straightforward (and therefore cost-effective) way.”⁷⁷ The principle is intuitively just (“the desire to allow all creditors to share equally is a

⁷⁴ Kull, *supra* note 61 at 274.

⁷⁵ *Ibid* at 274–75.

⁷⁶ For additional criticisms of the involuntary creditor/involuntary acceptance of risk argument, see William Swadling, “Policy Arguments for Proprietary Restitution” (2008) 28 *Legal Studies* 506.

⁷⁷ Calnan, *supra* note 36 at 1.152.

strong one”⁷⁸) and it has a long history.⁷⁹ In summary, “reliance on the principle that ‘equality is equity’ is a sensible, pragmatic solution which has history on its side.”⁸⁰ Calnan worries that it may have become too easy to create proprietary interests and that this trend unacceptably compromises the *pari passu* principle.⁸¹ Calnan does not address Chambers’ resulting trusts thesis, but it is clear from the tenor of his overall argument what his response would be. As for the “involuntary creditor” theory, Calnan’s response is in line with the criticisms in Part (C), above.⁸²

E) Assessment

Consistently with the argument in Part (C) Oosterhoff says that “all else being equal, society as a whole has an interest in a system that minimizes the costs associated with restitutionary claims and the effects of insolvency. Consequently, a complicated regime that turns largely on judicial discretion may be undesirable insofar as it inhibits settlements and encourages litigation.”⁸³ It might be added that, insofar as the goal of the bankruptcy laws is to maximize the returns to the creditors collectively,⁸⁴ a complicated constructive trusts regime is undesirable because, by encouraging litigation, it wastes scarce estate resources on an issue that is of purely distributional significance. As Alan Schwartz has remarked in a different context, “redistributing the assets of a failed firm among its general creditors amounts to redecorating the Titanic’s salon. Because redecoration is costly, [redistribution] diminishes the value of the bankrupt estate.”⁸⁵ The implications for the constructive trusts remedy in insolvency are that: (1) the remedy should be awarded only in exceptional circumstances; and (2) the courts should be as clear as possible about what those circumstances might be.

⁷⁸ *Ibid.*

⁷⁹ *Ibid.* at 1.153.

⁸⁰ *Ibid.* For a similar argument but from an economic perspective, see Thomas H Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge, Mass: Harvard University Press: 1986), ch 1 [Jackson].

⁸¹ *Supra* note 36 at 1.156. This concern is reflected in a number of Canadian cases. See, e.g. *Hoard (Re)*, 2014 ABQB 426, 2014 CarswellAlta 1205 (WL Can) and *McKinnon (Re)*, 2006 NBQB 108, 300 NBR (2d) 395 denying constructive trust relief on the ground that the *BIA* distribution rules provided a juristic reason for the defendant’s enrichment. But these cases arguably go too far, because the logical implication is that constructive trust relief should never be awarded in the defendant’s bankruptcy: contrast the cases discussed in Part (E), below.

⁸² Calnan, *supra* note 36 at 1.151.

⁸³ Oosterhoff, Chambers & McInnes, 8th ed, *supra* note 16 at 748.

⁸⁴ Jackson, *supra* note 80.

⁸⁵ “A Normative Theory of Business Bankruptcy” (2005) 91:5 Va L Rev 1199 at 1226.

Two relatively recent cases may help to point the way. In *Credifinance Securities Ltd v DSLC Capital Corp*,⁸⁶ DSLC Capital Corporation (“DSLC”) made a loan of \$400,000 to Credifinance Securities Limited (“Credifinance”), a company controlled by Benarroch. Benarroch made fraudulent misrepresentations which induced DSLC to make the loan. Credifinance became bankrupt. There was \$300,000 approximately in a bank account which could be identified as remaining from the loan. DSLC claimed a constructive trust over the bank deposit. The trustee in bankruptcy disallowed the claim, but the appeal judge overturned this decision. The Ontario Court of Appeal upheld the appeal judge. The evidence established that DSLC, Benarroch and DSLC’s lawyers were Credifinance’s only creditors and the court imposed the constructive trust to prevent Benarroch benefiting from his own wrongdoing. The court saw the constructive trust as necessary to prevent Benarroch’s unjust enrichment, but it made no reference to *Garland*. The case could be rationalized in *Garland* terms on the basis that the loan contract was *prima facie* a juristic reason for the enrichment (first stage), but Benarroch’s fraud negates this conclusion (second stage) and that, having regard to the particular facts of the case, as a matter of discretion the court should grant the constructive trust remedy. This comes close to what the court apparently had in mind, except that it sourced its discretion in the equitable jurisdiction vested in the bankruptcy court, rather than in the equitable nature of the constructive trust remedy.⁸⁷ In reaching its conclusion, the court stressed that the constructive trust is “a discretionary remedy” and that “in [most bankruptcy cases] there are other interests to consider besides those of the defrauder and defraudee: there are other creditors. Thus, the exercise of remedial discretion must be informed by additional considerations than in a civil fraud trial.”⁸⁸ In other words, this case was an exceptional one.⁸⁹

In *Re General Motors Corp and Peco Inc*,⁹⁰ Mantum agreed to facilitate refunds to Peco for overpayments to the Workers’ Safety and Insurance Board (WSIB). Mantum was to be paid 35 *per cent* of all refunds paid to Peco. Peco went into receivership. The receiver did nothing to stop Mantum from continuing to work on Peco’s behalf and it did not tell Mantum that its services were no longer required. Mantum claimed a constructive trust over funds which were traceable to WSIB refunds. The court granted the remedy. It found that there was an enrichment because the receiver was holding funds which it was contractually obliged to pay over to Mantum—and a corresponding deprivation to Mantum—and that there was no

⁸⁶ 2011 ONCA 160, 277 OAC 377 [*Credifinance*].

⁸⁷ *Ibid* at para 35.

⁸⁸ *Ibid* at para 44, La Forme JA.

⁸⁹ For a similar case see *Coast Capital Savings Credit Union v Symphony Development Corp*, 2014 BCSC 400, 9 CBR (6th) 307.

⁹⁰ 15 BLR (4th) 282, 2006 CanLII 4758 (ONSC) [*Peco*].

juristic reason for the enrichment given that the contract entitled Mantum to the payment. The factors the court took into account in the exercise of its discretion to award the constructive trust were that: (1) General Motors was Peco's only other creditor and it was General Motors which had appointed the receiver; (2) the receiver, by its conduct, adopted the contract between Peco and Mantum and encouraged Mantum to continue working on Peco's behalf; (3) therefore the receiver (and hence General Motors itself) could have no reasonable expectation of keeping Mantum's share of the funds.

The common thread running through *Credifinance* and *Peco* is that, in both cases, there was effectively only one other creditor apart from the claimant; the other creditor was guilty of wrongdoing (Benarroch's fraud in *Credifinance* and, in *Peco*, the receiver's conduct which could be seen as giving rise to an estoppel); and the purpose or effect of the constructive trust remedy was to prevent the other creditor benefiting from its own wrongdoing.⁹¹ The implication is that, outside these circumstances, the court should be reluctant to grant the remedy because: (1) if there are multiple other creditors, the court may have trouble identifying the potential adverse consequences for them; and (2) in the absence of wrongdoing on the other creditor's part, it is hard to see the justification for preferring the claimant. In the latter connection, both cases at least implicitly reject the voluntary acceptance of risk argument for constructive trust relief and, in *Credifinance*, the court comes close to doing so explicitly: "[the outcome of this case] should not be interpreted to suggest that once a civil fraud by the bankrupt on the claimant [...] is proven, and that is coupled with a loss and an ability to trace the consequences of the fraud, then a constructive trust will always be imposed. That, in my view, is too broad."⁹² That statement brings us full circle because it is entirely consistent with the ruling in *Baltman*.

5. Conclusion

The law in Canada governing the availability of constructive trust relief in insolvency is unsettled at both the doctrinal and policy levels. At the doctrinal level, it remains unclear whether the Supreme Court of Canada's decision in *Garland* was meant to be an exhaustive statement of the law on unjust enrichment or whether the older causes of action are still available. This uncertainty affects cases like *Baltman* and *i Trade* because,

⁹¹ In *Credifinance*, the court referred to the principles of unjust enrichment, but it also stressed the bankruptcy court's role in policing commercial morality. It might be argued that the main purpose of the constructive trust was to prevent wrongdoing, not to reverse unjust enrichment (*cf Soulos, supra* note 8). On the other hand in many, and perhaps most, fact situations, the two purposes are not mutually exclusive and so in *Credifinance*, the constructive trust may have been justified on either basis.

⁹² *Credifinance, supra* note 87 at para 43, La Forme JA.

as the various judgments in *i Trade* demonstrate, counsel may be unsure which cause of action they should be pleading while the court may be unsure which cause of action counsel has chosen to plead. The uncertainty unduly complicates the litigation process and increases costs. Overlaying this concern is uncertainty over the stage at which in the *Garland* test discretionary factors relevant to the constructive trust remedy should be raised. For example, in *Baltman*, many of the factors the court relied on could have been brought in at either the first or second stage of the *Garland* juristic reasons inquiry, or at the remedial discretion stage, and the courts have not yet fully articulated an explanation of which factor fits where. The point matters, not least because if the relevant issues are dealt with at either the first or second stage of the juristic reasons inquiry, the plaintiff's claim may end up being denied altogether. On the other hand, if they are dealt with at the remedial discretion stage, the plaintiff may end up being denied constructive trust relief, but it will still have some other remedy. Furthermore, if the relevant issues are dealt with at the first stage of the juristic reasons inquiry, the plaintiff has the burden of proof, whereas if they are dealt with at the second stage, the burden is on the defendant.

At the policy level, there is a tension in bankruptcy law between the *pari passu* principle and the principle that the bankruptcy estate does not extend beyond the debtor's own property at the date of the bankruptcy. The controversy surrounding the availability of constructive trust relief in bankruptcy is a product of this tension. On the one hand, if the remedy is too readily available, the *pari passu* principle may be compromised too much and this is an important argument against Robert Chambers' resulting trusts theory. On the other hand, a blanket denial of the remedy may prejudice legitimate third party claims. A solution might be to leave the balancing of the competing concerns to the courts' discretion, but too broad a discretion may lead to unpredictable outcomes and increased litigation, to the detriment of the estate. This is the main reason for scepticism about Paciocco's involuntary creditor approach.

It is hard to see how the courts' discretion can be eliminated altogether without doing excessive violence to either the *pari passu* principle or the property of the estate principle. But the discretion can be constrained in the interests of achieving both a better balance between the two principles and more predictability in the case law. Cases like *Credifinance* and *Peco* suggest that this may be the direction in which the courts are now heading.