Court of Appeal of Ontario: room for constructive trusts in insolvency proceedings

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On July 13, 2022, the Court of Appeal for Ontario allowed an appeal from the Order of a bankruptcy judge in *Sirius Concrete Inc. (Re), 2022 ONCA 524* (*Sirius*), which ruled that certain funds paid by a trade creditor formed part of the bankrupt's estate. The issue on appeal was whether a constructive trust should be imposed over certain funds due to a claim of unjust enrichment arising from alleged fraudulent misrepresentations made by the bankrupt on the eve of its bankruptcy filing. If ultimately successful, the funds paid by the appellant to the bankrupt would not form part of the bankrupt estate, and would therefore be returned to the appellant rather than distributed amongst the bankrupt's creditors.

Background

The appellant, Ayerswood Development Corporation (Ayerswood), was the general contractor for the construction of an apartment building (the Project). The bankrupt, Sirius, provided concrete forming services to Ayerswood on the Project. In its materials submitted before the bankruptcy judge, Ayerswood claimed that Sirius' performance on the Project was marked consistently by delays and deficiencies. Nonetheless, Ayerwood had been paying Sirius' periodic invoices to incentivize Sirius to complete its work on time.

In January of 2019, Sirius delivered an invoice to Ayerswood totaling $381,578.40 (the Invoice). By this time, Ayerswood had become increasingly frustrated with Sirus' lack of progress on the Project. As a result, Ayerswood determined it would not to pay the Invoice until Sirius rectified the problems and got the project back on track.

Ayerswood and Sirius then scheduled a meeting on March 1, 2019 to set out a plan to address the problems with Sirius' deficiencies and delays. Sirius' representative failed to attend this meeting, but later that day, the representative called Ayerswood to reschedule it. During this call, the Sirius representative also asked Ayerswood to pay the Invoice. When Ayerswood's representative expressed reluctance to do so, Sirius' representative advised that payment of the Invoice would ensure that the Project would get back on track. Based on this representation, Ayerswood paid the January Invoice. Sirius made an assignment into bankruptcy the next business day.

Subsequently, Ayerswood applied to the bankruptcy court seeking to impose a constructive trust over the funds it paid under the Invoice. It claimed that the funds were subject to a claim of unjust enrichment, which gave rise to a constructive trust and asserted that, by operation of section 67(1)(a) of the *Bankruptcy and Insolvency Act,* RSC 1985, c B-3 (the BIA), the funds fell outside the assets to be distributed to creditors. In particular, Ayerswood argued that it had been lied to during the telephone call with Sirius' representative on March 1, 2019, and that it only paid those funds to Sirius as a result of those lies.

Notably, only Ayerswood filed an affidavit for the motion before the bankruptcy judge and Ayerswood's affiant was not cross-examined on his affidavit. As a result, Ayerswood's evidence stood uncontested before the bankruptcy judge.

The motions decision

The bankruptcy judge proceeded on the basis of assuming Ayerswood's evidence as true but nonetheless held that "none of … [the evidence] could possibly lead to the imposition of a trust" as a matter of bankruptcy law. As a result, the judge summarily dismissed Ayerswood's claim, with the effect that monies paid under the Invoice would be divisible amongst Sirius' general body of creditors. Ayerswood appealed.

The decision of the Court of Appeal

A unanimous panel of the Court of Appeal for Ontario reversed the motions decision. In so doing, the Court of Appeal applied its prior decision in *Credifinance Securities Limited v. DSLC Capital Corp* (*Creditfinance).*

Creditfinance was a case in which the Court imposed a constructive trust over funds that had been loaned by the claimant to the debtor company prior to its bankruptcy. The debtor was in the business of retail investment services. Prior to the loan being advanced, the principal of the debtor assured the claimant that the debtor was not subject to any investigations by the investment services regulator. This, however, was known by the debtor's principal to be false. After the claimant advanced the loan, the regulator laid charges against the debtor. As a result of the charges, the debtor's business collapsed and the debtor was assigned into bankruptcy.

The Court in *Creditfinance* noted that the bar for proving the existence of a constructive trust in a bankruptcy is high, but that equitable circumstances can supersede the formulaic aspects of the BIA scheme of distribution in certain cases. With respect to constructive trusts, the Court stated:

> *"A constructive trust in bankruptcy proceedings can be ordered to remedy an injustice; for example, where permitting the creditors access to the bankrupt's property would result in them being unjustly enriched … A Trustee in bankruptcy is an officer of the court and must act in an equitable manner. Enriching creditors with a windfall and depriving another of its interest in property, has been held to be an offence to natural justice."*

In *Sirius,* the Court of Appeal affirmed that where unjust enrichment is established, a court may award a proprietary remedy in the form of a constructive trust where a

personal remedy is inadequate and the plaintiff's contribution is linked to the property over which the trust is claimed. In such circumstances, the funds that are subject to the constructive trust do not form part of the property of the bankrupt that vests in the trustee under Section 71 of the BIA.

On the facts at hand, the Court held that Ayerswood's evidence (which was uncontroverted and uncontested), if taken as true, could establish the requisite elements unjust enrichment, and that a court may view the circumstances as meriting the imposition of a constructive trust in order to avoid an offence to natural justice. In the result, the Court remitted the matter back to the bankruptcy judge for directions as to a process to adjudicate Ayerswood's constructive trust claim.

Conclusions

Sirius emphasizes the competing interests that bankruptcy trustees face when administering an estate. While trustees must maximize the bankrupt's estate for the benefit of creditors, they must also be mindful of misconduct by the bankrupt that may inequitably benefit the bankrupt's creditors at the expense of a third party.

The bar remains high when establishing a constructive trust in a bankruptcy proceeding. Courts are often reluctant to impose constructive trusts in insolvency proceedings due to many of the policy goals that underlie the various insolvency regimes. However, *Sirius* is a reminder that, in some circumstances, equity may intervene if failing to do so would permit the bankrupt's creditors to be unjustly enriched by the bankrupt's misconduct.

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