Following the money: The doctrines of knowing assistance, knowing receipt, and the tracing of defrauded funds

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After discovering they have been duped, an innocent victim of a fraud may wish to track the defrauded funds to their ultimate recipient, and to require their return. This “follow the money” approach describes the remedy of tracing, a process by which Canadian courts trace recoverable assets that have been received by another in order to return them to their rightful owner. Tracing is accomplished using principles of trust law and the imposition of a constructive trust, through which one party is deemed to hold property in trust for, or for the benefit of, another. A constructive trust is an equitable remedy that can arise whenever equity and good conscience require the imposition of a trust, and can be applied to non-parties of a fraud for the purposes of asset recovery.[1]

What you need to know

Potential causes of action

The remedy of a constructive trust and the related process of tracing can apply in cases of fraud in two main ways:

1. Where the stranger knowingly assisted in a fraudulent and dishonest breach of trust (“knowing assistance”); or
2. Where a stranger has received, in his or her own right, property obtained through a fraudulent breach of trust (“knowing receipt”).

Knowing assistance

A stranger to a fraudulent transaction may be liable under the doctrine of knowing assistance where the stranger, with actual knowledge, participates or assists in a fraudulent and dishonest scheme.[2] Sometimes described as “accessory liability”, liability for knowing assistance is fault-based, and is concerned with remedying matters related to the furtherance of the fraud.[3] As such, the knowledge requirement for knowing assistance is actual knowledge, recklessness, or willful blindness of the fraud; mere

negligence or constructive knowledge is insufficient to establish liability for knowing assistance.

The criteria for establishing a claim for knowing assistance are:

1. there must be a fiduciary duty between the fraudster and the victim;
2. the fiduciary must have breached that duty fraudulently and dishonestly;
3. the stranger to the fiduciary relationship must have had actual knowledge of both the fiduciary relationship and the fiduciary's fraudulent and dishonest conduct; and
4. the stranger must have participated in or assisted the fiduciary's fraudulent and dishonest conduct.[4]

The Supreme Court recently weighed in on the law of knowing assistance in *Christine DeJong Medicine Professional Corporation v. DBDC Spadina Ltd*.[5] As described in our previous article, the case involved a complex multi-million dollar commercial real estate fraud, by which the Waltons convinced investors to participate in real estate investments in equal-partnership, single-property ventures. Investors' contributions were matched by the fraudsters' companies. However, instead of investing their own funds, the fraudsters moved their investors' monies in and out of numerous corporate vehicles, through their own "clearing houses", in an elaborate shell game. The largest investor, the "DBDC Applicants", invested approximately $111 million into thirty-one specific properties. Another investor, Christine DeJong Medicine Professional Corporation (DeJong), invested nearly $4 million in what was known as the Walton's "Schedule C Companies". In addition to seeking recovery directly from the Waltons, the DBDC Applicants brought an application to collect $22.6 million against ten project-specific investors, including DeJong and the Schedule C Companies, on the basis that these companies had knowingly assisted in the fraud, since they were used as part of the Walton's fraudulent scheme.

The majority of the Ontario Court of Appeal allowed the DBDC Applicants' claim against DeJong and the Schedule C Companies, and held that the companies knowingly assisted the Waltons in their fraudulent scheme, because the Waltons has used the companies to defraud the investors of their funds. Integral to this finding was the Court of Appeal's reasoning that the Schedule C Companies had actual knowledge of the breach of trust because Mrs. Walton was the directing mind of the companies, and her knowledge was thus attributable to them.

The Supreme Court, however, reversed this decision on appeal, and ruled that DeJong and the Schedule C companies were not liable for knowing assistance to the fraud. Adopting the dissenting reasons of Justice van Rensburg of the Ontario Court of Appeal, the Supreme Court held that the knowledge of the fraudster, Mrs. Walton, could not be attributed to the Schedule C Companies via the doctrine of corporate attribution. Under that doctrine, actions are attributable to a company only where the action taken by the company's directing mind are: (1) within the field of operation assigned to that person; (2) not totally in fraud of the corporation; and (3) by design or result, partly for the benefit the company.[6] Since the Waltons' actions perpetrated a fraud against the Schedule C Companies and were not taken for their benefit, the Supreme Court found that the Waltons' knowledge could not be imputed to the Schedule C Companies. Therefore, the Schedule C Companies did not possess actual knowledge of the fraud,

and could not be liable to the DBDC Applicants under the doctrine of knowing assistance.

The Supreme Court's decision provides further clarity as to when a party can be held to have known about a breach of trust, and illustrates that when an officer of a corporation defrauds that corporation as part a larger fraudulent scheme, the officer's fraud may not be attributable to the company.

Knowing receipt

A recipient of defrauded funds may be liable to return them under the doctrine of knowing receipt where he or she receives the funds for their own benefit, has actual or constructive knowledge of facts which would put a reasonable person on inquiry, but fails to inquire as to the possible fraudulent misappropriation of the funds.[7]

Liability for knowing receipt is restitution-based, and is concerned with correcting the unjust enrichment of one party to the detriment of another.[8] As such, this cause of action is sometimes described as being "recipient-based", in that its focus is on the stranger's receipt of the property of another.

Receipt requirement

Liability for knowing receipt involves both a receipt requirement and a knowledge requirement. To fulfil the requirement of receipt, the defendant must have received and become charged with some part of the trust property. In other words, the stranger must have received the property in his or her own right, and must have received the property beneficially,[9] thereby becoming enriched at the plaintiff's expense.

Knowledge requirement

To satisfy the knowledge requirement, the stranger who has received trust property must have had either actual or constructive knowledge about the possible breach of trust. Constructive knowledge is understood to mean "knowledge of facts sufficient to put a reasonable person on notice or inquiry,"[10] and arises "where the recipient fails to make proper inquiry in circumstances where an honest and reasonable person would realize that the funds transferred were from a suspicious or improper source."[11] Notably, in requiring only constructive knowledge, the test for knowing receipt incorporates a lower threshold of knowledge than that required for knowing assistance, and could therefore be easier to prove from an evidentiary perspective.

It is unclear whether this knowledge component must exist at the time of receipt, and there appears to be a paucity of law on this issue. On one line of reasoning, such knowledge need not exist at the time of receipt. Courts that have accepted this rationale suggest that "[e]ven if the property is received innocently, once the recipient learns of the fraud or breach of trust…he is liable to return any of the property that he then still holds."[12]

The main case which affirms this proposition is *Holmes v Amlez International*.[13] There, the plaintiff, a senior lawyer, was defrauded by his former bookkeeper after she forwarded two cheques from the plaintiff totalling $300,000 to a third-party business colleague. The plaintiff moved for partial summary judgment against the third party

based on the doctrine of knowing receipt. In his defence, the third party alleged that the money was owed to him as a debt and that the bookkeeper was simply repaying him. The Ontario Superior Court found that the third party knew of plaintiff's fraud allegations against the bookkeeper at the time he cashed the cheques, and that there was no question that the $300,000 were the proceeds of fraud. The Court also rejected the third party's assertion that he had received the $300,000 in payment of a debt, and dismissed this argument as a bald assertion unsupported by any evidence. Ultimately, the Court granted the plaintiff's partial summary judgment motion. Notably, the timing of the third party's knowledge of the fraud was not an issue of major debate in the circumstances of the case. However, the Court's statement that "the requisite level of knowledge need not arise prior to or at the time of receipt" seems to respond to the third party's allegations that he received the fraudulent funds in good faith, and dismissed this argument as a defence to knowing receipt. This decision therefore suggests that the requisite knowledge to establish a claim in knowing receipt may arise upon or after the receipt of funds, and that a third party may be required to return any proceeds of fraud still in their possession upon learning of the fraud.

Other decisions, however, have adopted a different approach to timing of the knowledge component. These cases suggest that an innocent party who subsequently learns of a fraud will be required to return its proceeds only where no juristic reason exists for them to retain the funds. Such was the case in *Sarhan v Chojnacki*.[14] There, a lawyer defrauded the applicant of $450,000 and forwarded the sum to two other clients to restore trust funds which he had misappropriated. The applicant sought the return of the $450,000 from the recipient clients through a claim in knowing receipt. Ultimately, the Ontario Superior Court dismissed the action on the basis that the recipient clients could not have known about the fraud at the time of receipt, and there was a juristic reason for the recipient clients to be enriched to the detriment of the applicant – namely, their entitlement to be repaid the trust funds owed to them by the fraudster lawyer. This finding precluded the applicant's recovery of the funds in knowing receipt, as the elements of unjust enrichment upon which this claim is based were not fulfilled. As such, the recipient clients were not required to return the funds notwithstanding the fact that they had subsequently become aware of the lawyer's fraud. Notably, to reach this conclusion, the Court relied on the decision in *Toronto Dominion Bank v. Carotenuto*.[15] In that case, the British Columbia Court of Appeal held that the repayment of an investment qualified as a juristic reason for investors to be enriched to the detriment of a defrauded bank, and that no unjust enrichment – and thus no constructive trust – could be found in those circumstances.

Taken together, the foregoing decisions suggest that where no juristic reason exists for an innocent party to retain the proceeds of fraud, that party will be required to return the funds regardless of the timing of their knowledge of the fraud. However, where there is a juristic reason for the enrichment, such as the return of an investment or the repayment of a loan, an innocent party may not be required to return the funds to a defrauded party notwithstanding the existence of a fraud, unless they had a duty to inquire about the *bona fides* of the payment.

Whether fraud must be proven

There does not appear to be any decisions which expressly address the issue of whether a fraud must be proven before a defendant can be said to have knowledge giving rise to knowing receipt. However, the decision in *Holmes*[16]appears to suggest

that a fraud need not be previously proven in a court of law or any other competent authority for a claim in knowing receipt to be successful.

As described above, the plaintiff in *Holmes* brought an action in knowing receipt against a third-party recipient of fraudulently obtained funds. Notably, the Court found the third party liable for knowing receipt on the basis that "by the time [the third party] deposited the cheques, he knew that [the plaintiff] was alleging that he had been defrauded by [his bookkeeper]."[17] There, the fact that the fraud had been alleged, though not yet proven, was sufficient to give rise to the third party's constructive knowledge of the fraud and his consequent duty to inquire as to the source of the funds. In this way, it would seem that fraud does not need to be proven for constructive knowledge of knowing receipt to arise.

Key takeaways

The doctrines of knowing assistance and knowing receipt can unlock the powerful remedy of tracing to assist fraud victims to recover their funds. While important distinctions exist between the two doctrines, both can give rise to a constructive trust through which equity can place defrauded funds back into the pockets of their rightful owners.

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[1] *Treaty Group Inc. v Simpson,* 2001 CarswellOnt 617.

[2] *Citadel General Assurance Co. v Lloyds Bank Canada*, [1997] 3 SCR 805 at para 23, 1997 CarswellAlta 823 [*Citadel* cited to Carswell].

[3] *Gold v Rosenberg*, 3 SCR 767 at para 41, 1997 CarswellOnt 3273 [cited to Carswell]; *Citadel*, *supra* note 2 at paras 46–48.

[4] *Harris v Leikin Group Inc.*, 2011 ONCA 790 at para 8, citing *Air Canada v M & L Travel Ltd.*, [1993] 3 SCR 787; *Gold v Rosenberg*, *supra* note 3.

[5] 2019 SCC 30.

[6] *Canadian Dredge and Dock Company Limited v The Queen*, [1985] 1 SCR 662.

[7] *Citadel*, *supra* note 2 at paras 48–49; *Holmes v Amlez International Inc.*, 2009 CarswellOnt 6595 at para 7, citing *Goodbody v Bank of Montreal*, 1974 CarswellOnt 308 [*Holmes*].

[8] *Citadel*, *supra* note 2 at paras 48–49.

[9] *Gold v Rosenberg*, *supra* note 3 at para 40.

[10] *Citadel*, *supra* note 2 at para 48.

[11] *Holmes*, *supra* note 7 at para 10.

[12] *Ibid* at para 12; *Sarhan v Chojnacki*, 2012 ONSC 747 at para 28; *The Toronto-Dominion Bank v Storr et al*, 2014 ONSC 4278 at para 117. See also *Healthy Body Services Inc. v 1261679 Ontario Ltd.*, 2015 ONCA 516 at para 77 where Lauwers J.A., dissenting, noted that "the trial judge accurately observed" that the requisite level of knowledge need not arise prior to or at the time of the receipt of the monies. However, the majority in that case did not consider the issue of knowing receipt, and decided the appeal on other grounds.

[13] *Supra* note 7.

[14] *Sarhan v Chojnacki*, *supra* note 12.

[15] 1998 CarswellBC 23.

[16] *Holmes*, *supra* note 7.

[17] *Ibid* at para 28.

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