

## financial services litigation bulletin

September 2009

### when good lenders meet bad borrowers

#### Ontario Court of Appeal underscores rights of *bona fide* creditors for value

*Financing is fraudulently obtained from Bank A and used to purchase assets. Those assets are then used as security by the fraudster to obtain credit with Bank B. Millions of dollars of debt later, the fraud is revealed. Which of these two innocent institutional victims is entitled to the proceeds from the pledged assets and which should bear the loss?*

Is Bank B equivalent to a *bona fide* purchaser for value without notice, and thus entitled to retain its interest in the assets? Or has it been unjustly enriched at the expense of Bank A, the institution that was defrauded? In a recent decision, *Bank of Montreal v. i Trade Finance Inc.*,<sup>1</sup> the Ontario Court of Appeal held in favour of Bank B, reinforcing the principle that a *bona fide* purchaser is generally not required to surrender assets for which it provided value. Ontario's highest court held that a lender that advances funds on the basis of fraudulently-obtained security, but without notice of the fraud, is not required to relinquish its security to the victim of the fraud.

#### facts

The facts of this case are, unfortunately, probably not so unusual. An individual ("the Fraudster") induced i Trade Finance Inc. ("i Trade") to advance over \$11.2 million to his company in order to finance certain business transactions that the Fraudster's company supposedly had with a U.S. firm. Unfortunately, these deals didn't exist. The Fraudster subsequently increased his personal credit limit with the Bank of Montreal ("BMO"), using shares purchased with the money loaned from i Trade as security. BMO, oblivious to the fraudulent origins of the funds used to acquire the securities, accepted the pledged shares in exchange for advancing the credit, though no security agreement was officially signed or registered pursuant to the *Personal Property Security Act* (the "PPSA").

When the scam was uncovered, i Trade was out over \$5 million and BMO had extended almost \$140,000 in credit to the Fraudster, though it was able to recover

<sup>1</sup> 2009 ONCA 615.

approximately \$130,000 through the disposition of the shares it held as security (the “Share Proceeds”). A judgment was granted in favour of i Trade against the Fraudster for the full amount outstanding on the loan. More importantly, the Court also made a tracing order that allowed i Trade to determine whether any of the funds that it advanced to the Fraudster could be traced into the assets of other parties. i Trade asserted that its funds could be traced directly to the Share Proceeds. BMO maintained that it was entitled to keep the Share Proceeds as a *bona fide* purchaser for value without notice. The motions judge agreed with i Trade. BMO appealed.

## the court’s decision

The Court of Appeal allowed the appeal and allowed BMO to retain the Share Proceeds.

i Trade’s claim to the Share Proceeds was founded in unjust enrichment. It argued that it would be unjust to allow BMO keep the Share Proceeds when such funds were directly traceable to i Trade’s losses from the fraud.

The Court focused its analysis on whether there was a juristic reason, or legal basis, for BMO to retain the Share Proceeds. It found that there were three such reasons:

- the fact that the Fraudster had sufficient property in the shares to pledge them as security;
- the otherwise valid contractual arrangement between BMO and the Fraudster; and
- the fact that BMO was a *bona fide* purchaser for value without notice of the fraud.

The Court first considered whether the Fraudster had property rights in the shares that he could grant to BMO. The Court found that he did. The Court held that i Trade intended to pass title to the funds at issue to the Fraudster and that, notwithstanding that the transfer was induced by fraud, such intention was sufficient to transfer a voidable interest in the funds to the Fraudster for purposes of creating a security interest. As a result, the Fraudster had sufficient rights in the shares purchased with those funds to allow him to pledge them to BMO.

The Court held that when BMO took an interest in the shares in exchange for the advance of credit, the Fraudster’s interest in the securities ceased to become voidable and i Trade lost its ability to trace and recover the funds. BMO was a *bona fide* purchaser for value without notice. BMO advanced credit to the Fraudster in exchange for the pledged shares in good faith and without knowledge of the fraud. The Court held it was irrelevant whether or not the contract between the BMO and the Fraudster whereby the shares were pledged satisfied any formal requirements or constituted a valid security agreement pursuant to the PPSA given that the case did not involve a priority dispute.

The Court concluded that BMO’s status as a *bona fide* purchaser for value was sufficient legal basis for BMO to retain the Share Proceeds. BMO entered into a valid contractual relationship with the Fraudster without notice of the fraud and gave consideration for its

interest in the pledged shares. In reaching this determination, the Court emphasized that the juristic reason or legal basis for a defendant keeping the alleged enrichment “need not necessarily arise out of the relationship between the party asserting the claim for unjust enrichment (i Trade) and the party enriched (BMO).” Rather, BMO’s good faith dealings with a third party, the Fraudster, and the contractual relationship that gave it an interest in the shares were sufficient grounds to defeat i Trade’s claim to the Share Proceeds.

## implications of the decision

This decision reinforces the longstanding principle that a creditor’s ability to trace and recover assets that it has unknowingly advanced to a fraudster is always potentially limited by the fraudster’s dealings with innocent third parties. This principle ordinarily restricts a victim of fraud from exerting rights against assets that are in the hands of one who acquired them from the fraudster for value without knowledge of any connection of the assets to fraud. However, as seen here, the principle also restricts a fraud victim’s ability to claim an interest in assets used by the fraudster to collateralize a valid lending arrangement with a third party acting in good faith. Fraud losses cannot be recovered from a *bona fide* creditor who advanced financing without notice of the fraud-related origins of its collateral.

The decision also highlights certain limits on the ability of a creditor to recover fraud-related losses by relying on legal principles that allow recovery of funds paid on the basis of mistake of fact, as discussed in our August 2009 Financial Services Litigation Bulletin (This bulletin may be viewed [here](#)). Once funds paid under a mistake of fact have been pledged as security or have been used to acquire other assets that have been pledged as collateral in a valid lending arrangement with a third party creditor, they cannot be recovered from the secured creditor.

While the decision does not mark any significant departure from existing law, it lends support to the rights of secured creditors who rely on security taken in above board financing arrangements with not so above board borrowers.

Written by Lisa Brost and Richard McCluskey

For more information, contact any of the lawyers listed below:

Calgary	Michael A. Thackray, QC	403.531.4710	michael.thackray@mcmillan.ca
Toronto	Dan MacDonald	416.865.7169	dan.macdonald@mcmillan.ca
Montréal	Emmanuelle Saucier	514.987.5053	emmanuelle.saucier@mcmillan.ca

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### a cautionary note

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