

## security pledgees need not hire Watson

When a bank accepts pledged shares, is it obligated to investigate the origin of the shares and how they came to be in possession of the party pledging them? In *i Trade Finance Inc v Bank of Montreal*,<sup>1</sup> the Supreme Court of Canada recently had to balance the interests of creditors seeking residual funds after a fraud was unraveled. The Court's conclusion results in a greater onus on the party with closer proximity to the fraudulent party to inspect their transactions and to void transactions as soon as fraud is discovered.

### the facts

Mr. A and others were convicted of fraud. Mr. A obtained financing from i Trade Financing Inc. ("i Trade") for one of his companies on the basis of computer services contracts which did not exist (the "i Trade Financing"). Consequently, Mr. A and his spouse obtained credit from the Bank of Montreal ("BMO") by pledging shares which had been purchased using proceeds of the i Trade Financing.<sup>2</sup>

After discovering Mr. A's conduct, i Trade obtained a tracing order permitting it to assert a constructive trust or equitable lien against any party in the possession of assets purchased with the i Trade Financing. This tracing order did exclude a right to assets in the hands of *bona fide* purchasers for value without notice.<sup>3</sup>

The issue to be decided by the Court was which creditor – the initial financier who obtained the tracing order (i Trade) or the subsequent credit account provider (BMO) – was entitled to the

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<sup>1</sup> 2011 SCC 26 [*i Trade*].

<sup>2</sup> *Ibid.* at paras. 1-4.

<sup>3</sup> *Ibid.* at para. 7.

limited pool of money remaining from the sale of Mr. A's pledged shares.<sup>4</sup>

## the arguments before the Court

i Trade argued that BMO could not obtain a security interest in the pledged shares as BMO could not have obtained an enforceable security interest from Mr. A who did not have the rights to pledge the shares. BMO argued that any latent defect in title held by Mr. A could not impact BMO's status as a *bona fide* purchaser for value without notice with respect to the shares.<sup>5</sup>

## the SCC's view on the rights of the parties

i Trade's interest in the funds was created by the tracing order. The tracing order created an equitable interest of either a constructive trust or equitable lien.<sup>6</sup> The Court held that, as an equitable interest, i Trade's interest in the funds was not subject to *Ontario's Personal Property Security Act* (PPSA).<sup>7</sup>

BMO's interest pursuant to the PPSA arose from Mr. A's pledging of the shares bought with the i Trade Financing funds. BMO intended to create a security interest (the pledging of the shares) to secure payment or performance of the obligations of Mr. A and his spouse. However, in order for BMO to have a valid security interest under the PPSA, the interest had to attach.<sup>8</sup>

Mr. A and his spouse signed a security agreement, meaning that BMO had met one requirement for attachment of a security interest in the shares.<sup>9</sup>

The other requirement for attachment, being whether Mr. A and his spouse had rights in the shares when they pledged them to BMO, required more analysis. The Court ultimately held that Mr. A did have a right to the shares to permit them to be pledged to BMO.

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<sup>4</sup> *Ibid.* at para. 6.

<sup>5</sup> *Ibid.* at paras. 20-25.

<sup>6</sup> *Ibid.* at para. 32.

<sup>7</sup> RSO 1990, c P.10.

<sup>8</sup> *i Trade, supra* at para. 42.

<sup>9</sup> *Ibid.* at para. 43.

The Supreme Court noted that fraud makes an agreement voidable and not void. The transfer of interest in the funds to Mr. A was valid and i Trade had to bear a risk of loss until it voided the fraudulent transaction.<sup>10</sup> Since i Trade had not revoked its consent to pass title to the funds to Mr. A's company prior to Mr. A's use of those funds for paycheques and corporate loans used to purchase the pledged shares, Mr. A had rights to the shares at the time they were pledged and therefore BMO's interest could attach.

Having determined that BMO had an enforceable interest pursuant to the PPSA, the Court then considered whether BMO was a bona fide purchaser for value without notice. The Court turned again to the PPSA's definition of "purchaser", which means a person who takes by purchase, including by pledge, an interest in personal property.<sup>11</sup> The Court applied this definition and held that BMO was a *bona fide* purchaser for value without notice and was therefore exempt from the tracing order. In effect, the Court utilized the PPSA to establish that BMO had an enforceable interest and qualified as a *bona fide* purchaser for value without notice. As such, it was entitled to the disputed funds.

## the consequences of i Trade

The Court's holding in *i Trade* appears to seek a solution for the balancing of creditor claims once fraud has been discovered. The Court's determination of who had to bear the risk of fraud turned on the date at which a party voids a fraudulent transaction. The fashion in which the Court resolved the existence of fraud and a limited pool of assets to be distributed amongst creditors places a burden more directly on the party with closer proximity to the fraudulent party.

Placing an obligation on the party first dealing with a fraudulent party to, in fact, void a voidable fraudulent transaction is consistent with a common sense proposition that the party dealing with the fraudulent party is best able to determine that the fraud has occurred. It also negates a requirement for a *bona fide* purchaser for value to become excessively Holmesian beyond their own due diligence.

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<sup>10</sup> *Ibid.* at paras. 45, 50.

<sup>11</sup> *Ibid.* at paras. 63-66.

On the other hand, the decision also makes it apparent that where financing is granted, due diligence remains prudent to avoid suffering a loss in the event that a fraudulent transaction, upon which the financier is relying as security, has been voided by the defrauded party before the financing is granted and is therefore set aside by the Court. Surely, this conclusion is elementary.

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#### a cautionary note

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