



Defrauded Lender Loses to Innocent Purchaser For Value

by Laura McLennan

Originally published in *Blaneys on Business* (March 2010) - [Read the entire newsletter](#)



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Who wins when two innocent parties are the victims of fraud?

The Ontario Court of Appeal had to answer this question in *Bank of Montreal v. iTrade Finance Inc.*

Both the Bank of Montreal and iTrade Finance Inc. were the victims of a fraud perpetrated by Webworx Inc. and its principal, Mr. A. Webworx had induced iTrade into financing phony contracts payable to Webworx. By the time the scheme was uncovered, iTrade had lost more than \$5 million.

iTrade successfully sued Webworx and Mr. A, and was granted a tracing order against Mr. A to help it determine whether any of the iTrade funds could be traced to assets in the hands of persons “other than bona fide purchasers for value without notice” – bona fide buyers who had provided something of value in exchange for the assets and didn't know that the assets had been obtained fraudulently.

iTrade was able to trace some of the funds to a BMO Nesbitt Burns investment account in the names of Mr. A and his spouse, Ms. R. Unfortunately for iTrade, BMO claimed it was entitled to the funds held in the investment account.

Mr. A and Ms. R had a line of credit with BMO. The bank had agreed to raise their credit limit upon the spouses granting a pledge of their investment account to BMO. All parties agreed that BMO had no notice that the shares in the investment account had been purchased with proceeds of the iTrade fraud.

Despite some documentation being executed in connection with the pledge and increased credit limit, the bank never obtained a written security agreement pledging the investment account assets from Mr. A or Ms. R. Perhaps even more surprising, BMO did not register its security interest under Ontario's *Personal Property Security Act* (PPSA). Mr. A and Ms. R did, at a later point, sign a “Notice and Direction” which confirmed that they had granted a security interest in the investment account to the bank. Regardless, BMO argued that it had a security agreement with Mr. A and Ms. R, one that was partly written and partly oral.

The case boiled down to determining which party was entitled to the funds in the investment account, iTrade or BMO? Despite all of the shortcomings in the BMO pledge arrangement, the Court of Appeal ultimately found that BMO was entitled to the assets in the account.

The Court did not rely on priorities granted by the PPSA to resolve the dispute and even questioned whether the PPSA applied in light of section 4(1) of the PPSA which states that the PPSA *does not* apply to a lien given by statute or by rule of law. iTrade's claim of a constructive trust (a trust imposed by a court in cases of unjust enrichment) over the investment account funds was arguably a lien given by rule of law. Nevertheless, the Court found that if the PPSA did apply, BMO had an enforceable security interest in the investment account assets. Although BMO had not registered a financing statement under the PPSA, the Court found it had perfected its security interest by possession of the collateral (the investment account). [It should be noted that facts in the case arose before amendments to the PPSA permitting a secured creditor to perfect its security interest by "control" came into force.]

iTrade had argued that BMO could not have a security interest in the investment account assets because, since the assets in the account were obtained with funds fraudulently obtained from iTrade, Mr. A could not have sufficient rights in the assets to create a security interest in favour of BMO.

The Court of Appeal disagreed. iTrade, although induced to do so by fraud, intentionally transferred its rights in the funds to Webworx/Mr. A. At the time of the transfer from iTrade to Webworx, iTrade was in a position to void the transfer of the funds. However, once a fraudster (Mr. A) transfers such property to a bona fide purchaser for value without notice of the fraud (BMO), the original transaction can no longer be voided and the bona fide purchaser takes the property free of the fraud.

BMO was a bona fide purchaser for value without notice. All parties to the case agreed that BMO had no notice that the shares in the investment account had been purchased with funds fraudulently obtained. In exchange for the pledge of investment account assets, BMO gave value by increasing Mr. A and Ms. R's credit limit. [The Court stated that the fact that BMO purchased from Mr. A personally and not Webworx directly (to whom iTrade had advanced the funds) was immaterial. There was to be no distinction between the fraudster and the corporate vehicle he used to perpetrate the fraud.]

Lastly, the Court rejected iTrade's claim of a constructive trust over the assets in the investment account. In order for a court to grant this equitable remedy, there must be (i) a benefit to or enrichment of one party, (ii) a corresponding detriment suffered by the other party, and (iii) the absence of a juristic (recognized in law) reason for the enrichment. BMO conceded that iTrade suffered a detriment, and the Court proceeded on the assumption (but not the determination) that the bank had been correspondingly enriched.

The Court found that there were valid juristic reasons for the enrichment, namely, that, (i) there was a valid contractual agreement between BMO and Mr. A and Ms. R, (ii) Mr. A and Ms. R had sufficient rights in the investment account property to transfer that property to BMO, and (iii) BMO was a bona fide purchaser for value without notice of the fraud.

BMO had entered into a valid and legitimate contract with Mr. A and Ms. R without any knowledge that the assets in the investment account had been purchased using monies that were fraudulently obtained from iTrade.

While BMO ultimately succeeded in keeping the assets in the investment account, lenders in their position would be well advised to always obtain a pledge agreement in writing and to register their security interests under the PPSA, and, where appropriate, obtain control of the pledged securities.

In addition, it is critical that parties in iTrade's position be aware that even when the proceeds of fraud can be traced, recovery is rarely possible once the ill-gotten property has been purchased by an innocent third party.

iTrade may have succeeded if it had taken valid security from Webworx and Mr. A – including a security interest in any investment accounts in Mr. A's name – and registered their security interests under the PPSA. But it didn't and, as is inevitably the case when fraud is involved, innocent parties will rarely ever be made whole. ■