

The Director under the Consumer and Commercial Relations Act, R.S.O. 1990, Chapter C.31 v. The Toronto Dominion Bank et al.

[Indexed as: Ontario (Real Estate & Business Brokers Act, Director) v. NRS Mississauga Inc.]

64 O.R. (3d) 97
[2003] O.J. No. 1164
Docket Nos. C35463-C37167

**Court of Appeal for Ontario
O'Connor A.C.J.O., Catzman and Doherty JJ.A.**

April 9, 2003

Trusts and trustees — Constructive trust — Statutory trust — Knowing receipt — Real estate broker misappropriating trust funds — In breach of trust, some trust funds used in broker's day-to-day operations — Bank having security interest in assets of real estate broker — Trust claimants failing to establish statutory trust or constructive trust over assets realized by Bank under its security — Real Estate and Business Brokers Act, R.S.O. 1990, c. R.4

NRS Mississauga Inc. ("NRS") was a real estate broker subject to the provisions of the Real Estate and Business Brokers Act ("REBBA"), and Mr. Naem Puri was its principal and president. Pursuant to s. 20 of the REBBA, NRS was required to place deposits in respect of pending real estate transactions in a separate trust account pending the closing of the transactions, and NRS had a trust account and a general account with the Toronto Dominion Bank. In 1985 and 1986, NRS entered into security agreements with the Bank, and the Bank had a perfected security on NRS's assets, including its account receivables.

Mr. Puri committed suicide on November 8, 1989, and it was soon determined that NRS was insolvent. The Bank was owed over \$300,000. As of November 9, 1989, 29 individuals (the "trust claimants") had deposited funds in trust with NRS in connection with pending real estate transactions, and there was a shortfall of \$179,423.01 in the trust account. Investigations revealed that trust funds that should have been held in trust had been misappropriated and used for day-to-day operations. The Director under the Consumer and Commercial Relations Act (the "Director") represented the trust claimants. The Queen in Right of Canada represented by the Minister of National Revenue (the "Crown") claimed that NRS had failed to remit employee tax deductions and certain other payments required by federal law. The Crown claimed \$430,000, of which about \$260,000 was for income tax remittals from employees, and the Crown relied on the statutory trust provisions of the Income Tax Act.

NRS had four assets: (1) \$138,279.21 of accounts receivable, being moneys owing to NRS from other brokers; (2) \$35,782.17 in the trust account; (3) \$11,176 in a special trust account

established by government investigators after November 9, 1989; and (4) \$69,182.51 of surplus funds held by the Bank after it had liquidated NRS's assets and recovered its indebtedness.

The Director, the Bank and the Crown asserted competing claims to the assets of NRS. The Director asserted that the Bank could not claim the proceeds from its realization of NRS's assets and that the Bank's recovery was impressed by a constructive trust in favour of the trust claimants. On an application, Lamek J. held in favour of the trust claimants. He ruled that the funds realized from the collection of the accounts receivable by the Bank were impressed with a constructive trust. Lamek J. also held that when the Bank realized on the accountants receivable, it knew or ought to have known that the proceeds were impressed with a trust. He further held that the funds in the [page98] trust accounts were trust funds not available to NRS's creditors. The Bank and the Crown appealed.

Held, the appeals should be allowed.

It was agreed that the deposits were subject to a trust and that NRS had breached its trust and fiduciary duty when it misappropriated the deposits. However, contrary to the Director's submission, this trust was not created by s. 19(2) and 20(1) of the REBBA. Neither section of the Act created a trust but rather assumed the existence of a trust. Further, contrary to the submission of the Director, nothing in the REBBA gave the trust claimants any remedies or special status over other creditors. The Bank made no claim with respect to the two trust accounts but, for the Director to establish the trust claimants' entitlement to the accounts receivable, he had to establish (1) that the accounts receivable were the subject of a constructive trust; and (2) that when the Bank realized on the accounts receivable, it was in knowing receipt of trust property. The trial judge, however, conflated these two distinct issues and erroneously turned to the knowing receipt issue before first determining that there was a constructive trust.

In *Soulos v. Korkontzilas*, the Supreme Court of Canada identified four conditions generally necessary before a court would impose a constructive trust based on wrongful conduct: (1) the defendant must have been under an equitable obligation that courts of equity have enforced; (2) the assets in the hands of the defendant must be shown to have resulted from deemed or actual agency activities of the defendant in breach of the equitable obligation; (3) the plaintiff must have a legitimate reason for seeking a proprietary remedy; and (4) there must be no factors that would render imposition of a constructive trust unjust in all the circumstances of the case.

In this case, the first and third prerequisite were established. However, there were considerable difficulties in establishing the second prerequisite. The evidence was too general to draw a direct and clear link between any of the accounts receivable and the misappropriation of trust funds. The material did not establish the extent of the misappropriation or how much of the misappropriated money was actually used in the operation of NRS. It would produce considerable commercial uncertainty if a constructive trust were to be imposed on all business assets upon the showing only that some unspecified amount of trust funds were used at some unspecified time in some unspecified way to assist in some unspecified degree in maintaining the operation of the business. In light of Lamek J.'s finding that the evidence showed no more that the trust moneys were used for the general business purposes of NRS, it was inappropriate to impose a constructive trust on the accounts receivable. Under the terms of its security

agreements, the Bank was entitled to realize on the accounts receivable. Accordingly, the Bank's appeal should be allowed.

Turning to the Crown's appeal, it related to the surplus after the Bank had recovered its debt and to the two trust accounts. The trust claimants having failed to establish a constructive trust over the accounts receivable, they could claim no priority over the Crown's claim, which was based on the deemed trust provisions in s. 227(4) and (5) of the Income Tax Act. As to the funds in the NRS trust account or in the account established by the government regulators, Lamek J. had found in favour of the trust claimants having concluded that the funds in these accounts should be regarded as restored or replaced trust funds. However, it is only where the defaulting trustee deposits new funds into a trust account with the intention of restoring or replacing misappropriated trust funds that the new funds will be impressed with the trust. It was not established that NRS intended *[page99]* that the funds replace the misappropriated trust funds. Accordingly, the Crown's appeal should be allowed.

Cases referred to

Carson (Re), [1924] 4 D.L.R. 492, 4 C.B.R. 683, 55 O.L.R. 649 (C.A.), revg (1924), 4 C.B.R. 600, [1924] 2 D.L.R. 566 (Ont. S.C.); Citadel General Assurance Co. v. Lloyds Bank Canada, [1997] 3 S.C.R. 805, 66 Alta. L.R. (3d) 241, 152 D.L.R. (4th) 411, [1999] 4 W.W.R. 135, 35 B.L.R. (2d) 153, 19 E.T.R. (2d) 93; Kolari (Re) (1981), 36 O.R. (2d) 473, 39 C.B.R. (N.S.) 129 (Dist. Ct.); Ontario (Ministry of Consumer and Commercial Relations, Business Practices Commission) v. Safeguard Real Estate Ltd. (1994), 114 D.L.R. (4th) 546, 27 C.B.R. (3d) 103 (Ont. Gen. Div.); Ridout Real Estate Ltd. (Re) (1958), 36 C.B.R. 111 (Ont. S.C.); Royal Bank of Canada v. Sparrow Electric Corp., [1997] 1 S.C.R. 411, 46 Alta. L.R. (3d) 87, 143 D.L.R. (4th) 385, 208 N.R. 161, [1997] 2 W.W.R. 457, 44 C.B.R. (3d) 1, 97 D.T.C. 5089; Soulos v. Korkontzilas, [1997] 2 S.C.R. 217, 32 O.R. (3d) 716, 146 D.L.R. (4th) 214, 212 N.R. 1, 46 C.B.R. (3d) 1, 17 E.T.R. (2d) 89, 9 R.P.R. (3d) 1

Statutes referred to

Canada Pension Plan, R.S.C. 1985, c. C-8
Consumer Protection Act, R.S.O. 1990, c. C.31
Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), s. 227(4), (5)
Ministry of Consumer and Business Services Act, R.S.O. 1990, c. M.21
Real Estate and Business Brokers Act, R.S.O. 1990, c. R.4, ss. 12, 15, 18, 19(2), 20

APPEAL from a judgment of Lamek J. (2000), 194 D.L.R. (4th) 527 (S.C.J.) in proceedings to determine priorities.

Colin Taylor, for respondent/appellant Toronto Dominion Bank.
Nancy Arnold and Peter Vita, for respondent/appellant Attorney General of Canada.
William Manuel, for applicant/respondent, the Director.
J. Gardner Hodder and M.K. Shaw, for trust claimants, DeLuca and Lin.

The judgment of the court was delivered by

DOHERTY J.A.: —

I

Overview

[1] NRS Mississauga Inc. ("NRS") operated as a real estate broker from 1985 to November 1989 and as such was subject to the provisions of the Real Estate and Business Brokers Act, R.S.O. 1990, c. R.4 ("REBBA"). Mr. Naeem Puri, the principal and president of NRS, committed suicide on November 8, 1989. Subsequent investigation of the affairs of NRS revealed that it was insolvent and that funds which should have been held in trust by *[page100]* NRS for various individuals had been misappropriated and put towards the day-to-day operation of the company.

[2] This proceeding concerns the priorities of several claims made on the assets of NRS after it failed. The outcome of this proceeding will determine who, among the various entities with valid claims against NRS, will bear the financial brunt of the failure of the company.

[3] There are essentially three claimants. [See Note 1 at end of document] The Director, [See Note 2 at end of document] acting under the auspices of REBBA, represented 29 individuals (the "trust claimants"). The trust claimants had deposited funds in trust with NRS in connection with real estate transactions that were pending on November 9, 1989. Section 20 of REBBA required NRS to hold those deposits in a separate trust account pending the closing of the transactions. The Director contended that the trust claimants should recover their entire claims from the proceeds of the various assets of NRS before any payments were made to any other claimants. [See Note 3 at end of document]

[4] The Toronto Dominion Bank (the "Bank") had made loans to NRS over the years. When NRS failed, the Bank was owed over \$300,000 and held perfected security on virtually all of the assets of NRS, including the accounts receivable. The Bank took the position that funds held in NRS bank accounts designated as trust accounts should be used to pay the trust claimants, but that under the terms of its security, it was entitled to realize on all of the other assets of NRS without regard to the claims made on behalf of the trust claimants.

[5] The Queen in Right of Canada represented by the Minister of National Revenue (the "Crown") alleged that NRS had failed to remit certain deductions taken from its employees for tax purposes to the Crown and had also failed to make certain payments to the Crown required by federal law. The Crown accepted that its claim ranked behind the Bank's claim. It also accepted that the trust claimants had a first claim on any true trust funds. The *[page101]* Crown contended, however, that the funds in the trust accounts were not trust funds. It also argued that after the Bank had been paid in full, the Crown had first claim on the remaining assets of NRS by virtue of the statutory trust provisions of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.). Those provisions applied to the deductions taken by NRS but not remitted to the Crown for the 1989 tax year (about \$260,000).

[6] The application judge held in favour of the trust claimants. He ruled that the funds realized from the collection of the accounts receivable by the Bank were impressed with a constructive trust in favour of the trust claimants. He further held that the funds in the trust accounts were trust funds and were not available to the creditors of NRS. In the result, the trust claimants were to be paid in full and the Bank would first claim on the remaining assets. The Crown would not recover any part of the debt owed to it by NRS.

[7] The Bank and the Crown appeal. I would allow both appeals.

II

The Nature of the Competing Claims

[8] NRS was a registered real estate broker under REBBA from 1985 to November 1989. It voluntarily surrendered its registration on about November 16, 1989. Pursuant to s. 20 of REBBA, NRS was required to maintain a trust account and a general account. It had both accounts at the same branch of the Bank. NRS was required to place deposits received from individuals in respect of pending real estate transactions in a trust account. As of November 9, 1989, there was a shortfall of about \$350,000 in that trust account. That shortfall decreased as transactions closed after November 9. It was eventually determined that the trust claimants were owed \$179,423.01 as of the date of the application in 1993. Most of that amount arose out of a few transactions that did not close thereby entitling the putative purchasers to the return of their entire deposit.

[9] Four assets of NRS are germane to the claims advanced in this proceeding.

- The accounts receivable collected by the Bank (\$138,279.21). [See Note 4 at end of document] *[page102]*
- The funds in the trust account established by NRS (\$35,782.17).
- The funds in the special trust account established by government investigators after November 9, 1989 (\$11,176.69).
- The surplus held by the Bank after it had liquidated the NRS assets and recovered its indebtedness in full (\$69,182.51). [See Note 5 at end of document]

[10] As indicated above, the trust claimants were owed \$179,423.01. [See Note 6 at end of document] The Director submitted that the funds in both trust accounts totalling about \$47,000 were trust funds or restored trust funds and were, therefore, the property of the trust claimants in accordance with the terms of the trust on which the deposits had been made. The Director further claimed that there was a direct and substantial connection between the misappropriation of the trust funds and the accounts receivable generated by the day-to-day operation of the business justifying the imposition of a constructive trust over the accounts receivable in favour of the trust claimants. Lastly, the Director submitted that when the Bank purported to realize on the accounts receivable, it knew or reasonably ought to have known that the accounts receivable were impressed with the constructive trust in favour of the trust claimants. The Bank was, therefore, a

constructive trustee of the proceeds of the accounts receivable and was required to remit to the trust claimants the funds needed to fully pay their claims.

[11] The Bank's claim is based on security agreements entered into with NRS in 1985 and 1986. It is undisputed that the Bank had a perfected security interest in the accounts receivable of NRS as of November 9, 1989. The accounts receivable represented moneys owing to NRS from other brokers as a result of completed real estate transactions. Under the terms of the Bank's security, any payments received by NRS on account of a debt owed to NRS was to [be] held by NRS in trust for the Bank. The Bank maintained that its charge on the accounts receivable was a fixed charge so that when NRS received payment on an accounts receivable, the Bank had legal title to the funds. *[page103]*

[12] The Crown's claim was for some \$430,000 owing as of the end of 1989. NRS had failed to remit money deducted from its employees for tax purposes and had also failed to make the required payments under the Canada Pension Plan, R.S.C. 1985, c. C-8 and to pay the required unemployment insurance premiums. The income tax claim of \$260,000 was subject to a deemed statutory trust under s. 227(4) of the Income Tax Act. Based on *Royal Bank of Canada v. Sparrow Electric Corp.*, [1997] 1 S.C.R. 411, 143 D.L.R. (4th) 385, the Crown accepted that its claim was behind that of the Bank. The Crown contended, however, that the funds in the two trust accounts, over which the Bank made no claim, were not trust funds, but were rather the proceeds from the operation of the business of NRS. It contended that its claim took priority over any other claim insofar as these amounts were concerned. It made the same argument in relation to the surplus (\$69,182.51) remaining after the Bank had recovered the amounts owing to it.

III

Events Following Mr. Puri's Suicide

[13] On November 10, 1989, two days after Mr. Puri's suicide, the Registrar of Real Estate and Business Brokers (the "Registrar") ordered an inspection of the books and records of NRS pursuant to s. 12 of REBBA. That inspection quickly revealed that trust funds were missing. The Registrar made an investigation order under s. 15 of the Act a few days later.

[14] On November 11, 1989, the remaining shareholders of NRS, some of whom were guarantors of the company's indebtedness to the Bank, and had provided collateral security to the Bank, asked the Bank to appoint a receiver over NRS and to realize on its security. The Bank appointed Arthur Anderson Inc. to take possession of the assets of NRS. The Bank made a formal demand for repayment of the loans owed by NRS and on or about November 22, 1989 began the process of collecting the accounts receivable.

[15] Within two weeks of undertaking the receivership, Arthur Anderson Inc. reported to the Bank that the books and records of NRS were inaccurate and misleading, NRS was experiencing significant operating losses and there was a substantial shortfall in the NRS trust account. Arthur Anderson Inc. advised that trust funds had been used to pay operating expenses and to prepay commissions to salespersons of NRS. The misuse of trust funds had been going on for up to two

years. Arthur Anderson Inc. also advised the Bank that some deposits had never been placed in *[page104]* the trust account, but had been deposited directly into the general account.

[16] Inspectors from the Business Practices Division of the Ministry of Consumer and Corporate Relations were conducting their own investigation at the same time that Arthur Anderson Inc. was conducting its review on behalf of the Bank. The investigation by the government regulators included interviews with employees of NRS. The regulators' findings were consistent with those reported by Arthur Anderson Inc. One employee advised that she had been depositing trust moneys directly into the general account on the instruction of Mr. Puri. These moneys had gone towards the payment of the operating expenses of NRS, including the making of advance payments on commissions to salespersons.

[17] On November 22, 1989, the Director, acting under s. 18 of REBBA, issued a "freeze" order directing the Bank:

[T]o hold any and all assets or trust funds on deposit or under control for safekeeping which are or are being or have been kept and maintained by NRS in any account . . .

[18] Despite the direction, the Bank proceeded to realize on its security. It recovered about \$417,500, leaving a surplus of slightly over \$69,000 after the Bank had recovered its loans. The Bank did not attempt to seize the money in the NRS trust account or the money in the special trust account.

[19] In addition to the security on which it realized, the Bank held personal guarantees from the other shareholders of NRS and collateral mortgages on property owned by those shareholders. The Bank regarded that security as sound and initially anticipated looking to it for recovery. When the assets of NRS proved sufficient to cover the debt to the Bank, it was unnecessary to take any steps to realize on the additional security.

IV

The Bank's Appeal

[20] The Bank's appeal focuses on its claim to the proceeds from the realization of the accounts receivable. If the Bank is entitled to those proceeds, it will be repaid in full and it has no interest in the other assets. The application judge held that the proceeds were impressed with a constructive trust in favour of the trust claimants. He so held based on his finding that the trust funds were improperly used to support the day-to-day operations of NRS and thereby to generate the accounts receivable. The application judge next held that when the Bank realized on the *[page105]* accounts receivable after November 22, 1989, it knew or ought to have known that the proceeds were impressed with a trust. The Bank was, therefore, in the position of a constructive trustee and was required to remit the funds realized from the collection of the accounts receivable to the trust claimants to the extent required to fully satisfy their claims.

[21] It is agreed that the deposits were subject to a trust and that NRS breached that trust and its fiduciary duty to the trust claimants when it misappropriated the deposits. The Director also argues that the deposits were subject to a statutory trust created by s. 19(2) and s. 20(1) of REBBA. I disagree. These provisions provide:

19(2) Every broker shall maintain a trust account for every person from whom trust money is received in which shall be entered full details of all trust money so received and disbursements therefrom.

20(1) Every broker shall maintain an account designated as a trust account in a bank listed in Schedule I or II to the Bank Act (Canada), loan or trust corporation, credit union, as defined in the Credit Unions and Caisses Populaires Act, or Province of Ontario Savings Office in which shall be deposited all money that come into the broker's hands in trust for other persons in connection with the broker's business, and shall at all times keep the money separate and apart from money belonging to the broker or to the partnership, in the case of a partnership, and shall disburse the money only in accordance with the terms of the trust.

[22] Neither section creates a trust. Instead, both assume the existence of a trust and require that the broker maintain appropriate books and records and a separate account designated as a trust account. Nor can I agree with counsel for the Director's submission that REBBA reveals a legislative intent that trust claimants should rank in priority to any other claimant should the broker become insolvent. Nothing in the Act gives the trust claimants any remedies or special status over other creditors in the event of the broker's default: see *Ontario (Ministry of Consumer and Commercial Relations, Business Practices Division) v. Safeguard Real Estate Ltd.* (1994), 114 D.L.R. (4th) 546, 27 C.B.R. (3d) 103 (Ont. Gen. Div.) at p. 548 D.L.R.

[23] Counsel for the Director also relies on the Director's power in s. 18 of REBBA to freeze "assets or trust funds". While this power is clearly directed to the protection of "clients or customers", it does no more than preserve the status quo by preventing the dissipation of assets or trust funds. Section 18 does not give a trust claimant, or for that matter anyone else, any right in the assets subject to the freeze order that the claimants did not otherwise have. Similarly, a failure to comply with an order made *[page106]* under s. 18 cannot create or destroy property rights in the assets which are subject to that order.

[24] The Director could establish the trust claimant's entitlement to the proceeds of the accounts receivable only if he could demonstrate two things. First, that the accounts receivable were properly made the subject of a constructive trust. Second, that when the Bank realized on the accounts receivable, it was in knowing receipt of trust property in accordance with the principles described in *Citadel General Assurance Co. v. Lloyds Bank Canada*, [1997] 3 S.C.R. 805, 152 D.L.R. (4th) 411.

[25] The application judge referred to the authorities, including *Soulos v. Korkontzilas*, [1997] 2 S.C.R. 217, 146 D.L.R. (4th) 214, governing the determination of whether a constructive trust should be imposed on assets. He also recognized that the trust claimants could not rely on tracing principles to demonstrate that the accounts receivable were trust property. He said at paras. 31-

[E]ven if strict tracing rules are not to apply here, how does that help the trust claimants as against the bank?

In my view, this case has to be considered under the rubric of "knowing receipt" as a variety of potential restitution situations. . . .

[26] With respect, I think the application judge erred in conflating two distinct issues. The question of whether the Bank was in knowing receipt of trust property could only arise after it had been determined that the accounts receivable were properly the subject of a constructive trust. Evidence relevant to the determination of whether the Bank was in knowing receipt of trust property, which the application judge canvassed in detail, was not relevant to the question of whether the accounts receivable should be the subject of a constructive trust. The application judge erroneously turned to the question of whether the bank knew or ought to have known of the existence of the constructive trust without first determining whether the evidence relied upon by the bank justified the imposition of a constructive trust over the accounts receivable.

[27] In *Soulos*, supra, at p. 228 S.C.R., p. 221 D.L.R., McLachlin J., for the majority, described the constructive trust in these terms:

[T]he constructive trust is an ancient and eclectic institution imposed by law not only to remedy unjust enrichment, but to hold persons in different situations to high standards of trust and probity and prevent them from retaining property which in "good conscience" they should not be permitted to retain. This served the end, not only of doing justice in the case before the court, but of protecting relationships of trust and the institutions that depend on these relationships. *[page107]*

[28] McLachlin J. then divided the circumstances which can give rise to a constructive trust into two broad categories. She said at p. 237 S.C.R., pp. 227-28 D.L.R.:

The first category concerns property obtained by a wrongful act of the defendant, notably breach of fiduciary obligation or breach of duty of loyalty. The traditional English institutional trusts largely fall under but may not exhaust (at least in Canada) this category. The second category concerns situations where the defendant has not acted wrongfully in obtaining the property, but where he would be unjustly enriched to the plaintiff's detriment by being permitted to keep the property for himself. The two categories are not mutually exclusive. Often wrongful acquisition of property will be associated with unjust enrichment, and vice versa. However, either situation alone may be sufficient to justify imposition of a constructive trust.

[29] In *Soulos*, supra, the plaintiff was the beneficiary of the trust and the defendant was the defaulting trustee. In this case, the contest is between the Director representing the beneficiaries and the Bank, a secured creditor of the trustee. The Bank cannot be said to have acquired the

proceeds of the accounts receivable by a wrongful act. While the Director contends that the Bank realized on the assets in violation of the "freezing" order, I can give little credence to this submission given that the Director had full knowledge of the Bank's conduct and did not suggest that it was improper until about six years after the fact. The terms of the "freezing" order also did not speak to the Bank's ultimate entitlement to the proceeds of the accounts receivable.

[30] It also begs the question to contend, as the Director does, that the Bank was unjustly enriched by realizing on the accounts receivable. The Bank was unjustly enriched only if the accounts receivable were impressed with a constructive trust. If they were not, the Bank was entitled to the proceeds. To speak of the Bank as being unjustly enriched by realizing on the accounts receivable is to presume the existence of the very fact in dispute, that is the existence of the constructive trust.

[31] I think the Director's contention that the proceeds of the accounts receivable should be impressed with a constructive trust should be examined first from the perspective of the relationship between the trust claimants and NRS and the conduct of NRS. Viewed in that way, there is no doubt that NRS, a fiduciary, misappropriated trust property by a wrongful act.

[32] In *Soulos*, supra, at p. 241 S.C.R., p. 230 D.L.R., McLachlin J. identified four conditions which were generally necessary before a court would impose a constructive trust based on wrongful conduct:

- (1) The defendant must have been under an equitable obligation, that is, an obligation of the type that courts of equity have enforced, in relation to the activities giving rise to the assets of his hands; *[page108]*
- (2) The assets in the hands of the defendant must be shown to have resulted from deemed or actual agency activities of the defendant in breach of his equitable obligation to the plaintiff;
- (3) The plaintiff must show a legitimate reason for seeking a proprietary remedy, either personal or related to the need to ensure that others like the defendant remain faithful to their duties and;
- (4) There must be no factors which would render imposition of a constructive trust unjust in all the circumstances of the case; e.g., the interests of intervening creditors must be protected.

[33] The first prerequisite poses no difficulty in this case. NRS owed a fiduciary duty to the trust claimants. That duty required it to hold the trust moneys. Instead, NRS used the moneys for its own purposes in clear breach of both the terms of the trust and NRS's equitable duty of loyalty.

[34] The third prerequisite identified in *Soulos* is also established in this case. By imposing a proprietary remedy, the court would stress the importance of the relationship between NRS and the trust claimants and seek to maintain the integrity of that relationship by deterring others from violating the terms of their trust.

[35] The second prerequisite identified in *Soulos*, supra, the connection between the assets over which it is sought to impose a constructive trust and the misconduct of the trustee raises considerable difficulties in this case. The evidence offered by the Director speaks at a level of generality that makes it very difficult to draw a direct and clear link between any of the accounts receivable and the misappropriation of trust funds. This disconnect between the constructive trust claim advanced by the Director and the evidence relied on by the Director is explained by the history of the proceedings. When the Director initially brought the application in 1993, he did not claim a constructive trust or any entitlement to any part of the proceeds of the accounts receivable except the surplus. The material the Director filed did not speak to the factual issues relevant to the existence of a constructive trust. The claim for a constructive trust first emerged in 1997. The Director did not file any new material apart from an agreed statement of fact. Consequently, counsel for the Director and the individual claimants were left to cull through evidence filed in reference to one claim to find support for an entirely different claim. Counsel took the court to various exhibits to affidavits filed on the application in an effort to forge a clear link between the misappropriation of trust funds and the accounts receivable collected by the Bank. Those submissions sounded more like evidence that might be given by a forensic accountant than legal argument. *[page109]*

[36] The material relied on by the Director does not draw any connection between a specific account receivable and the misappropriated trust funds. Indeed, the material does not reveal when the particular accounts receivable on which the Bank realized came into existence. For example, while the evidence showed that trust funds were used to make advance payments on commissions, there was no attempt to connect any of those commissions to transactions which generated accounts receivable collected by the Bank. Nor does the material establish the extent of the misappropriation or how much of the misappropriated money was actually used in the operation of the business. Finally, there is no indication as to the extent to which the day-to-day operation of the business was maintained by the use of misappropriated funds. If the business was maintained entirely through the use of trust funds, then the imposition of a constructive trust on the accounts receivable would seem more appropriate than if the misappropriated funds played a relatively small role in maintaining the operation of the business. I agree with the application judge's description of the state of the evidence (para. 31):

The most that they [the trust claimants] can do is show (as I have found they have) that trust moneys were used for general business purposes of NRS.

[37] There is merit to counsel for the Bank's submission that considerable commercial uncertainty would result if a constructive trust were to be imposed on all business assets to the full extent of the trust claim upon a showing only that some unspecified amount of trust funds were used at some unspecified time in some unspecified way to assist to some unspecified degree in maintaining the operation of the business. While *McLachlin J.*, in *Soulos*, supra, was careful to avoid any suggestion that any of the four conditions she described were prerequisites to the finding of a constructive trust, I think the nature of the connection between the misconduct of the trustee and the assets over which it is sought to impose a constructive trust is of significant importance in a commercial context.

[38] This record reveals only the most general of connections between the misappropriation of trust funds and the accounts receivable over which the Director seeks to impose a constructive trust. If a constructive trust is properly imposed on this record, it would seem to me that a constructive trust is properly imposed on all business assets whenever it is shown that trust funds of whatever amount were improperly used in the conduct of the business. That result would shift the risk that the trustee might act dishonestly entirely to the shoulders of the trustee's business creditors. *[page110]*

[39] In the light of the application judge's finding that the evidence showed no more than that trust moneys were used for the general business purposes of NRS, a finding with which I fully agree, it was inappropriate to impose a constructive trust on the accounts receivable. The Bank was entitled, under the terms of its security agreements with NRS, to realize on those accounts receivable.

[40] Although I would not impose a constructive trust given the absence of any clear connection between the misappropriation of trust funds and the accounts receivable collected by the Bank, I will consider the fourth prerequisite identified in *Soulos, supra*, for the sake of completeness. That condition speaks to a consideration of the equities as between the victim of the misconduct and third parties such as creditors. In one sense, the Bank can justifiably claim that the imposition of a constructive trust would be unjust. It had perfected security on the accounts receivable which predated the misappropriation of the trust funds by several years. Realistically speaking, the Bank could not be expected to have guarded against the misconduct of NRS.

[41] While this view of the events is not unattractive, I think the equities as between the Bank and the trust claimants would justify the imposition of a constructive trust if a clear connection between the misconduct and the assets over which the trust was sought to be imposed had been established. I say that for three reasons. First, the trust claimants were not, and never intended to be, creditors of NRS in the ordinary sense. By depositing trust funds with NRS, the trust claimants were not accepting any risk of economic harm should NRS become insolvent. They were entitled to expect that their money would be kept separate and apart from the assets of NRS and would be returned to them in its entirety in the event of insolvency. The Bank was a creditor. As such, it must be taken to have assumed the economic risks associated with the potential insolvency of the borrower.

[42] Second, while the Bank could reasonably expect to have recourse to the assets of NRS should NRS default on the loan, the Bank could not reasonably expect that the value of those assets would be increased through the misappropriation of trust funds by NRS and the use of those funds to augment the value of the business assets of NRS. In other words, the Bank could not expect its borrower to become a thief in order to enhance or protect the value of the Bank's security.

[43] Third, the Bank had recourse to other security in the form of personal guarantees and collateral mortgages. That security was solid and initially the Bank had intended to look to that security for recovery. It is appropriate when considering the *[page111]* equities as between trust

claimants and the Bank to bear in mind that the Bank had other security which could have fully satisfied the debt of NRS.

[44] In summary, I think the application judge erred in imposing a constructive trust on the accounts receivable. As I would not impose a constructive trust on those assets, the question of whether the Bank was in knowing receipt of trust assets does not arise. Given my conclusion that the Bank was entitled to realize on the accounts receivable, it has no interest in the other assets in issue in this proceeding. I will address those assets in the context of the Crown's appeal.

V

The Crown's Appeal

[45] The application judge dealt with the Crown's claim in short order. He acknowledged that the funds in the trust accounts were not the funds deposited by trust claimants, but were rather earned but unpaid commissions owing to salespersons by NRS. In the case of the trust account existing as of November 9, the funds had not been transferred from that account to the general account when the transactions to which they referred closed. The application judge went on to hold, however, that as the funds were in trust accounts, they should be regarded as replacing or restoring trust funds that NRS had improperly removed from the trust accounts prior to November 9, 1989. As I read the reasons, the application judge was satisfied that the mere fact that the funds were in trust accounts was sufficient to hold that they were restored or replaced trust funds.

[46] The Crown's claim relates to the funds in the two NRS trust accounts and the surplus left after the Bank had fully recovered its debt. I will address the claim for the surplus first. The surplus, \$69,182.51, consists of \$12,329.80, left in the NRS general account on November 9, 1989, and about \$57,000 representing part of the proceeds from the realization on the accounts receivable. The Director's claim to the \$57,000 rested entirely on the assertion that the proceeds of the accounts receivable were subject to a constructive trust. As I would reject that claim, it follows that the Director can claim no priority over the Crown to the \$57,000. The Crown's claim, based on the deemed trust provisions in s. 227(4) and s. 227(5) of the Income Tax Act, gives it priority over any claim the Director might have once it has been determined that the funds were not subject to a constructive trust.

[47] The funds in the general account on November 9, 1989 stand in a different position. Trust funds had been placed directly into the *[page112]* general account on a regular basis for up to two years prior to November 9. It is a safe inference that over \$12,000 in trust moneys were placed into the general account during that time. Where a trustee mixes its own funds with those of a beneficiary and afterwards withdrawals are made from that mixed fund, the trustee is deemed to have drawn out his own money first: *Re Kolari* (1981), 36 O.R. (2d) 473, 39 C.B.R. (N.S.) 129 (Dist. Ct.) at p. 478 O.R. On this approach, the money in the general account as of November 9 was trust money and is properly payable to the trust claimants.

[48] The Crown contends that as the funds in the trust accounts were not trust funds, they could only be regarded as replacing or restoring misappropriated trust funds if they were placed in the

trust accounts with the intention of replacing misappropriated trust funds. The Crown submits that the application judge erred in relying on Ontario (Ministry of Consumer and Commercial Relations, Business Practices Division) v. Safeguard Real Estate Ltd., supra, to support the proposition that any funds left in a trust account should be regarded as restored or replaced trust funds.

[49] I do not think that the funds in the NRS trust account (\$35,782.17) or in the trust account established after November 9 by the government regulators (\$11,176.19) can be said to be replaced or restored trust funds. It is clear from the authorities that it is only where the defaulting trustee deposits new funds into a trust account with the intention of restoring or replacing misappropriated trust funds, that the new funds will be impressed with the trust: *Re Carson*, [1924] 4 D.L.R. 492, 4 C.B.R. 683 (Ont. C.A.) at pp. 493-94 D.L.R.; *In Re Ridout Real Estate Ltd.* (1958), 36 C.B.R. 111 (Ont. S.C.) at pp. 118-19. If Ontario (Ministry of Consumer and Commercial Relations, Business Practices Division) v. Safeguard Real Estate Ltd., supra, can be read as standing for the proposition that the mere fact that funds are in a trust account is enough to give them the status of replaced or restored trust funds, I must disagree with that authority. I would, however, observe that in respect of at least part of the money described in *Safeguard*, supra, the defaulting trustee elected to place money realized from the collection of accounts receivable into the trust account after a Director's freeze order had been made under REBBA. That conduct could support the inference of an intention to restore trust funds.

[50] NRS had nothing to do with the \$11,176.19 placed into a trust fund established by the government inspectors after November 9, 1989. There is no basis upon which to hold that NRS intended that those funds should replace the misappropriated trust funds. *[page113]*

[51] The \$35,782.17 in the trust account as of November 9 was there because NRS had not moved those funds into the general account after the completion of the relevant transactions. There is no evidence as to NRS' intention in respect of those funds. Given the chaotic nature of the business affairs of NRS in November 1989, it cannot be reasonably inferred that by leaving the funds in the trust account, NRS intended to restore previously misappropriated trust funds. NRS had simply not moved the money to the general account when the end came suddenly on November 9, 1989.

VI

[52] I would allow the appeal of both the Bank and the Crown. The Bank was entitled to realize on the accounts receivable. The Crown has first claim on the funds in the two trust accounts and the surplus funds except for the funds in the general account as of November 9, 1989.

[53] The Bank and the Crown should serve and file their submissions with respect to costs both on the application and on the appeal within ten days of receipt of these reasons. The Director and the individual claimants who were represented in these proceedings shall serve and file their submissions with respect to costs within ten days of receipt of the submissions of the Bank and the Crown.

Order accordingly.

Notes

Note 1: There are many other creditors who are not parties to this proceeding.

Note 2: As originally styled, the Director was the director under the Ministry of Consumer and Business Services Act, R.S.O. 1990, c. M.21, as defined in the Consumer Protection Act, R.S.O. 1990, c. C.31. The Ontario Real Estate Association initially advanced a claim, but is no longer involved in the proceedings.

Note 3: Four of the trust claimants were represented by counsel in these proceedings (Angelo DeLuca, Daniela DeLuca, David Lin and Esther Lin). These claimants had also obtained judgment against NRS. Their claim accounted for about half of the total amount claimed on behalf of the trust claimants. The positions advanced on behalf of the DeLucas and Lins is consistent with the position taken by the Director.

Note 4: In addition to the accounts receivable, the Bank realized on other assets of NRS and recovered some \$280,000. The Bank's entitlement to realize on these assets is not in issue.

Note 5: The figures I use are those used by Lamek J. in his reasons. They reflect calculations made as of the date of the application (May 31, 1993). The judgment uses different numbers calculated as of a different date.

Note 6: This amount represented the ultimate shortfall as of November 9, 1989 after various transactions were completed, and interest on that amount to May 1993 when the application was initially returnable.