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CALGARY, ALBERTA

COURT FILE NUMBER	**0901-11866**
COURT	COURT OF QUEEN'S BENCH OF ALBERTA
JUDICIAL CENTRE	Calgary

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED, *THE JUDICATURE ACT*, R.S.A. 200, c. J-2, AS AMENDED AND *THE BUSINESS CORPORATIONS ACT*, R.S.A. 2000, C. B-9, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF
SHIRE INTERNATIONAL REAL ESTATE INVESTMENTS LTD., SHIRE CAPITAL LTD., HALAMA GARDENS LLC, SHIRE ASSET MANAGEMENT LTD., WINN RIVER RESORT LTD., FORT MCMONEY PROPERTIES II LTD., HALAMA GARDENS LTD., MAPLES AND WHITE SAND INVESTMENT LTD., FORT MCMONEY PROPERTIES LTD., CHEMAINUS PROPERTIES LTD., SKAHA LAKE DEVELOPMENT LTD., TSEHUM HARBOUR LTD., BEARSPAW AT 144TH AVENUE LTD., BEARSPAW AT 144TH EQUITIES LTD., BEARSPAW AT 144TH BONDS INC., TSEHUM HARBOUR EQUITIES LTD., TSEHUM HARBOR BONDS LTD., ORILLIA INVESTMENT LTD.,0726028 B.C. LTD., 0675816 B.C. LTD. and BOSUN'S HOLDINGS LTD.

DOCUMENT	**BRIEF OF THE APPLICANT, JENNIFER LOFGREN**

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I. INTRODUCTION

1. This Brief is submitted on behalf of Jennifer Lofgren ("Lofgren"), an investor in the Shire Group (as defined in the within action), on behalf of all Shire Group investors, in support of an application seeking the following relief:

   a) The Court Order that the balance of the net sale price of the real property located at 10109-10119 Manning Avenue, Fort McMurray, Alberta (the "Fort McMurray Property") be held in trust for the benefit of all of the investors of the Shire Group, pending the outcome of the ongoing Investor Action or further Order in this Action..

   b) In the alternative, the Court order a *pro-rata* distribution of the balance of the net sale price of the Fort McMurray Property (the "Net Sale Proceeds") to all investors of the Shire Group, rather than to the Olympia Trust Company.

2. Lofgren respectfully submits the requested relief should be granted, in light of the fact that the Shire Group commingled the funds of its numerous investors, <u>which commingled funds were used to purchase the Fort McMurray Property</u>. Lofgren further submits that all of the Investors were the victims of a fraudulent investment scheme, and as such should be treated equally, rather than favouring a limited, select sub-set of investors.

3. Commencing in or about 2005, the Shire Group and Jeanette Cleone Couch ("Couch") solicited and converted funds from numerous investors by promoting land projects in various jurisdictions. In reality, the Shire Group investment model was nothing more than a fraudulent "Ponzi" scheme, designed and carried out by the Shire Group - through Couch - to acquire and convert monies from thousands of investors (the "Investors").

4. Investors' funds were solicited, raised and spent in a manner that contravened the Securities Act (Alberta) and equivalent legislation in other Provinces. As a result of the actions of the members of the Shire Group, the Alberta Securities Commission commenced proceedings against the Shire Group and Couch. The Hearing was recently concluded and the Panel's decision is expected shortly.

5. Lofgren and Lucia de Wet ("de Wet") as Representative Plaintiffs for the Investors, commenced the Court of Queen's Bench Action 0901-10090, (the "Investor Action") as against Couch and the Shire Group. et al, as Defendants. In the Investor Action, Lofgren and de Wet have requested a tracing, freezing of assets, accounting and disgorgement of the Investors' funds, as well as judgment in the amount of $75 million, as against Couch and the Shire Group, among others, on the basis of their fraudulent actions.

II. FACTS

6. Between 2005 and 2009, the Shire Group illegally solicited funds from more than 2800 investors, in connection with approximately ten purported real estate development projects, the Fort McMurray project being just one of those. In total, the Shire Group raised more than $65,000,000 from the Investors.

7. The essence of the investment scheme was to create a separate company for each project, raise funds purportedly in respect of that project, represent to investors that they would receive either bonds or mortgage units that would pay interest, plus a share entitling the holder to significant eventual profits. Once the Investors' funds were received, they were commingled by the Shire Group, and in many instances, used for purposes other than intended or represented to the Investors.

8. None of the Investors' money has been repaid or produced a return; instead, it has been converted by the Shire Group.

9. Of the money received from the Investors, approximately $48,402,000 was received from "bond holders" and approximately $16,500,000 from "mortgage unit holders."

10. Olympia Trust Company ("Olympia") holds a mortgage of $6,500,000 over the Fort McMurray Property, owned by the Fort McMoney Properties II Ltd. ("FM II"). Olympia may also hold a $14.1 million mortgage over property owned by Maples and White Sands Investment Ltd. ("MWS"). Both FM II and MWS are companies within the Shire Group.

11. Some Investors were issued mortgage units in the Fort McMurray Property (the "Unitholders"), purportedly on the basis that they were investing in that particular project. Similarly, Investors in MWS were to have been issued mortgage units in the Property purchased through that Project. No other Investors were issued mortgage units, but instead were issued bonds in the various Shire Group projects.

12. The accounting firm of Ernst & Young Inc. ("the Monitor") prepared a report in relation to the Shire Group in these proceedings on October 7, 2009 (the "Third Report"). Based on its investigation, the Monitor concluded that Investors' funds were co-mingled, used contrary to their intended purpose and without investor approval. The Monitor's key findings include the following:

- Each Project Company is a separate legal entity and had its own bank account; however, the majority of the transactions relating to a specific project were made by and through Shire as opposed to the Project Companies.

- While the majority of the Investors' funds were deposited into the intended Project Company's bank account, a significant portion of the funds initially deposited into the Project Company's bank account, were subsequently transferred to Shire.

- Of the approximately $67,400,000 received from Investors into the bank accounts of the individual Project Companies during the Investigation Period, approximately $51,300,000 was subsequently transferred to the Shire Group.

- Shire acquired assets in its own name and acknowledges there is an intercompany payable from Shire to certain project companies and that the assets held by Shire in its own name, and are held for the benefit of its creditors and investors.

- The intercompany transactions occurred between Project Companies themselves, and between the Project Companies and Shire, without apparent investor approval or supporting documentation such as Promissory Notes or other information evidencing the advances. Furthermore, the inter company transactions between entities do not balance in the underlying general ledgers.

- Shire's primary relationship with respect to the Project Companies was to facilitate the raising of the funds required by the Project Companies from individual investors.

- Shire's management maintained control of the books and records of each of the Project Companies, as well as having significant authority on each bank account. In addition, the Monitor understands that Shire essentially acted as project manager for each Project Company, with the exception of Orillia, Chemainus and Skaha Lake, and controlled the funds and related disbursements.

- Shire received approximately $51,300,000 in net receipts from the Project Companies over the Investigation Period. It appears that basically since inception, the Shire Group operated on the basis of consolidating the funds raised by the individual project companies to Shire's account, with Shire using the funds to cover the related selling costs, overhead, general and administrative costs, as well as Shire being reimbursed for amounts paid by Shire on behalf of the Project Companies.

Paragraphs 17 – 33; pages 13 – 24 of the Third Report [Tab 1]

13. The Monitor sets out its specific findings with respect to FM II at pages 59 through 64 of the Third Report as follows:

(a) The Fort McMurray Property was acquired for a total purchase price of $4.8 million, acquired through a combination of $1.3 million in cash, and $3.5 million in mortgage financing provided by Quest Capital Corporation ("Quest").

(b) Approximately $4.7 million was raised from the Unitholders; however FM II's investor database details investments of approximately $6.5 million;

(c) $909,898 was raised from a legal trust account; $444,000 was advanced from MWS; $509,000 was advanced from Shire.

(d) The Monitor believes $3.893 million was used to repay the Quest mortgage; $932,000 was paid to Olympia; and $1.4 million was transferred to Shire.

(e) FM II continues to owe Shire between $1.8 and $1.9 million.

Pages 59 – 64 of the Third Report [Tab 2]

14. The Debtor in Possession of the Fort McMurray Property, Romspen Investment Corporation ("Romspen") has received an offer to purchase the Fort McMurray Propety from Allstar Property Management Ltd for $6 million. Romspen has brought an application requesting court approval of the sale of the Fort McMurray Property, and is requesting that the balance of the Net Sale Proceeds be paid to Olympia, in light of Olympia's registered mortgage.

15. Lofgren submits that Investors' commingled funds were used to purchase the Fort McMurray Property. As such, the mortgage held by Olympia, is held on behalf of all of the investors, not a select group. Lofgren further submits that if the sale is approved, the Net Sale Proceeds should be disbursed on a *pro rata* basis to all Investors; or in the alternative, held in trust, pending the outcome of the ongoing Investor Action.

II. LAW & ANALYSIS

Commingled Funds:

16. In *Holden Financial Corp. v. 411454 Ontario Ltd.* [1992] O.J. No. 1783, Holden Financial Corp. ("HFC"), a mortgage brokerage firm, registered certain mortgages in the name of investors, others were registered in trust for investors, and others were simply registered in HFC's name in trust. In total, 335 investors provided funds in excess of $9.7 million; however the total face amount of the mortgages actually held by HFC amounted to only $7.9 million, and the realizable value of the mortgages was in the range of $4.5 million to $6 million. Similarly to *Winnipeg Mortgage (described below)*, the vast majority of investors left the investment of their funds entirely to HFC's discretion; however, at least one investor, played an active role in deciding which mortgages his funds were to be invested.

17. The Court held that <u>its role was to determine the rights of the various investors as *against one another*</u> and not their rights against HFC; otherwise, the litigation would be endless. Some investors would argue that the allocation of a worthless security to them should not affect their rights to participate. Other investors would argue that the allocation of a good security to them should entitle them to an assignment of that security and the proceeds of that security. Once the trust funds had been improperly dealt with, no investor could establish that their funds were the specific funds used to purchase a specific security. As such, the Court concluded that the trust assets were to be treated as assets acquired by a single common fund, and the appropriate allocation was on a *pro rata* basis, relative to the respective contributions of the investors.

***Holden Financial Corp. v. 411454 Ontario Ltd.* [1992] O.J. No. 1783 [Tab 3]**

18. In the present action, the Monitor has determined that the Shire Group maintained control over the books, records and bank accounts of its various project companies; transactions relating to the various project companies were made by the Shire Group, rather than the project companies, without apparent investor approval; and from the beginning the Shire Group consolidated Investors' funds from the various project companies into its own bank account, comingling the Investors' funds.

19. None of the funds invested by the Unitholders were used by FM II in the initial purchase of the Fort McMurray Property. Instead the Fort McMurray Property was acquired through a combination of $1.3 million in cash, and $3.5 million in mortgage financing provided by Quest. Following the purchase of the Fort McMurray Property, FM II obtained $4.7 million from Unitholders, as well as an additional $1.86 million from a combination of a legal trust account, MWS and Shire. Given the Monitor's key findings, it seems apparent that the $1.3 million in cash used in the initial purchase of the Property, as well as the additional $1.86 million later transferred into FM II's account, came from the Investors' commingled funds.

20. The Quest mortgage was later repaid, from a combination of the Unitholders collective investment of $4.7 million, and the $1.86 transferred by the Shire Group into FM II's account. However, the initial $1.3 million cash does not appear to have been repaid. In fact the Monitor concludes that there was a shortfall of between $1.8 million and $1.9 million, which FM II continues to owe Shire.

21. Investors' funds were commingled, and used by Shire as one single bank account. It is clear that Investors' funds, other than Unitholders' funds, were used in the initial purchase of the Fort McMurray Property, and FM II continues to be indebted to Shire, to the extent of at least $1.8 million. At the very least $1.3 Million of Investors' funds, other than Unitholders' funds, were used to acquire the Property. At most, $3.16 million of non-Unitholders' funds, were used to acquire the Fort McMurray Property. It is not yet clear as to what portion of the Unitholders' funds were used to repay Quest. Therefore it seems clear that all Investors have a claim to the Fort McMurray Property, not only Unitholders.

Equitable Sharing

22. The case of *Ranjoy Sales and Leasing Ltd. v. Estates of Winnipeg Mortgage Exchange Ltd.* (1982) M.J. No. 36 (CA) ("*Winnipeg Mortgage*"), supports Lofgren's position that the Net Sale Proceeds should be shared equally amongst all Investors, as opposed to only Unitholders.

23. In *Winnipeg Mortgage*, a large number of investors invested money with a mortgage brokerage company, which then lent investor money to various borrowers. These loans were secured by way of mortgages in the names of investors. The mortgage company went bankrupt, after which some investors held "good mortgages" while others held "bad mortgages". Those investors holding mortgages with equity, sought preferential treatment over those investors who held mortgages with no equity. Despite the secured claims of the investors with "good mortgages" in their names, the Court held that all investors were to be treated equally and that all available assets were to be pooled and distributed according to investors' prospective claims.

24. In coming to its decision, the Court considered: (1) the intention of the parties when the transactions were entered into; and <u>(2) the necessity for fairness in the ultimate result.</u> The Court held that, to make preferred creditors out of those who, by sheer luck, received good mortgages, would make the Court a slave to contingency and to deny the Court the powers to do justice according to the maxim, equality is equity.

***Ranjoy Sales and Leasing Ltd. v. Estates of Winnipeg Mortgage Exchange Ltd.* (1982) M.J. No. 36 (CA) [Tab 4]**

25. The rationale set out in *Winnipeg Mortgage* is particularly applicable to the present case, given that the Investors were the victims of a fraudulent investment scheme. In this scheme, whether at any given moment a particular Investors' funds were still available, is a result of the fortuitous fact that the Shire Group converted the money of other Investors first. It is a matter of chance that FM II has property, with remaining equity – only one other Shire Group project is fortunate enough to be in that position. It is a matter of chance that FM II actually proceeded with its plans as stated in its offering memorandum – many other Shire Group projects did not. Fortunately for the Unitholders, the Olympia mortgage was registered and mortgage units were issued to Investors – it appears that the MWS investors may not have been so lucky. The necessity for equity and fairness, along with the fact that the property was not purchased solely by the Unitholders, dictates that the Net Sale Proceeds should be shared equally amongst all of the Investors, and not only those investors who, by sheer luck, are now able to claim a secured interest through mortgage units.

26. The present case differs somewhat from *Winnipeg Mortgage,* in that here the Investors chose the project in which their funds were supposedly going to be invested. However, subsequent Canadian decisions have followed the Courts' rationale in *Winnipeg Mortgage*, ordering an equitable distribution, even when investors chose how their money was to be invested. One such case is *Holden*, mentioned above.

27. Another is *Can Corp. Financial Services Ltd. (RE)* 1991 CarswellOnt 193, 6 C.B.R. (3d) 216 ("*Can Corp.*"). In this case, three investors, who exercised control over their specific investments, sought a declaration that they had a superior claim to certain mortgage investments made on their behalf. After the funds were invested, *Can Corp.* would forward investors a Declaration of Trust, which set out their investment, and the percentage of their interest in a specific mortgage. The Court held that it was apparent that of the 102 investors, some had good and some bad mortgages, while some investors were moved from good mortgages to bad mortgages without consultation or approval. The Court concluded that *Can Corp.* <u>pooled all of the interest paid on mortgages in one account, and also mixed funds from the general account in order to meet their monthly commitments</u>. Applying *Winnipeg Mortgage*, the Court held that it was in the best interest of all the investors that the assets of the bankrupt estate be distributed by way of a pooling arrangement; despite the fact that some investors chose the property in which they invested.

***Can Corp. Financial Services Ltd. (RE)* 1991 CarswellOnt 193, 6 C.B.R. (3d) 216 [Tab 5]**

28. In *Eron Mortgage Corp. (Trustee of) v. Eron Mortgage Corp* [1999] B.C.J. No. 347, Eron was a mortgage broker that would pool investors' funds in order to provide loans to various borrowers. Mortgages, or other security would be taken in Eron's name, which signed a declaration that it held the security for its investors. Typically, Eron gave investors several choices of financing opportunities, and the 4,000 investors would choose their investment. At the time Eron's mortgage brokers license was suspended there were 76 outstanding loans in the approximate amount of $222 million, of which only $40 million would be recovered.

29. The Court distinguished that case from *Winnipeg Mortgage* in that the Eron investors chose to invest in certain mortgages that were allocated to them by way of a trust declaration. The Court held that the parties' intention was that investors would have an interest in the mortgage they selected and that there was no equitable reason to deprive the investors of their choices. Equality among investors would constitute an inequality, as it would represent a variation to the contract and trust arrangements entered into, without proper justification at law or in equity.

***Eron Mortgage Corp. (Trustee of) v. Eron Mortgage Corp* [1999] B.C.J. No. 347 [Tab 6]**

30. The *Eron* case is distinguishable from the present case. Firstly, the Fort McMoney Property was acquired with Investors' commingled funds. Secondly, the Investors as a whole were the victims of a fraudulent investment scheme. Both of these grounds provide proper justification in law and equity for this Court to award an equitable distribution.

The American Approach

31. Looking to other jurisdictions, in deciding cases involving Ponzi schemes, the American Courts take an equitable approach, and favour a *pro rata* distribution of funds to investors of Ponzi schemes where investors' funds have been commingled. The rationale being, to hold otherwise would allow one investor to recover more at the expense of another.

32. In *Securities and Exchange Commission v. Credit Bank Corp. Ltd.* 290 F.3D 80 (2002) [United States Court of Appeals, Second Circuit], Credit Bank Corp. Ltd. ("CBL") was running a classic Ponzi scheme, paying initial investors from the assets transferred by later investors. One particular CBL investor, SECO, was to retain an equitable and beneficial ownership of its security. (SECO's claim was distinguishable from that of many CBL's customers in that its shares that were deposited were not converted to cash and were being held in CBL's brokerage accounts).

At paragraph 26 the Court held the following:

> ...whatever beneficial interest SECO might have in the transferred shares arising from a constructive trust does not defeat the equitable authority of the District Court to treat all fraud victims alike (in proportion to their investments) and order a pro rata distribution. Courts have favoured pro rata distribution of assets where, as here, the funds of the defrauded victims were co-mingled and victims were similarly situated with respect to their relationships to the defrauders.

At paragraph 27 the Court stated:

> As the District Court noted the use of a pro rata distribution has been deemed especially appropriate for fraud victims of a "Ponzi scheme". In such a scheme, whether at any given moment a particular customer's assets are traceable is "a result of the merely fortuitous fact that the defrauder spent the money of other victims first". (emphasis added)

Securities and Exchange Commission v. Credit Bank Corp. Ltd. 290 F.3D 80 (2002) [United States Court of Appeals, Second Circuit] [Tab 7]

33. In the case of *In Re Builder's Capital v. Ilga Rubino et al* 317 B.R. 603 (United States Bankruptcy Court for the Western District of New York) (2004), Builder's Capital and Services Inc. ("Builder's Capital") represented to investors that it would pool their investment in order to fund short term construction loans. In reality, Builder's Capital operated a Ponzi scheme. At issue were the rights to eight disputed mortgages that had been given to secure repayment of loans that Builder's Capital had advanced from investors co-mingled funds. In each instance, the mortgage identified the lender as Builder's Capital, as agent for a named investor.

34. The investors understood that Builder's Capital would arrange construction loans for which they would be designated as a mortgagee, and would receive a rate of return. The investors funds were then co-mingled in Builder Capital's general account. The Court held that any constructive trust arose for the benefit of all investors, not just those named on the mortgage, and that no individual investors could obtain a better claim to a disputed mortgage, which is in line with the maxim, equity is equality.

***In Re Builder's Capital v. Ilga Rubino et al* 317 B.R. 603 (United States Bankruptcy Court for the Western District of New York) (2004) [Tab 8]**

Conclusion:

35. Investors' funds were commingled and used by Shire as a single bank account. Investors' funds, other than Unitholders, were used in the initial purchase of the Fort McMurray Property. These initial purchase funds have not been repaid, and in total FM II continues to be indebted to Shire for more than $1.8 million. Furthermore, it is as yet unclear what portion of the Unitholders' funds were used to repay the Quest Mortgage. (The Investor Action has not proceeded to full discovery.) At a minimum, $1.3 million of non-Unitholders' funds were used to acquire the Property. At most, $3.16 million of non-Unitholders' funds were used to acquire the Property. Therefore it seems clear that all Investors have a claim to the Fort McMurray Property, not only Unitholders.

36. Following *Winnipeg Mortgage*, and the cases that have followed that decision, the equitable approach in this matter would be for the Court to order an equal distribution of the Net Sale Proceeds to all Investors. The Unitholders are of course included therein. Similarly to *Winnipeg Mortgage* it would be inequitable to only compensate those Shire Group investors who, by sheer luck, are now able to claim a secured interest through mortgage units. To do otherwise would make the Court a slave to contingency.

37. Olympia Trust may argue that the facts of this case are more in line with *Eron Mortgage*, and there should not be an equitable division of the Net Sale Proceeds – given the Investors thought they were choosing where their funds would supposedly be invested. Lofgren submits that the facts of this case are distinguishable from *Eron Mortgage,* in that there is an equitable reason to distribute the Net Sale Proceeds equally among all Investors given that they each were the victims of a fraudulent investment. Furthermore, unlike *Eron*, and a key distinction, it seems clear that all Investors funds were used to purchase the Fort McMoney Property, as Investor funds were commingled.

38. Finally, Lofgren submits that the favoured approach of American jurisprudence, namely to distribute the funds of defrauded investors equitably in cases involving Ponzi schemes, is persuasive. As stated by the American authorities, to hold otherwise would allow one investor to recover more at the expense of another.

39. All of which is respectfully submitted this 19th day of October, 2011.

BORDEN LADNER GERVAIS LLP

JOHN D. BLAIR, Q.C., and **CORY H.D. RYAN**
COUNSEL FOR THE DEFENDANTS,

LIST OF MATERIALS AND AUTHORITIES

Description	Tab No.
Paragraphs 17 – 33; pages 13 – 24 of the Third Report	1.
Pages 59 – 64 of the Third Report	2.
Holden Financial Corp. v. 411454 Ontario Ltd. [1992] O.J. No. 1783	3.
Ranjoy Sales and Leasing Ltd. v. Estates of Winnipeg Mortgage Exchange Ltd. (1982) M.J. No. 36 (CA)	4.
Can Corp. Financial Services Ltd. (RE) 1991 CarswellOnt 193, 6 C.B.R. (3d) 216	5.
Eron Mortgage Corp. (Trustee of) v. Eron Mortgage Corp [1999] B.C.J. No. 347	6.
Securities and Exchange Commission v. Credit Bank Corp. Ltd. 290 F.3D 80 (2002) [United States Court of Appeals, Second Circuit]	7.
In Re Builder's Capital v. Ilga Rubino et al 317 B.R. 603 (2004) (United States Bankruptcy Court for the Western District of New York)	8.

TAB
1

Consolidation of funds within Shire and Inter-company transactions between Shire and the Project Companies

i. Each Project Company is a separate legal entity and had its own bank account, however the majority of the transactions relating to a specific project were made by and through Shire as opposed to the Project Companies.

j. While the majority of the investors' funds were deposited into the intended Project Company's bank account, a significant portion of the funds initially deposited into the Project Companies bank account were subsequently transferred to Shire.

k. For example, as detailed further in this Third Report, of the approximately $67.4 million in cash receipts from investors received in the bank accounts of the individual Project Companies during the Investigation Period, approximately $51.3 million was subsequently transferred to Shire on an 'as needed' basis.

l. The Monitor is in the process of reconciling investor listings by Project Company as between the cash records and Shire's investor database resulting in an investor listing by project that details those investors who provide cash and those investors transferred from other projects. The Monitor has not attached the investor listing to this report due to its confidential nature (individual name and investment amount) but will seek further direction from the Court with respect to making the investor listings public.

m. Management advised that it believes that the consolidating of funds from the Project Companies into Shire's account was allowable and appropriate and consistent with industry standards and that doing so provided certain administrative efficiencies. The Monitor notes that the offering memoranda reviewed did not disclose that a significant portion of the funds would be consolidated into a Shire bank account.

n. The $51.3 million in funds received by Shire from the Project Companies was primarily used to:

   i. Reimburse Shire for the 10% selling commissions Shire earned on raising the funds;

   ii. Reimbursing Shire for certain payments made by Shire on behalf of the Project Company such as deposits made by Shire to acquire the property or other items;

   iii. Allow Shire to acquire assets in its own name. Shire acknowledges that there is an inter-company payable from Shire to certain Project Companies and that the assets held by Shire in its own name are held for the benefit of its creditors and investors; and

   iv. Pay Shire's overhead costs including advertising, salaries and wages, travel expenses, and other general and administrative expenses.

o. The process of the majority of the funds from the Project Companies being consolidated into Shire's bank account and Shire making the majority of the disbursements creates significant inter-company balances as all costs paid by Shire on behalf of the Project Companies need to be applied to the respective Project Company through an inter-company account. The analysis below indicates that Shire may owe the Project Companies in excess of $5.6 million due to the fact that certain Project Companies transferred more funds to Shire than was owed or owing to Shire. Such inter-company balances will need to be resolved and considered in any restructuring and/or recovery efforts.

p. Management advised that the policy of consolidating funds within Shire allowed certain operating efficiencies and that consolidating purchasing (and therefore payment) resulted in more favourable rates. However, each of the Project Companies was a separate legal entity with its distinct investors / creditors, which is not consistent with the methodology of consolidating the majority of funds in Shire's bank account.

Lack of approval / formal documentation of inter-company transactions

q. The inter-company transactions occurred between Project Companies and between the Project Companies and Shire without apparent investor approval or supporting documentation such as promissory notes or other information evidencing the advance. Furthermore the inter-company transactions between entities do not balance in the underlying general ledgers.

Allocation of costs

r. Shire paid for the majority of the overhead costs comprising advertising costs, salary and wages and other 'head office' expenses. These costs were then allocated by Shire to each of the Project Companies based on the funds raised by each individual Project Company. The allocation process was not documented in a formal agreement (as to the methodology or what expenses should be included or excluded) and was not specifically addressed in the various offering memoranda.

s. The costs allocated by Shire to the Project Companies has a material impact on the inter-company balances as the allocated costs were applied against the inter-company accounts.

Legal Due Diligence

t. Significant and material deficiencies were noted in the review of the Legal Analysis including:

    i. Missing or incomplete agreements (purchase and sale agreements, extension agreements, etc.);

    ii. In certain cases, the assets to be purchased as set out in the offering memoranda were acquired and held in different entities than disclosed in the offering memoranda and, in others, the properties were never ultimately acquired; and

iii. Certain Project Companies obtained mortgage financing to assist with the acquisition of the respective properties, when such financing was not disclosed in the offering memorandum and when it appears sufficient funds should have ultimately been raised from the funds received from investors to repay the mortgage.

u. Examples of the limitation of documentation of certain material related party transactions includes a transaction whereby Shire purportedly entered into a joint venture with Williamson & Associates Inc. ("Williamson") for the purchase and development of a property known as the Marda Loop Lots with the intent to develop and market this property for resale. The shareholder of Williamson is Ms. Luree Williamson, who the Monitor understands is the daughter of Mrs. Cleone Couch. The Monitor understands that the basis for the joint venture was that Shire was to contribute the initial cash deposit for the acquisition of this properties and that Williamson was to obtain the financing for the acquisition. The Monitor understands that the Legal Analysis prepared by the Applicants' legal counsel has determined that Williamson holds legal ownership to this property as evidenced by legal title. However, no joint venture agreement or loan documentation exists with respect to the amounts contributed by Shire towards the acquisition, maintenance or development of this property. The Monitor would note that this venture was ultimately unsuccessful.

v. Documentation relating to property acquisitions and structure

    i. For certain projects, the corporate structure set out in the offering memorandum was not followed. The Bearspaw project contemplated a series of entities and transactions, however, it appears that only one bank account and general ledger was maintained;

    ii. In certain circumstances the transactions contemplated in the offering memorandum were not completed however, funds were not returned to the investors;

iii. At times, the current owner of the project is not as contemplated or disclosed in the offering memorandum; and

iv. Certain Project Companies arranged for third party mortgages when it appears that sufficient funds should have existed from the investors to acquire the properties.

Assets held by the Project Companies and Shire

w. The value of assets currently held by the Project Companies and Shire is significantly less than the total value of funds raised with the difference comprising:

i. The commissions paid on the raising of funds;

ii. The funding of Shire's general and administrative expenses which were allocated back to the Project Companies;

iii. Costs incurred in attempting to acquire properties, forfeited deposits and other costs when the Shire Group was not successful in closing the acquisition of the properties; and

iv. Other higher than anticipated costs in acquiring certain properties.

Shareholder loan account

x. Although the Monitor continues its investigation, based on the information examined thus far, the Monitor has not found evidence of any significant funds being paid directly by Shire or the Project Companies to Mrs. Cleone Couch ("Mrs. Couch") other than repayments of shareholder loan accounts totalling approximately $590,000 during the Investigation Period. Mrs. Couch advised that the repayments relate to reimbursement of expenses incurred personally on behalf of the Applicants as well as other monies contributed into the Applicants. The Monitor is in the process of continuing to review the shareholder loan account and will provide a further update to this Court in due course.

y. The Monitor understands that the composition of the shareholder loan related to:

   i. Fees and/or salaries earned but not drawn by Mrs. Couch; and

   ii. Other amounts advanced by Mrs. Couch to Shire.

z. The shareholder loan account per Shire's books and records indicates that approximately $663,000 is owing to Mrs. Couch as at May 31, 2009 and Mrs. Couch has advised that she has incurred additional debts relating to the Applicants business since this time. Mrs. Couch also advised that any commissions that would accrue to her personally as a result of sales to her individual client contacts were retained by Shire and were not redeemed or credited to her shareholder loan.

aa. The Monitor is continuing to analyze the shareholder loan account and advises that certain transactions are continuing to be analyzed.

OVERVIEW OF SHIRE GROUP

18. The Shire Group was comprised of Shire and the following individual legal entities, collectively referred to as "Project Companies" or individually as the "Project Company":

    a. Shire Capital Ltd.

    b. Halama Gardens LLC;

    c. Shire Asset Management Ltd.;

    d. Fort McMoney Properties II Ltd.;

    e. Halama Gardens Ltd.;

    f. Maples and White Sands Investment Ltd.;

    g. Fort McMoney Properties Ltd.;

    h. Chemainus Properties Ltd.;

    i. Skaha Lake Development Ltd.;

    j. Tsehum Harbour Ltd.;

    k. Bearspaw at 144th Avenue Ltd.;

    l. Bearspaw at 144th Equities Ltd.;

    m. Bearspaw at 144th Bonds Inc.;

    n. Tsehum Harbour Equities Ltd.;

    o. Tsehum Harbour Bonds Ltd.; and

    p. Orillia Investments Ltd.

19. Shire's primary relationship with respect to the Project Companies was to facilitate the raising of the funds required by Project Companies from individual investors. At times, Shire initially acquired a property or entered into a purchase agreement for a property and placed the required deposit. The completion of the acquisition of the property was to be completed by the Project Company using the funds raised from the investors.

20. The Monitor understands that Shire's management maintained control of the books and records of each of the Project Companies as well as having signing authority on each bank account. In addition, the Monitor understand that Shire essentially acted as project manager for each Project Company with the exception of Orillia, Chemainus and Skaha Lake and controlled the funds and related disbursements.

21. In exchange for raising the required funds for the Project Companies, under the terms of the individual offering memorandum, Shire was generally entitled to;

   a. Receive a selling commission equal to 10% of the funds raised (a portion of which would be paid by Shire to selling agents, if any were involved);

   b. Receive an annual or one-time management fee to cover Shire's services for providing administrative services to the project; and

   c. Be reimbursed for offering costs from the Project Companies.

22. The Project Companies were to receive the funds raised by Shire from the various investors and use these funds to:

   a. Pay Shire its selling commissions and fees;

   b. Pay Shire any offering costs or management fees as set out in the respective offering memoranda; and

   c. Use the funds to acquire the respective property or proceed with development as set out in the respective offering memoranda.

23. Each Project Company was a separate legal entity and had its own bank account. The Monitor's understanding based on discussions with management and a review of the various offering memoranda, was that each Project Company was to raise funds which were then to be used to pay the expenses related to the respective project. Each Project Company had its own bank account, legal structure and books and records, however Project Companies associated with the same general project (i.e. Bearspaw at 144th Avenue Ltd., Bearspaw at 144th Equities Ltd. and Bearspaw at 144th Bonds Inc.) would generally only have one bank account.

24. The Monitor's understanding as to how the flow of funds was to work as between the Project Company and Shire is illustrated by the following example. Assuming Shire raised $10 million for a specific Project Company, the Monitor understands the following:

a. that $10 million would be received by the Project Company and deposited into the Project Company's individual bank account;

b. The Project Company would then pay Shire the established commission fee (10%) which in this example would equal $1 million;

c. The Project Company would pay Shire any other selling and administrative costs allowed by the offering memorandum. In this example offering costs are assumed to be $500,000;

d. The Project Company would reimburse Shire for any direct costs that had been paid by Shire on behalf of the Project Company (i.e. deposit placed on the purchase and sale contract). In this example, no direct costs have been assumed; and

e. In summary, in the above example, it would be expected that the Project Company would hold approximately $8.5 million in its bank account representing the $10 million in investor funds raised, less the commissions payable to Shire ($1 million or 10% of the funds raised) and the offering costs (assumed in this example to be $500,000). The funds would then remain in the Project Companies' account to be used to complete the acquisition of the property or continue with the development of the project as set out in the offering memorandum.

25. However, the Shire Group did not operate precisely in this fashion. Based on the analysis below, it appears that while the funds raised by Shire on behalf of the Project Companies were originally deposited into the individual bank accounts maintained by the Project Companies, a significant portion of the investors funds were transferred from the Project Companies' bank accounts to the bank accounts of Shire creating inter-company accounts between the individual Project Companies and Shire. The inter-company balances would then further be adjusted to reflect the following:

   a. Payments made by Shire on behalf of the Project Companies for reimbursement of payments made in advance of the raising of the funds (i.e. purchase deposits relating to the properties to be acquired by the Project Company);

   b. Commissions that were owed by the Project Companies to Shire for the raising of the funds;

   c. Other selling costs incurred by Shire that were deemed by Shire to be chargeable to the Project Companies;

   d. Overhead costs incurred by Shire that were allocated to the Individual Project Companies (referred to the "Allocated Costs"); and

   e. Payments made by Shire on behalf of the Project Companies following the raising of the funds (eg. costs of engineering studies on a particular property).

26. Management advised that it believes the consolidating of funds held into Shire's account was allowable and that doing so provided certain administrative efficiencies. However, the Monitor notes that the offering memoranda that were reviewed did not indicate that Shire would hold the majority of the funds raised.

27. Shire did not invoice the Project Companies for costs incurred including commissions, managements fees, direct costs paid on behalf of the Project Companies or the Allocated Costs, but instead credited these payments against the amount of funds transferred from the individual Project Companies to Shire through the inter-company accounts. Depending on the amount of funds advanced by the individual Project Companies and the amount of payments and Allocated Costs applied by Shire against the inter-company account there would be an intercompany receivable or payable balance between each Project Company and Shire.

PROJECT COMPANIES – SOURCES AND USES OF FUNDS

28. Attached at Appendix 1 to this report is a schedule that summarizes the funds raised by individual Project Company and the use of the funds. The table below summarizes the total for all Project Companies:

Sources and uses of cash:	
	Total
Sources of cash:	
Net other intercompany transfers in	242,000
Funds raised from investors	67,375,722
Other sources of cash	1,963,005
Total sources of cash	**69,580,726**
Uses of cash:	
Net intercompany transfers to Shire	51,310,334
Purchase/deposits on property	14,114,643
Interest	2,244,093
Other uses of cash	1,876,850
Total uses of cash	**69,545,919**

29. The table above illustrates that in total the Project Companies received approximately $67 million of investor funds with these funds being deposited into the individual bank accounts of the Project Companies. Of this amount, the Project Companies made the following net disbursements over the Investigation Period:

a. Approximately $51.3 million was transferred to Shire;

b. $14.1 million was used directly by the Project Companies in an attempt to acquire properties or commence development; and

c. $4.1 million was used for the payment of interest and other expenses.

30. As outlined in the First Report of the Monitor, the investor database maintained by the Applicants include certain investors who had exercised a remedy provided to them known as a "Roll-over" whereby they were provided with an opportunity to effectively "transfer" their original investment for an investment in another Project Company, without a subsequent cash outlay. For purposes of the analysis within this Third Report with respect to the sources and uses of cash, the Monitor has considered only the cash amount of contribution made by investors and has disregarded the "roll-over" amounts.

31. The Applicants maintained an investor database outlining the amount of cash investments, RRSP investments and tax free savings account investments which the Monitor compared to the cash received from investors in the individual Project Company sections below. The Monitor continues to reconcile certain variances as discussed below.

32. Details of the sources and uses of the individual Project Companies is discussed in further detail below.

SHIRE – SOURCES AND USES OF FUNDS

33. As discussed above, Shire received approximately $51.3 million in net receipts from the Project Companies over the Investigation Period. It appears that, basically since inception, the Shire Group operated on a basis of consolidating the funds raised by the individual Project Companies to the account of Shire, with Shire using the funds to cover the related selling costs, overheads, general and administrative costs, as well as Shire being reimbursed for amounts paid by Shire behalf of the Project Companies (for amounts paid relating to the acquisition and/or development of the properties).

34. Management advised that the cash funds were consolidated within Shire's bank accounts primarily due administrative reasons and to allow for flexibility in cash flow management. Management advised that it was easier from an administrative aspect to have Shire hold the funds, as Shire paid for the majority of the costs and expenses and

TAB

2

Fort McMoney Properties II Ltd. ("Fort McMoney II")

Offering Memorandum

119. The Fort McMoney II offering memorandum dated March 24, 2008 (the "Fort Money II OM") indicated that Fort McMoney II intended to raise up to $6.5 million in mortgage units with the proceeds to be used to repay certain mortgages and fund the development of property located at 10109, 10111, 10113, 10115, 10117 and 10119 Manning Avenue, Fort McMurray, Alberta (collectively, the "Fort McMoney II Lands").

120. Further analysis of Fort McMoney II, including its ownership structure, investment structure and information on the material agreements can be found in the Legal Analysis contained at Appendix 2.

121. The Fort McMoney II OM indicated that Fort McMoney II owned the Fort McMoney II Lands and that $3.4 million of the proceeds from the offering would be used to repay a mortgage owing to Quest Capital Corporation ("Quest") with the remaining funds being used for development of the property.

122. Investors in the mortgage units offered by Fort McMoney II received mortgage units administered by Olympia Trust Company ("Olympia") with the mortgage bearing interest at 15% per annum, paid quarterly in arrears. Olympia registered a mortgage against the Fort McMoney II Lands on behalf of the mortgage investors.

123. Fort McMoney II's material agreements related to a series of purchase and sale agreements relating the Fort McMoney II Lands as more fully described below:

Date	Vendor	Purchaser	Amount
10109 and 10111 Manning Avenue (Note 1)			
15-May-06	374796 Alberta lTd.	R. Couch and C.Couch	1,475,000
10109 Manning Avenue			
01-Jun-07	Robert and Cleone Couch	Fort McMoney II	900,000
10111 Manning Avenue			
01-Jun-07	Robert and Cleone Couch	Fort McMoney II	900,000
10113 Manning Avenue			
29-Aug-07	844796 Alberta Ltd.	Fort McMoney II	800,000
10115 Manning Avenue			
25-Aug-07	Donald Gordon Seeley	Fort McMoney II	687,610
10117 Manning Avenue			
28-Aug-07	Michelle Dee Kruetzer	Fort McMoney II	687,610
10119 Manning Avenue			
29-Aug-07	John and Deme Brownlee	Fort McMoney II	800,000
		TOTAL PURCHASED	**4,775,220**

Note 1: This information is based upon a transfer of lands dated May 15, 2006. However, there are agreements that would suggest that this transaction onlyy closed in Dec06 and that Luree Williamson or her nominee originally agreed to purchase the property with C Couch.

124. The table above indicates that Luree Williamson or her nominee and Cleone Couch agreed to purchase 10109 and 10111 Manning Avenue for $1.475 million. As discussed above, these two lots were originally included in the Fort McMoney OM (defined as the Manning Avenue Lots in the Fort McMoney section above). The Monitor has not yet obtained an explanation as to why these properties were not purchased by Fort McMoney.

125. Ultimately, Robert and Cleone Couch became the owners of 10109 and 10111 Manning Avenue and sold these two lots to Fort McMoney II for $1.8 million, of which $725,272 of the proceeds were used to repay mortgages owing to the TD Bank. The remaining four properties were acquired for approximately $3.0 million, resulting in a total purchase price of $4.8 million for the Fort McMoney II Properties.

Acquisition of property

126. It appears that the Fort McMoney II Properties were originally acquired by Fort McMoney II through a combination of cash and $3.5 million in mortgage financing provided by Quest.

127. The purpose of the Fort McMoney II OM was to raise mortgage units which would be used to take out the existing mortgage owing to Quest which the Monitor understands was in the amount of approximately $3.5 million and to use the surplus funds for development purposes.

Sources and uses of funds related to Fort McMoney II

128. From a review of the books and records, the flow of funds relating to Fort McMoney II is set out in the table below:

Sources and uses of cash:	
	Ft McMoney II
Sources of cash:	
Net other intercompany transfers in	358,500
Funds raised from investors	4,712,507
Other sources of cash	909,898
Total sources of cash	**5,980,905**
Uses of cash:	
Net intercompany transfers to Shire	885,800
Purchase/deposits on property	3,893,000
Other uses of cash	1,199,267
Total uses of cash	**5,978,067**

129. The table above illustrates the sources and uses of cash per the Fort McMoney II bank account and excludes any Shire transactions relating Fort McMoney II. The Shire related transactions are discussed below. The significant sources and uses of cash per the Fort McMoney II bank accounts include:

a. Approximately $4.7 million was raised from investors of the mortgage units. The investor database maintained by Fort McMoney II details investors of approximately $6.5 million (excluding Roll-overs as described below) and the Monitor is in the process of analyzing this variance;

b. $909,898 from a legal counsel trust account, which the Monitor is still investigating;

c. $444,000 was advanced from MWS to Fort McMoney II;

d. $509,000 was advanced from Shire to Fort McMoney II;

e. Fort McMoney paid Schinnour Matkin & Baxter approximately $3.893 million which the Monitor understands was the repayment of the Quest mortgage;

f. $932,000 was returned to Olympia Trust; and

g. $1.4 million was transferred to Shire.

Intercompany analysis with Shire

130. The table below summarizes the intercompany balance between Shire and Fort McMoney II based on management's books and records and that estimated by analysis of the Monitor which is based on a review of the offering memorandum

Fort McMoney Properties II Ltd. Inter-company with Shire International	Assuming Allocated Costs	Costs per Offering Memorandum	Notes
Gross Payable to / (Receivable from) Shire International	(885,800)	(885,800)	1
Less:			
Commissions at 10% of Funds Raised	649,000	649,000	2
Project management fees earned by Shire	130,000	320,000	3
Other administrative expenses	580,758	250,000	4
Direct costs paid by Shire International	1,467,947	1,467,947	5
Net Payable to / (Receivable from) Shire International	1,941,904	1,801,147	

Notes

1 Amounts per detailed cash analysis performed by the Monitor as detailed in the Third Report.

2 Calculated as 10% of funds raised as generally provided for in the Offering Memorandums.

3 Project management fees earned by Shire are calculated by the Applicants using a base rate of 2% of all funds raised. However, the individual Project Companies Offering Memorandums detail varying amounts of management fee entitlements from 1 to 3% of amounts raised and in one instance, outlines a one-time fixed fee.

4 Other administrative charges refer to costs incurred by Shire International on behalf of the individual Project Companies. The Applicant's pro-rate total Shire costs deemed to be Allocable Costs using the funds raised by the Applicant's as a basis, whereas the Offering Memorandums appear to outline an expected usage of proceeds from each offering thus generating the variance illustrated by this analysis.

5 Amounts per detailed Shire International books and records reflecting charges paid by Shire International on behalf of individual Project Companies as well as funds transferred by Shire and allocated to individual Project Companies. Ultimate payee is indiscernible due to classification in the books and records and the Monitor has not yet been able to cross-reference payments to source documentation to validate amounts.

131. The table above estimates that Shire is owed approximately between \$1.8 million and \$1.9 million as set out below:

a. Fort McMoney II advanced Shire approximately \$0.9 million from the funds raised from investors pursuant to the Fort McMoney II OM;

b. From the cash transferred to Shire, the following amounts have been applied to reduce the inter-company payable:

i. \$0.6 million in selling commissions earned by Shire;

ii. \$130,000 in management fees;

iii. Allocated Costs of \$580,000 or estimate of \$250,000 based on the net use of proceeds in the Fort McMoney II OM; and

iv. Approximately \$1.5 million of payments purportedly made by Shire on behalf of Fort McMoney II as summarized in the table below:

Fort McMoney Properties II Ltd. Direct costs paid or transferred by Shire International	Costs	Notes
Quest Capital	313,266	
Norlights	183,015	
Terracon	72,887	
Schinoor Matkin Baxter	26,293	
Other disbursements	363,285	1
Other transfers	509,200	2
	1,467,946	

Notes

1 Relates to amounts to whom ultimate payee is indiscernable due to the classification in the G/L. The Monitor has not yet been able to crossreference payments to source documentation.

2 Relates to transfers to whom recipient is indiscernable due to the classification in the G/L. The Monitor has not yet been able to crossreference recipients to source documentation.

132. Certain of the payments included as direct expenses paid by Shire on behalf of Fort McMoney are unsupported and not fully explained in the Fort McMoney OM and are being further analyzed by the Monitor. Per discussion with management, a majority

of the other transfers were made to Olympia Trust for payment of interest to investors. The Monitor is continuing to investigate these disbursements.

Current status of the Fort McMoney II Lands

133. From the analysis above, it appears that Fort McMoney II's principal asset consists of the ownership of the Fort McMoney II Properties which were acquired for approximately $4.8 million. The significant obligations of Fort McMoney II consist of:

   a. The secured obligations owing to the mortgage unit investors; and

   b. Inter-company payable to Shire, subject to confirmation of the allocation of costs and appropriateness and support of other direct costs paid by Shire on behalf of Fort McMoney II.

TAB
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Indexed as:

Holden Financial Corp. v. 411454 Ontario Ltd.

Between
Holden Financial Corporation, Applicant, and
411454 Ontario Limited et al., Respondents

[1992] O.J. No. 1783

Action No. B126/92

Ontario Court of Justice - General Division
Toronto, Ontario

Rosenberg J.

Heard: July 29, 1992
Judgment: August 28, 1992

(26 pp.)

Debtor and creditor -- Investors advancing funds to brokerage firm for investment -- Investments not invested in specific mortgages -- Tracing was impossible -- Whether funds in trust assets of brokerage firm should be distributed pro rata.

This was an application by the Trustee for advice and direction with respect to its recommendation that all proceeds of trust assets be pooled and the net proceeds be distributed pro rata among persons entitled thereto, to whether additional claimants were entitled to share in the proceeds and whether a mortgage should be discharged. Investors claimed to be entitled to specific mortgages. HFC was a mortgage brokerage firm and the trustee was appointed to investigate HFC's affairs. Some funds given to HFC to invest had been improperly removed from the trust accounts. Some mortgages were registered in the name of the investors, some were registered in trust for a specific investor and others were simply registered in HFC's name in trust. The additional claimants had provided money to either H or companies in the H Group which funds were not received in HFC's trust account.

HELD: The recommendations of the trustee was adopted. The additional claimants had no claim against the trust account or assets purchased with funds from the trust account. HFC's action negated a specific ownership of the securities. The investors were unable to trace their funds and therefore the trust assets had to be treated as assets acquired by a single common fund. The mortgage was not to be discharged.

STATUTES, REGULATIONS AND RULES CITED:

Mortgage Brokers Act, R.S.O. 1980, c. 295. Registry Act, R.S.O. 1980, c. 445. Trustee Act, R.S.O. 1980, c. 512.

Joseph M. Steiner, for the Applicant/Trustee Peat Marwick Thorne Inc.
Malcolm Bennett, for Mariana Haas.
Keith M. Landy, for Brian Foley and David Wilby.
Michael E. Mitchell, for Murray Satchell and Marian Satchell.
G. Timmins, for the Ministry of Financial Institutions.
Steven J. Stefanko, for Dora Moses, William Skidmore and Lyle Montgomery.
Andrew L. Szemenyei, for John Bari and eleven others.
C.J. Haber, for Fairshore Investments Ltd.
Peter J. Fallis, for Robert and Margaret Lindsay.
I.A. Duncan, for Joaquin Domingues.
Robert McGillen, for Tracy and Beverly Robinson.
Jeffrey D. Lanctot, for Stewart Shea and twenty others.
Tom Robson, for a number of Counter Applicants.
D. McMillan, for Clark Harnden.
D. McGillen, for Millard & McGillen.

ROSENBERG J.:--

NATURE OF PROCEEDINGS

The initial motion of Peat Marwick Thorne Inc., as Trustee under the Trustee Act and Receiver ('the Trustee") of certain assets of Holden Financial Corporation ("HFC") was for advice and direction of the court in respect of certain aspects of its administration of the Trust Assets.

In particular, the Trustee sought the Court's advice and direction as to the following matters:

(i) the Trustee's recommendation that all proceeds of the Trust Assets be pooled and that the net proceeds, after the fees and disbursements of the Trustee and its legal counsel, be distributed pro rata among the persons entitled to the proceeds on the basis of their trust investments with HFC as determined by the Trustee, such distributions to be made quarterly beginning after the expiry of the period for appealing from the Order authorizing same;

(ii) the claims of certain persons ("the Additional Claimants" who are listed in Schedule A hereto) to be included among the persons entitled to share in the proceeds of the Trust Assets; and

(iii) the claims of Robert McGillen and Tracy and Beverly Robinson respecting a mortgage on property municipally known as 2239 Woodglade Boulevard, Peterborough.

In response to the motion by the Trustee there were a number of cross applications and cross motions which are categorized generally as follows:

(a) By various individual investors who had specific mortgages registered showing HFC as the registered mortgage holder in trust for them. These investors opposed the Trustee's recommended pooling and claimed to be entitled to these specific mortgages allegedly held in trust for them.

(b) Some investors shown as owning specific mortgage interests on the books of HFC claiming entitlement to those specific mortgage interests.

(c) The motions by the Additional Claimants claiming to be entitled to participate in any pooling arrangement that is eventually ordered.

(d) A motion brought by Robert C. McGillen that the mortgage on the property of Tracy and Beverly Robinson be discharged.

In support of these various cross motions and cross applications there were a number of affidavits by the individual investors setting out the details of their negotiations with and the transaction with HFC. A number of the Additional Claimants have outlined the details of their negotiations with HFC and with David Holden and other Holden Corporations alleging that their dealings were with HFC and that they should be treated as having dealt with HFC. After a review of all of the affidavit evidence filed I am unable to conclude that the Trustee's analysis is inaccurate in any respect. Accordingly for the purpose of this application and series of cross applications and cross motions I am accepting the facts as set out in the first report of the Trustee dated June 10, 1992. This will not prejudice any of the parties or others who may have additional facts available to them at some later date in regard to claims against David Holden, HFC and/or other Holden companies or with regard to any proceedings that may arise in the future.

THE FACTS

By judgment dated May 26, 1992 ("the Judgment") made on the application of HFC, the Trustee was appointed in place of HFC, of all funds, mortgages, assets, rights and other interests of any kind of which HFC was trustee ("the Trust Assets"). The Trustee was also appointed Receiver of all assets of HFC used in the administration and management of mortgages and other assets of HFC in respect of which it provided administrative or management services. The Trustee was further directed to investigate the affairs of HFC's mortgage brokerage business and report to the court thereon.

The Trustee delivered its First Report, dated June 10, 1992, and has served copies on all of the trust investors identified from HFC's records ("the Investors"), as well as on counsel for certain investors, together with its Motion Record, in mid-June 1992.

HFC is a wholly-owned subsidiary of Holden Bancorp Ltd. ("HBL"). HBL is the immediate or indirect parent of a number of corporations referred to as the Holden Group of Companies. David B. Holden holds 60% of the shares of HBL.

HFC, until early May 1992, carried on business as a mortgage broker and was registered under the Mortgage Brokers Act. HFC solicited investors to provide funds to it in trust for investment in mortgages to be held by HFC in trust. HFC earned revenue from brokerage fees charged to borrowers and from the spread between interest rates paid by the borrowers and interest rates paid to investors. HFC administered mortgages both for RRSP and non-RRSP investments but was trustee only of the funds and mortgages in the non-RRSP program. These proceedings are concerned only with the non-RRSP program.

Investors placing money with HFC for investment in mortgages were given Mortgage Investment Receipts which specified the amount of the investment, the date of receipt by HFC, the maturity date of the investment and the interest rate payable to the Investor. The funds received from investors were to be held in HFC's trust account until they were advanced to fund mortgages to be held in trust for the investors whose funds were so used. In fact, from the beginning of HFC's operations, some funds were transferred from HFC's trust account to its general account and used by HFC rather than being invested in mortgages.

At the time of the Trustee's appointment, the status of the non-RRSP mortgage program and the Trust Assets was as follows:

(i) 335 investors had provided funds to HFC for investment in mortgages to be held in trust for them. Some investors provided funds on more than one occasion so that there were a total of 497 separate investments by the 335 investors.

(ii) The total amount of the funds provided by the investors was $9,695,685.

(iii) The face amount of mortgages actually held by HFC in trust or administered by it amounted to only $7,885,600 in 70 mortgages and there was $167,466 in HFC's trust account. After allowing for accrued interest owing to investors and certain other claims, the Trustee calculated the Trust Asset Deficiency as $1,806,057.

(iv) Of the $7,885,600 of mortgages held or administered by HFC:

$4,063,250		were shown on the registered instruments to be held by HFC for named investors in specified proportions;
$	384,000	were registered directly in the names of investors contrary to HFC's instructions to the solicitors involved to have them registered to HFC in trust for the investors in question 2 of the 17 investors involved in these mortgages had been repaid although the mortgages are outstanding);
$3,370,350		were allocated to named investors on HFC's records but the registered instruments were in the name of HFC in trust with no investors named;
$	48,000	were registered in the name of HFC in trust for specific investors, but these investors had been paid on the maturity of their Mortgage Investment Receipts despite the fact the mortgages had not yet matured;
$	20,000	were registered in the name of HFC in trust with no investors named and with no allocation on HFC's records.
$7,885,600		

The Trustee anticipated that the realizable value of the $7,885,600 in mortgages was in the range of $4,500,000 to $5,950,000. The two largest components of this "shrinkage" in realizable value were mortgage loans to other companies in the Holden Group of Companies (face value, $1,043,000; anticipated realizations, $30,000 to $320,000) and so-called compensating balance mortgages in respect of which the borrowers asserted contractual rights of set off against loans they had made to other Holden Group companies (face value, $2,587,850, anticipated realizations, $1,072,000 to $1,716,000).

After allowing for anticipated costs of the Trusteeship, the Trustee estimated that the investors as a group would recover 44% to 59% of their total investments. To the extent the court concludes that any of the Additional Claimants are entitled to claim against the Trust Assets, those percentage recovery rates would decline.

The Trustee's examination of HFC's affairs revealed that the process whereby Holden allocated particular investments by particular investors to specific mortgages was essentially arbitrary. The Trustee made the following observations:

(a) Most mortgages placed in 1991 were registered in the name of HFC in trust with no investors shown in the registered instruments. Some investors were given draft assignments which were never registered. In one case an Investor was given a photocopy of an assignment to which his name had been added on the photocopy only, not on the registered instrument.

(b) Beginning in December 1991, HFC began to attempt to "rectify" this situation retroactively by matching particular investments to particular mortgages on the basis of the amount of the investment in relation to the amount of the mortgage and the relative dates of the investment deposit and the mortgage advance. When this allocation was done, assignments were registered on title, to HFC in trust for named investors, in approximately half the cases.

(c) For a brief period, in December 1991 and January 1992, some mortgages were registered, when placed, in the name of HFC in trust for named investors. This was no indication that their specific investments were used to fund those mortgages. Rather it was a matter of administrative convenience. Thereafter HFC reverted to its earlier practice of registering mortgages in the name of HFC in trust, without named investors, and at later dates either registering assignments to HFC in trust for named investors or making allocations on its own records.

(d) A review of mortgage funding and maturity dates relative to investment deposit and maturity dates of investments assigned or allocated to the mortgages in question demonstrated a lack of any consistency. For example, 29 investments totalling $506,000 were allocated to mortgages funded before the investments were deposited with HFC. There were 245 investments totalling $4,560,600 which, by the terms of the Mortgage Investment Receipts, were repayable to the investors 2 weeks or more before the maturity dates of the mortgages to which they were allocated or assigned.

In carrying on its business, HFC paid no attention to the relationship between mortgage maturity dates and the maturity dates of the investments allocated or assigned to the mortgages. HFC paid investors their monthly interest payments in accordance with the Mortgage Investment Receipts whether or not HFC received payment on the supposedly corresponding mortgages, if any. Similarly, HFC repaid the principal amount of investments on their maturity in accordance with the Mortgage Investment Receipts whether or not the supposedly corresponding mortgages, if any, were repaid. HFC was able to do this by utilizing funds from other investors or from other companies in the Holden Group.

The vast majority of investors with HFC (a) left the investment of their funds entirely in

HFC's discretion; (b) played no part in the selection of the mortgage or mortgages, if any, to which their investments were assigned or allocated; and (c) requested or received, after the fact, no documentation evidencing the allocation or assignment of their investments to particular mortgages. Until receipt of detailed information from the Trustee, few investors had any knowledge of how or where their funds had been placed. The assurance given by HFC to those investors who sought to exclude "their" mortgages from pooling were no different than the assurances given to all investors with HFC.

Whether a particular Investor's funds were allocated or assigned to a mortgage was largely a matter of happenstance. For example, HFC received ten investments on January 6, 1992 totalling $188,400. Of these, six were allocated to mortgages totalling $102,500 which were funded from as early as January 17, 1992 to as late as march 12, 1992. Of these six, four were registered to HFC in trust for the named investors while two were simply allocated on HFC's books. Four of the ten investments, totalling $85,900, were never allocated to any mortgage.

The Trustee had located only one investor, Clark Harnden, who played an active role in the selection of the mortgages in which his funds were to be invested. One of those mortgages was registered directly in Mr. Harnden's name and was not considered by the Trustee to be part of the Trust Assets. One of the mortgages was registered in the name of HFC in trust for Clark Harnden. The third mortgage was registered to HFC in trust, with no reference to Mr. Harnden. It was repaid before maturity, but HFC did not pay the proceeds to Mr. Harnden.

Trustee's Recommendation

From its review of HFC's affairs, the Trustee concluded that it could not be said that the mortgages held by HFC were held for specific investors in any meaningful sense. HFC did not follow specific instructions or even its own general guidelines in the management of trust funds. The allocation of investments to mortgages was almost totalling arbitrary and was largely carried out after the fact by attempts to match investments received some time earlier against mortgages that were often funded much earlier. Few investors had any influence over the placement of their funds. Few investors were in a position to know whether they would be better or worse off if the Trust Assets were treated as a single, common pool until they received and analyzed detailed information supplied by the Trustee in the context of this proceeding.

The Trustee therefore recommended that the Trust Assets should be treated as a single, common pool to be shared, after deduction of the expenses of the Trusteeship, on a pro rata basis by the investors on the basis of the amounts of their respective investments.

Additional Claimants

Eighteen individuals and one corporation (referred to herein as the Additional Claimants) filed material on this motion in support of allegations that they were entitled to be included among the investors with claims on the Trust Assets.

Upon reviewing the material filed, it appeared to the Trustee that the persons in question provided the funds which they sought to recover either to David B. Holden or to companies in the Holden Group other than HFC, and that they provided their funds either as loans or on a trust basis. The material indicated that documentation supplied to the persons concerned contemporaneously with their investments confirmed that the investments were with David B. Holden or companies in the Holden Group other than HFC. Nothing in the documentation indicated that the funds were received or held by HFC in trust for any Additional Claimants.

There was no evidence to suggest that any of the funds in respect of which these claims were made were received into HFC's trust account or were utilized to acquire any of the Trust Assets.

The Trustee therefore recommended that the claims of the Additional Claimants not be accepted as claims against the Trust Assets and that the Additional Claimants not share in the proceeds of the Trust Assets.

I accept the Trustee's recommendation in that regard.

Robinson/McGillen Claim

On May 7, 1992 HFC issued an uncertified cheque from its trust account to the law firm of Millard & McGillen in Trust and delivered the cheque to Robert C. McGillen. The cheque was to fund a mortgage loan to Tracy and Beverly Robinson. Mr. McGillen deposited the cheque to his firm's trust account and issued a corresponding cheque to the Robinsons and registered a mortgage on the Robinsons' property in favour of HFC in trust for three named investors.

The cheque from HFC in trust was dishonoured by reason of a freeze order made under the Mortgage Brokers Act. The Robinsons obtained funds from another source which, presumably, have been paid into Millard & McGillen's trust account to cover its shortfall. The Robinsons have demanded a discharge of the mortgage to HFC in trust.

The Trustee has declined to give the discharge without the direction of the Court. The Trustee's concern was that the transaction could be characterized as having resulted in the advance of mortgage funds by HFC in trust to the Robinsons, the funds having been provided to HFC in trust by way of a loan, albeit unintended, by Millard & McGillen. In that event, Millard & McGillen would be indebted to the Robinsons, who obtained funds to reimburse the advance from the Millard & McGillen trust account, and Millard & McGillen would have a corresponding claim against HFC or HFC in trust, either as an unsecured creditor or as one more claimant against the Trust Assets.

The Trustee brought to the attention of the court that while it would appear to be unfair to inflict such a loss on Millard and McGillen, it would be no more unfair than the situation faced by all the investors.

PRACTICAL CONSIDERATIONS

In a similar situation known as the Consortium Group of Companies which had some similarities to the HFC situation but is of course quite different in many respects, many investors were claiming to be in preferred positions. The net result is that litigation is continuing and the assets are being dissipated so that there may be nothing left for any of the investors. In a similar way, if each Investor were entitled to whatever security or designation on HFC's books that specifically refers to that Investor, it would necessitate a court review of each Investor's position. If eventually such Investor does establish entitlement to a specific mortgage or a share in a specific mortgage that Investor's recovery would depend on the value of the security to which the Investor is proven entitled.

These proceedings are to determine the rights of the various investors inter alia and not their rights against HFC, David Holden or any of the Holden Companies. If individual investors were allocated specific securities the arbitrary act of HFC would have determined whether they receive good or bad securities or none at all. The litigation process would be endless. Some investors would argue that the allocation of a worthless security to them should not affect their rights to participate. Other investors would say that the allocation of a good security to them should entitle them to an assignment of that security and the proceeds of that security. The individual facts and negotiations and the terms of the transaction with HFC would have to be examined in each case and a separate determination made in that regard. From the Trustee's report and the proceedings I have heard to date, I have no hesitation in finding that such proceedings, if deemed appropriate, would waste most if not all of the assets available for distribution as the Trustee would have to examine into and take a position with regard to each such application.

Some of the additional claimants thought they were dealing with HFC and had had previous dealings with HFC. If they were not allowed to participate in the pool then this will raise a distinction in treatment between two types of investors who might for example have dealt in following ways. Investor A gave a cheque for $100,000 to HFC, which was put into the trust account and improperly withdrawn immediately. Investor B gives a cheque to David Holden for $100,000 intending it to go to HFC but never deposited in the trust account of HFC. Investor B would not be entitled to participate in the pool and Investor A would.

While this appears to be an unfair distinction, in fact, the trust account never received anything from Investor B and as the Trustee's Report states "nothing in the document indicates that the funds were received or held by HFC in trust for any of the Additional Claimants". It would appear that the recommendation of the Trustee who appropriately acts for all of the investors in their best interest would result in the maximum benefit to the majority of the investors. It may be that none of the investors would realize anything if the Trustee's recommendation were not accepted by the court.

These practical considerations however do not govern. The questions that arise are questions of law and the court must determine whether an individual investor, for example, who has a mortgage registered in trust for him in whole or in part is subject to the advantage or disadvantage of ownership in that security.

DECISION

Additional Claimants

The Additional Claimants funds were not deposited in the trust account which is the subject matter of these proceedings. Accordingly whatever claim the Additional Claimants may have against others they have no claim against the trust account or the assets purchased with funds from the trust account. Any pooling arrangement sanctioned by the court will not include them. Although many of the affidavits filed show strong cases with regard to the expectation of the investors and the actions that led to these expectations, none of them satisfactorily prove that the funds invested by them became part of the trust account in question and therefore they are not entitled to share in the trust account or the assets purchased with the trust funds.

Claim of the Law Firm of Millard & McGillen

When Millard & McGillen received an uncertified cheque from HFC and chose to issue a cheque from their trust account in the same amount to advance on the mortgage in question, they created and registered a proper mortgage. Nothing has since been done to discharge that mortgage and the mortgage remains a proper charge on the title of the Robinsons. When payment was stopped and the HFC cheque dishonoured, this did not void the mortgage. The stopping of payment created a claim by Millard & McGillen against HFC and they are entitled to share in the pooling to the extent of this claim. The failure to pay the cheque left the funds in the trust account and the claim of Millard and McGillen is therefore a valid claim against these trust funds pro rata with the other claimants.

The Pooling Proposal

In order to consider whether any of the investors should be entitled to assignment of specific assets, I examine the strongest claim, that is of the investor Clark Harnden. If Mr. Harnden's claim to an assignment of a specific mortgage does not succeed, then none of the other investors who have claims that are not as strong as Mr. Harnden can succeed. Mr. Harnden as previously stated played an active role in the selection of the three mortgages in which his funds were to be invested. One of these mortgages was registered directly in his name and is not part of the pooling arrangement recommended by the Trustee. One of the mortgages was registered in the name of HFC in trust for Clark Harnden and this is the strongest case of any of investors for a specific interest in a particular investment. The third of the three mortgages was registered to HFC in trust with no reference to Mr. Harnden. It was repaid before maturity but HFC did not pay the proceeds to Mr. Harnden and to that extent he is entitled to be part of the pooling arrangement. The question to be determined is whether or not Mr. Harnden is entitled to an assignment of the specific mortgage registered in the name of HFC in trust for him. If so, then his participation in the distribution of assets will depend on the value of that specific mortgage. The case for Mr. Harnden is the strongest one because he unlike many other investors knew the specific property in which he was purchasing an investment. He, unlike most others, inspected the property and made his own assessment of the value of the property and the value of the covenant involved before agreeing to the investment. Mr. Harnden unlike many other investors has an arguable case that HFC was not entitled to transfer him to other securities without his consent. The funds from Mr. Harnden were deposited October 25, 1991 and the mortgage transaction closed November 4, 1991. In this instance, unlike many of the others, the mortgage funds were advanced after the cheque was received by HFC. In many of the investors cases the funds were advanced before the mortgage investment was made. In many others the funds were not put into a specific mortgage for as long as a year or more after the investment was made. But in Mr. Harnden's case there was an advance under mortgage made some ten days after the cheque was given to HFC. The Trustee argues that in that 10-day interval hundreds of thousands of dollars were improperly removed from the trust fund and therefore Mr. Harnden being unable to say that it was not his funds that were removed improperly in whole or in part cannot trace his funds to the investment in question. This raises important principles of law.

Is it necessary to trace the specific funds invested to the investment in order to establish ownership or can the original agreement be followed to the registration of the trust and ownership claimed of the security in question? A second question is - if the registration does not take place but is recorded on the books of HFC does this establish ownership even if the specific funds cannot be traced to the investment?

Before dealing with these questions however there is another matter. I have some concern that the general creditors of HFC were not represented in the proceedings. In the Manitoba Court of Appeal in the case of Re Manitoba Securities Commission v. Winnipeg Mortgage Exchange Ltd. et al. (1980), 113 D.L.R. (3d) p. 257 O'Sullivan J.A. speaking for the court said in part at p. 259:

> I deal first with the submission that there is a general trust in favour of all investors consisting of all of the assets of the companies in receivership. I note that no one was appointed to represent the general creditors. Although we are told the general creditors are not numerous, nevertheless in an action to declare a trust of all assets in favour of a group of investors to the detriment of general creditors, I do not think the general creditors can be affected without the opportunity to be heard.

In the Manitoba Securities Commission case which in some respects bears striking similarities to the present situation, O'Sullivan J.A. reviewed the decision of A.-G. B.c. v. A.-G. Canada et al., [1937] 1 D.L.R. 695 at p. 700 where Lord Thankerton for the Judicial Committee reviewed the meaning of insolvency. O'Sullivan J.A. pointed out that the description of an insolvency proceeding was adopted by the Supreme Court of Canada in Reference re Validity of Orderly Payment of Debts Act, 1959 (alta.), c. 61 (1960), 23 D.L.R. (2d) 449, [1960] S.C.R. 571, 1 C.B.R. (N.S.) 207. After considering these cases O'Sullivan J.A. stated at p. 261:

> In the case now before us I am not sure under what authority the receiver was appointed. Normally a receiver is appointed as an interlocutory step in an action by one or more creditors. Here the receiver was appointed on an originating notice of motion by the Manitoba Securities Commission. However, I do not question the validity of the appointment as the appointment of the receiver has not been challenged by anyone and he has acted under the order and appears to have been doing a creditable job in gathering the assets of the companies in receivership.

This is strikingly similar to the situation in the case before me in that the receivership was created on the originating notice of motion by the Ministry and not by any other particular investor or creditor.

In the Manitoba Securities case O'Sullivan J.A. also stated:

> However, I think that once it appears that the debtor is insolvent it is not appropriate to continue proceedings under provincial law. Indeed it may well be unconstitutional to do so. I think the proper course is to direct the receiver to make an assignment in bankruptcy.

I have concluded however that the case before me is very different than the Manitoba Securities case in that in the Manitoba Securities case the company was insolvent and the receiver was in charge of all of the assets of the company and the claim was for a trust security against general assets. In the case of HFC the trustee is in charge of a specific trust account so designated and the assets purchased with funds from the trust account. The deficiency is as a result of monies improperly removed from the trust account. There is no direct evidence with regard to the solvency of HFC although it is assumed by the Trustee that HFC is insolvent. However, the Trustee is not in possession of the general assets of HFC and it would in my view be improper to order that there be an assignment in bankruptcy of HFC at this stage with no direct evidence of insolvency and no action being taken by general creditors.

The effect of ordering that an assignment be made would be disastrous in that all of the proceedings to date would be wasted and the trustee in bankruptcy would have to start over to determine all of the questions that are before me with the right then of each individual Investor to contest the Trustee's determination. The expenses of the Trustee in having the proceedings so channelled might dissipate some or all of the assets with which I am now dealing.

While the Manitoba Securities case differs with respect to the form of the proceedings, it is a precedent with regard to the legal problem arising in the HFC case in that it defines the requirements to establish a trust. At p. 260 O'Sullivan J.A. stated:

> It may be that there are some few persons who may be able to establish some trust such as a trust arising out of the collection of money in those

> rare cases where an investor took an assignment of a mortgage and appointed the company as their agent to collect, but there would be in any event formidable difficulties in the way of tracing such trust money. (Emphasis added.)

These words apply even more strongly to the present case where no investor, even Mr. Harnden, can establish that their funds were the specific funds used to advance under a specific security. In every case money was removed from the trust account between the time that their cheque was deposited and the document indicating the trust was created. In some cases the intervening period was short and in others longer. In some cases funds were advanced under the security prior to the investment being made by the Investor. In all cases the actions by HFC as previously listed negated a specific ownership of the security. Once the trust fund and trust investments have been improperly dealt with and monies improperly taken each of the investors is in the position of being unable to trace their specific funds and therefore the trust with regard to that specific amount attributable to each investor has been mixed and cannot be traced. HFC cannot reinstate the trust relationship in favour of some investors against other investors by then registering assignments in favour of some investors in trust and designating some securities on the books of HFC as belonging to certain investors. The Trust Assets must therefore be treated as assets acquired by a single common fund (to which all the investors contributed) a portion of which was dissipated by the former trustee. In that circumstance the appropriate allocation of the trust assets and of the shortfall is on a pro rate basis relative to the respective contributions of the investors. Re Ontario Securities Commission and Greymac Credit Corp. (1986), 55 O.R. (2d) 673 (C.A.) affirming (1985) 51 O.R. (2d) 212 (H.C.), affirmed (1988) 65 O.R. (2d) 479 (S.C.C.). pro rata distribution is feasible and straightforward and is to be preferred to other distribution schemes. The investors who contributed to HFC in trust are known and the amounts that they invested with HFC in trust as at the date of the Trustee's appointment are known. It is therefore appropriate that the pro rata distribution scheme be approved by the court. Re Winsor v. Bajaj (1990), 75 D.L.R. (4th) 198 (Ont. Gen. Div.).

There will therefore be judgment adopting the recommendations of the Trustee; ordering a pro rata distribution amongst the investors; that the Additional Claimants are not to be part of the distribution; that the Robinson mortgage not be discharged and that the firm of Miller & McGillen be entitled to share in the pro rata distribution for the amount advanced by them out of their trust account on account of the Robinson mortgage.

It was argued that the Registry Act prevails and that the assignments registered in favour of some of the investors are binding because they are in fact registered, I do not accept this argument.

The Registry Act applies as to priorities of people having legitimate claims and in effect gives notice to subsequent registrants of the prior claim. This does not however prevent a registered claim from being defeated if in fact it is obtained by fraud or theft. In this case since I have found the acts of HFC in creating the securities in favour of certain investors to be improper, the Registry Act does not apply. The Registry Act sets priorities as between proper securities or proper title interests. It does not mean that a fraudulent interest in title become legitimate because it is registered nor would it mean that title obtained by theft became legitimate. Accordingly since these interests in title were created by the wrongful acts of HFC they are not protected by the Registry Act.

ROSENBERG J.

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Ranjoy Sales and Leasing Ltd. v. Estates of Winnipeg Mortgage Exchange Ltd.

[1982] M.J. No. 36

[1983] 1 W.W.R. 213

19 Man.R. (2d) 1

43 C.B.R. (N.S.) 119

Suit Nos. 235/82 and 236/82

Manitoba Court of Appeal

Freedman C.J.M., Monnin and Huband JJ.A.

Heard: September 7, 1982.
Judgment: November 1, 1982.

Bankruptcy -- Secured creditors -- Bankrupt companies buying mortgage on behalf of large number of investors -- Investors holding "good mortgages" seeking preferential treatment as secured creditors -- Fairness requiring all investors to be treated equally in accordance with pre-bankruptcy intentions -- Available assets to be pooled and distributed according to respective claims.

This was an appeal by a trustee in bankruptcy and certain creditors from a decision declaring that the respondents were secured creditors and entitled to be paid in priority to the appellant creditors. For a summary of the facts and decision under appeal see 82 DRS P94-081.

HELD (one diss.): The appeal was allowed. The disposition of this controversy required a consideration of two matters: (1) the intention of the parties when the transactions were entered into; and (2) the necessity for fairness in the ultimate result. Concerning the first, it could not be doubted that if, on the day before the bubble burst, the investors had all been asked whether each of them stood on the same level as the others, the answer would assuredly have been in the affirmative. An answer suggesting that the investors stood on different levels would have been inconsistent with the intention both of the investors and of the companies. As for the second to make preferred creditors out of those who by sheer luck received "good" mortgages would be to make the Court a slave to contingency and to deny the Court the power to do justice according to the maxim that equality is equity. All investors should therefore be treated equally by pooling the available assets and dividing them among the investors according to their respective claims as proved. The variations between the documents did not warrant a difference in treatment.

Counsel:

R.J. Scott, A. Anhang, D.M.R. Cheop and K.I. Simonsen, for the unsecured creditors of Winnipeg Mortgage Exchange Ltd. and Winnipeg Mortgage Holdings Ltd.
R.M. Kozminski, for Ranjoy Sales & Leasing Ltd.
H.I. Pollock and R.B. Doyle, for Alward, Rego, Rudnik and Seavers.
W.C. Kushneryk, for Down, trustee in bankruptcy.

Reasons for judgment were delivered by Freedman C.J.M. and concurred in by Monnin J.A. Separate partly dissenting reasons delivered by Huband J.A. (para. 15).

1 **FREEDMAN C.J.M.**:-- I am grateful to my brother Huband for having marshalled the facts of this case with clarity and in appropriate detail. It renders my task much less difficult. I propose to move on from his statement of facts to the enunciation of my conclusions.

2 Central to an understanding of this case is the recognition that the investors became such under circumstances that were markedly different from the usual case of this kind. Ordinarily a person wishing to invest his money in a mortgage will be concerned with the nature of the mortgage - what property is it on, what is the value of that property, is there a sufficient margin between the amount of the proposed mortgage and the total value of the property, is the personal covenant of the mortgagor reliable as an added protection in the event that things go sour and resort to that covenant becomes necessary? These are the kind of questions which will engage the attention of a prospective investor in the ordinary case. But not so here; and that is what makes this case unique, that is why it must be uniquely treated.

3 The evidence is clear that prospective investors in the present case exhibited a massive unconcern on the value or location of the property on which their mortgage would be placed, or on whether there was an adequate margin of safety between the amount of their mortgage and the value of the property. Nor did they give even a momentary thought to the worth of the mortgagor's covenant, since they did not have the slightest idea who that mortgagor might be.

4 Why then did they enter this trackless unknown to become investors? For the answer to this question we must turn our attention to the two companies here involved - Winnipeg Mortgage

Exchange Ltd. (WME) and Winnipeg Mortgage Holdings Ltd. (WMH) - and to the two men who ran these companies, namely Donald W. Reid and John Ross White.

5 I need not go back to the origin of WME. Rather I pick up the narrative at a point when the two companies were functioning with great success and in a manner in which they continued to function over several years into the future, until trouble descended upon them.

6 The main ingredients of this success are easily identified. They were three in number:

> (1) They paid investors interest on their money at a rate that was at least 2% higher than was currently available at other institutions; and
>
> (2) their cheques came to the investor every month without fail; and
>
> (3) the two companies guaranteed the investors that the monthly cheques would continue to be paid even if the mortgagor fell behind in his payments to them.

7 Here then was the attractive scenario: a high interest rate, regularity of payments, and a guarantee against default. It was enough to build for the two companies, and for Mr. Reid and Mr. White, a solid reputation for integrity, leading to a successful operation by the companies, with the investors emerging as happy beneficiaries of that success. That is why the investors were content to put up their money with no concern about its destination, whether it would go to mortgage A or mortgage B or mortgage C. That is why they were content to allow the mortgage to be taken in the name of the company. That is why they were also content to leave the management and control of the mortgage to the company.

8 All went well for some years. Trouble began when the operation moved into British Columbia. As outlined by my brother Huband, heavy losses began to be incurred, of such dimensions that ultimately the companies were unable, despite their guarantee, to continue the monthly payments to the investors.

9 The nature of the mortgage investment, a matter of no concern when things were going well, suddenly became a thing of importance, when financial reverses were encountered. For some investments had found their way into "good" mortgages, and others into "bad" mortgages. The holders of the good mortgages say they should be paid first, any balances of funds remaining to be divided among the holders of the bad mortgages. The latter contend that all the assets should be pooled and divided among all the investors in proportion to the amount of their respective claims as proved.

10 The problem facing us is a difficult one. Its solution calls for the application of principles of equity, but without arbitrariness. I find assistance in reaching that solution in the following extract from the evidence of Mr. White, at pp. 2097 and 2098:

> Q. And from your perspective as an equal owner of Winnipeg Mortgage Exchange, was it your perspective that investors would be dealt with differently, depending upon whether the underlying mortgage that was being purchased and registered in the name of Holding was good or bad, or did you have some other concept of your obligation of the investors as a total group?
>
> A. Very much the concept that all investors were to be treated equally and that there was to be no preference to one investor over the other because of the status of any particular mortgage.
>
> Q. And why was that your perspective?
>
> A. Because we, in effect, that was the way we did our business. That's what we needed in order to make our business successful over the years, was treating everyone the same and making up any losses out of our profits, that was needed.
>
> Q. And if I suggested to you that a fact that entered into your answer, as well, was that the investor had really no control over what mortgage was allocated to him, would that be another reason for your perspective?
>
> A. He had no control. There is no question about the fact that he could ask any questions he wanted, be shown any documents that he wanted at the time he purchased the mortgage, but basically, those questions were very, very rarely asked and he had no control over it, really.
>
> Q. And when they were asked what the investor was interested in was whether or not he could be allocated part of a mortgage that equated with the amount of money he had to invest. He was interested in the term and he was interested in the interest rate?
>
> A. That is correct.
>
> Q. And whether the description of the mortgage said Enderby or Kilpatrick #2 or Afghanistan, really didn't matter?
>
> A. That is correct.
>
> Q. And that's what I mean by control.
>
> A. Yes.
>
> Q. And in that sense the investor didn't have any control over which mortgage was selected and allocated to him?
>
> A. That is correct. He was allocated whatever mortgage we had on the books at the time.
>
> Q. And absolutely no control over whether the mortgage ultimately turned out to be a quote, "good mortgage" or a quote "bad mortgage"?
>
> A. That is correct.
>
> Q. It was just the luck of the draw?
>
> A. That is correct.

11 In the light of the facts emerging from that extract, it would be grossly unfair to give a preferred position to those who happened to have been allocated "good" mortgages, and a subordinate position to those who were allocated "bad" mortgages. Our disposition of the controversy should reflect two things - (1) the intention of the parties when the transactions were entered into, and (2) the necessity for fairness in the ultimate result. Concerning the first, it cannot be doubted that if, on the day before the bubble burst, the investors had all been asked whether each of them stood on the same level as the others the answer would assuredly have been in the affirmative. An answer suggesting that the investors stood on different levels would have been inconsistent with the intention both of the investors and of the companies. As for the second, to make preferred creditors out of those who by sheer luck received "good" mortgages would be to make ourselves slaves to contingency and to deny ourselves the power to do justice in accordance with the maxim that equality is equity. I would treat all the investors equally by pooling the available assets and dividing them among the investors according to their respective claims as proved.

12 I touch briefly on two other matters. One concerns the claim of Ranjoy Sales & Leasing Ltd., a company owned or controlled by Mr. Jim Gauthier. He, alone among the investors, did put some questions to Mr. Reid concerning the investment. But in the last analysis he accepted without demur a mortgage different from the kind he had requested. His acquiescence in that regard, in the context of the facts above set forth, disqualifies him from now demanding separate treatment from that of the other investors.

13 Finally, the judgment of my brother Huband shows that the documentation arising from the investments was of four different types. The differences in language, in my view, do not necessarily require a difference in treatment. All the documents should be considered in relation to the intention of the parties, a matter on which we already have had the clear declaration of Mr. White, a declaration applying to all the transactions and not merely to some. As for the investors their intention can be deduced from their conduct, and there was nothing in their conduct, prior to the collapse of the companies, in any way inconsistent with the true nature of the transactions as Mr. White has described them. That his evidence on that point was admissible is attested to by Phipson on Evidence (11th Ed. 1793) in these words:

> Extrinsic evidence (including, in some cases, direct declarations of intention) is admissible to show the true nature of the transaction, or the legal relationship of the parties, although such evidence may vary or add to the written instrument. I conclude, therefore, that the variations between the documents do not warrant a difference in treatment. All the investors, whether falling within one of the four classes or another, should be treated in the same way.

14 In the result I would allow the appeal and direct pooling and distribution of the available assets as above indicated. Costs may be spoken to.

INTRODUCTION

The following is the judgment of:

15 HUBAND J.A. (dissenting in part):-- Winnipeg Mortgage Exchange Ltd. (W.M.E.) and its subsidiary, Winnipeg Mortgage Holdings Ltd. (W.M.H.), are bankrupt companies. There are hundreds of creditors. Some claim that they are entitled to monies now in the hands of the trustee in bankruptcy on the basis of a trust relationship with W.M.E. and/or W.M.H. Alternatively, those same creditors (the applicants) claim that they are secured creditors and entitled to exercise their rights under their security. The applicants are being opposed by the trustee in bankruptcy representing the unsecured creditors.

16 The applicants are individuals or corporations who "invested" with W.M.E. They did not receive the same sort of documentation from W.M.E. The documents indicate that some investors purchased mortgages. Some purchased parts of mortgages. Some loaned money to W.M.E. on the security of a mortgage of a mortgage, or part of a mortgage of a mortgage. In all cases however the documentation (the transfer of mortgage, or the mortgage of mortgage, as the case may be), was not delivered to the individual applicant. Instead, each applicant received a "trust agreement" in which W.M.H. declared that it held certain property in trust for the applicant/customer.

17 Because the documentation varied from one customer to another, a number of "test cases" were brought before Wright, J., of the Court of Queen's Bench in Bankruptcy. The first of the series was that of the applicant Ranjoy Sales & Leasing Ltd. The documentation is in the name of Pan Am Motors Ltd., which was the corporate name of Ranjoy at the time. A trial hearing devoted to the Ranjoy application took place on June 22 and 23, 1981. A second trial took place over a period of nine days in February, 1982, in which documentation provided to the applicants Elizabeth D. and Harry B. Alward, Madeleine and Antonio Rego, Theodore J. and Margaret N. Rudnik, and Walter Murray Seavers, was considered.

18 On March 26, 1982, Wright, J., delivered reasons for judgment in all of the test cases. He concluded that the documentation provided to Ranjoy created a valid trust which entitled Ranjoy to claim the monies in the hands of the trustee in bankruptcy. He also ruled that the documentation created an equitable mortgage of a mortgage which made Ranjoy a secured creditor and entitled Ranjoy to the same relief by way of an alternative mechanism. The same conclusion was reached relative to the documentation considered by Wright, J., with respect to Alward and Rudnik. Concerning Seavers, Wright, J., concluded that Seavers was protected as beneficiary of an express trust, not as a secured creditor. With respect to Rego, he concluded that an express trust had not been created, but that an equitable mortgage of a mortgage gave the Regos protection as secured creditors.

19 The unsecured creditors have appealed these rulings.

HISTORICAL BACKGROUND OF W.M.E. and W.M.H.

20 In each of the test cases the documentation is crucial to the determination of the applicant's rights, - as beneficiary of a trust or as a secured creditor. Nevertheless, that documentation and the variations and mutations which took place in the form of the documentation with the passage of time, should be seen in the historical context of W.M.E.

21 W.M.E. was incorporated and began doing business in Manitoba in 1959. Its president and sole shareholder was Donald Reid, a lawyer-businessman. It started as a mortgage brokerage business. Reid would find the owner of a mortgage who was interested in selling his mortgage interest. He would find a buyer for the mortgage, and W.M.E. would make its profit by charging a commission for having brought vendor and purchaser together.

22 The business was successful; customers were pleased with their dealings with W.M.E.; the operation expanded.

23 In 1966 John Ross White, a long time friend and a graduate in commerce, joined Reid as an equal shareholder of the company, and became the corporate secretary.

24 The nature of the business altered. Instead of simply introducing the seller of a mortgage interest to a buyer and charging a commission, W.M.E. began to purchase mortgages at a discount and then reselling at face value or close to face value, making its profit on the difference in price. Sometimes the mortgage acquired by W.M.E. would be resold to a single purchaser, but on some occasions the mortgage would be resold to two or more purchasers, each of whom would obtain a proportionate interest in the mortgage. The test case involving Seavers involved a transaction of this kind.

25 A change in the way business was conducted led to the incorporation of W.M.H. in 1966. It is a wholly owned subsidiary of W.M.E. It came into being when questions were raised as to the capacity of W.M.E. to own a mortgage, and a new corporate entity having that authority was required. It is common ground that for the purposes of this litigation W.M.E. and W.M.H. should be treated as a single entity. In the course of these reasons I intend to refer to W.M.E. and W.M.H. interchangeably.

26 By the late 1960's or early '70's, the business practise of W.M.E. changed again. It was difficult for W.M.E. to acquire good residential mortgages at a discount and so a different mechanism was devised. W.M.E. would purchase a mortgage and then resell it to its investor-customers, but with W.M.E. retaining an interest differential. That is to say, W.M.E. might acquire a mortgage with interest at 16% and then sell the mortgage to one or more of its customers at 12% interest. The applicants Theodore J., and Margaret N. Rudnik made three separate "investments" with W.M.E., two of which were in the category of purchases of part of a mortgage owned by W.M.H. In both cases the mortgage was not completely sold in that there was a residue of the interest differential retained by W.M.H.

27 In the mid-1970's a more substantial change in the way W.M.E. conducted its business took place. W.M.E. (through W.M.H.) continued to acquire mortgages. It would at first purport to sell the mortgage to one or more of its customer-investors. But the documentation which would then follow indicated that the customer-investor was not purchasing the mortgage, but rather was lending money on the security of a mortgage of part of a mortgage. Whether the customers appreciated it or not, it would appear that they were no longer making purchases from W.M.E., but rather were lending their money to W.M.E. The action commenced by Ranjoy involved four separate "investments", which fell within this category. The Alward claim is based upon identical documentation. One of the Rudnik "investments" is supported by the same documentation. With slight but significant amendment, that is also the nature of the eight Rego "investments", which were tested in court before Wright, J.

28 The person who developed the package of documentation which each customer received was W.M.E.'s president, Donald Reid. In every instance the package of documents consisted of a "purchase contract", a letter of allocation, and a "trust agreement". In some instances there was additional documentation such as an amortization table or some additional correspondence, but the common denominator of all transactions was the purchase contract, the letter of allocation, and the trust agreement.

29 While the form of the purchase contract changed over the years, its effect remained the same. The document, signed by the customer, recites that the customer has purchased an "approved" mortgage from W.M.E. for a certain price. The document identifies the mortgage by way of an address or a mortgage registration number. The document indicates what the customer can expect to receive; - "X" dollars per month, "Y" interest rate, and a term of "Z" years. The major modification which took place in the purchase contract was to add provisions giving W.M.E. a free hand in the administration of the mortgage, including taking foreclosure or other proceedings without consultation or notice to the customer-investor. There were good reasons why a customer would be prepared to give W.M.E. this broad authority. One of the special attractions of an investment with W.M.E. was that Messrs. Reid and White orally guaranteed the monthly payments. As a public relations feature they undertook to pay the monthly sums to the customer-investors regardless of whether W.M.E. received the payment from the mortgagor under the mortgage being administered. Given that guarantee, customers were content to allow W.M.E. a free hand in the administration of the business without customer interference.

30 The allocation letter advised the customer-investor that his money had been used to purchase either the whole or part of a particular mortgage owned by W.M.E. The allocation letter also enclosed the third and most important element of the package of documents, namely, the trust agreement. In the test cases involving the four Ranjoy investments, the Alward investment, one of the Rudnik investments and the eight Rego investments, the letter of allocation is contrary to what is spelled out in the trust agreement, in that the trust agreement does not indicate that a purchase of a mortgage has been made, but rather that there has been a mortgage of a mortgage.

31 As previously noted the trust agreements, containing many features in common, differed in form. On the following pages the four types of trust agreements are reproduced. The samples are as follows:

A. The Seavers trust agreement relative to the purchase of mortgage 7165 K.C.;
B. The Rudnik trust agreement relative to the purchase of mortgage 74-1108083;
C. The Alward trust agreement relative to mortgage M69747;
D. The Rego trust agreement relative to mortgage M53578.

'A'

TRUST AGREEMENT

WINNIPEG MORTGAGE HOLDINGS LTD. hereby certifies:-

1. THAT it is named as the owner of a Mortgage dated the 17th day of September A.D. 1969, made between STANLEY W. PAWCHUK as Mortgagor, and WESTERN DEVELOPMENT CORPORATION LTD. as Mortgagee, and registered in the Calgary Land Titles Office as No. 7165 K.C. and transferred to WINNIPEG MORTGAGE HOLDINGS LTD. by a Transfer of Mortgage registered in the Calgary Land Titles Office on the 16th day of April A.D. 1969 at 2:08 p.m. as No. 3628 K.J., and affecting the lands described in the above Mortgage and that the said Mortgage secured SIXTY-FOUR HUNDRED and THIRTY and TWENTY ONE-HUNDREDTHS ($6,430.20) DOLLARS, as at the 15th day of April A.D. 1969.
2. THAT One-third of the said Mortgage was sold to WALTER SEAVERS for the sum of TWENTY-ONE HUNDRED and FIVE and FORTY ONE-HUNDREDTHS ($2,105.40) DOLLARS.
3. THAT WINNIPEG MORTGAGE HOLDINGS LTD. holds and stands possessed of the said Mortgage as Trustee for the said WALTER SEAVERS.
4. THAT it shall remit one-third of all moneys received by it pursuant to the said Mortgage including the final payment to the said WALTER SEAVERS by forwarding a cheque for the same payable to the order of the said WALTER SEAVERS.
5. THAT in the event of the said WALTER SEAVERS assigning his interest in the said Mortgage to any person, firm or corporation and giving WINNIPEG MORTGAGE HOLDINGS LTD. written notice of such assignment, that it shall stand possessed of the same interest for the said assignee and in the same manner and under the same terms and conditions as herein set forth.

WINNIPEG MORTGAGE HOLDINGS LTD.,

Per: 'D.W. Reid' President -----------

'L.S.'

Per: 'Ross White' Secretary -----------

'B'

TRUST AGREEMENT

WINNIPEG MORTGAGE HOLDINGS LTD. hereby certifies:-

1. THAT it is named as the owner of a Mortgage dated the 22nd day of November A.D. 1974, and registered in the Land Titles Office as No. 74-1108083.
2. THAT on the 25th day of November A.D. 1974, part of the said Mortgage was purchased by MARGARET RUDNIK and THRODORE RUDNIK, (herein called the purchaser) for the sum of TWO THOUSAND ($2,000.00) DOLLARS. That this part of the mortgage bore interest at 12 1/2%, was repayable at $22.00 per month, and terminates the 1st day of December A.D. 1979.
3. THAT WINNIPEG MORTGAGE HOLDINGS LTD. holds and stands possessed of part of the said Mortgage as Trustee for the said purchaser.
4. THAT it shall remit part of all moneys received by it pursuant to the said Mortgage to the said purchaser.
5. THAT in the event of the said purchaser assigning his/her interest in the said Mortgage to any person, firm or corporation and giving WINNIPEG MORTGAGE HOLDINGS LTD. written notice of such assignment, that it shall stand possessed of the same interest for the said assignee and in the same manner and under the same terms and conditions as herein set forth.

WINNIPEG MORTGAGE HOLDINGS LTD.,

Per: 'D.W. Reid' President -----------

'L.S.'

Per: 'Ross White' Secretary -----------

'C'

TRUST AGREEMENT

WINNIPEG MORTGAGE HOLDINGS LTD. hereby certifies:-

1. THAT it is named as the owner of a Mortgage dated the 22nd day of November A.D. 1977, and registered in the Land Titles Office as No. M 69747.
2. THAT on the 11th day of January A.D. 1978, it mortgaged the said mortgage to ELIZABETH D. ALWARD & HARRY B. ALWARD, for the sum of THIRTY THOUSAND ($30,000.00) DOLLARS, to bear interest at 10 1/2%, to be repayable at $270.00 per month and to terminate the 15th day of December 1982.
3. THAT it now holds and stands possessed of the said mortgage as Trustee for the said purchaser.
4. THAT it shall remit the above mortgage payment monthly to the said purchaser.
5. THAT in the event of the said purchaser assigning his/her interest in the said Mortgage of Mortgage to any person, firm or corporation and giving WINNIPEG MORTGAGE HOLDINGS LTD. written notice of such assignment, that it shall stand possessed of the same interest for the assignee and in the same manner and under the same terms and conditions as herein set forth.

WINNIPEG MORTGAGE HOLDINGS LTD.

Per: 'D.W. Reid' President -----------

'L.S.'

Per: 'Ross White' Secretary -----------

'D'

TRUST AGREEMENT

WINNIPEG MORTGAGE HOLDINGS LTD. hereby certifies:-

1. THAT it is named as the owner of a Mortgage dated the 29th day of August A.D. 1977, made between STANLEY E. ARNOLD, as Mortgagor and SKEENA MORTGAGE & INVESTMENTS LTD. as Mortgagee, and registered in the Land Titles Office as No. M 53578 and that such Mortgage has been transferred to THOMPSON VALLEY PROPERTIES LTD. by Transfer of Mortgage No. M

53579 and that such mortgage has again been transferred to WINNIPEG MORTGAGE HOLDINGS LTD. by Transfer of Mortgage No. M 54936 and affecting the lands described in the above Mortgage and that the said Mortgage secured SIXTY-SEVEN THOUSAND and FIVE HUNDRED (67,500.00) DOLLARS as at the 15th day of September A.D. 1977 and terminating the 15th day of September A.D. 1982.

2. THAT part of the said Mortgage was mortgaged to MADELINE REGO and ANTONIO REGO for the sum of FIVE THOUSAND ($5,000.00) DOLLARS, with interest of 10 1/2% and monthly payments of $45.00.
3. THAT WINNIPEG MORTGAGE HOLDINGS LTD. holds and stands possessed of part of the said Mortgage of Mortgage as Trustee for the said MADELINE REGO and ANTONIO REGO.
4. THAT it shall remit part of all moneys received by it pursuant to the said Mortgage of Mortgage to the said MADELINE REGO and ANTONIO REGO.
5. THAT in the event of the said MADELINE REGO and ANTONIO REGO assigning their interest in the said Mortgage on Mortgage to any person, firm or corporation and giving WINNIPEG MORTGAGE HOLDINGS LTD. written notice of such assignment, that it shall stand possessed of the same interest for the said assignee and in the same manner and under the same terms and conditions as herein set forth.

WINNIPEG MORTGAGE HOLDINGS LTD. 'W. Cornack' for
Per: 'D.W. Reid' President ----------- 'L.S.'
Per: 'Ross White' Secretary ------------

32 It will be observed that these four sample documents have some common characteristics:

1. None of the "agreements" is dated, but the date that the whole or part of the underlying mortgage was sold or mortgaged to the customer-investor is specified.
2. They are not trust "agreements" at all, but rather trust declarations made by W.M.H. under which W.M.H. purports to constitute itself trustee of certain property for the customer-investor.
3. In each case the trust declaration certifies that W.M.H. is the owner of a mortgage. The mortgage is identified with greater or lesser particularity. In documents B and C, the reference is to a number only. The document does not indicate the location of the Land Titles Office where the underlying mortgage is registered. The identification of the mortgage, however, does not constitute a problem. The books and records of W.M.E., supplemented by inquiry after receivership and bankruptcy had taken place, was sufficient to properly identify the mortgage number in the trust agreements with a specific mortgage owned by

W.M.H.

4. Each of the trust agreements contains a clause which permits the customer-investor to assign his interest.

33 There are, however, profound differences between the four types of trust agreements.

1. The Seavers trust agreement, document A, indicates that the customer-investor has purchased a part of a mortgage, and it specifies with precision that the part is precisely one-third.
2. The Rudnik agreement, document B, also refers to the purchase of part of a mortgage, and there is reference to the amount, and the terms of repayment, including interest of 12 1/2%. In fact, the underlying mortgage owned by W.M.H. bore a higher interest rate than 12 1/2%. Of greater significance, the Alward and Rego agreements, documents C and D, make no reference to a purchase at all. On the contrary, the document indicates that W.M.H. has mortgaged its mortgage to the customer-investor for a certain sum repayable on specified terms.
3. Paragraphs 3 and 4, taken in conjunction, constitute the trust declaration in all of the trust agreements. In the Seavers agreement, document A, W.M.H. holds and stands possessed of the mortgage which Seavers has purchased, as trustee for him. There is a declaration that one-third of the money that W.M.H. receives as payments on the mortgage will be remitted to Seaver. Reading paragraphs 3 and 4 together, it seems to me to be an inescapable conclusion that, prima facie, a trust has been constituted covering those monies. The Rudnik agreement, document B, is almost the same, except that para. 4 states that part of all monies received by W.M.H. under the underlying mortgage will be remitted to the Rudniks. The Rudniks, of course, had purchased only a part of the underlying mortgage, not the whole of it. W.M.H. retained an interest differential which it intended to keep as its profit margin.
4. Once again, more profound differences appear in the Alward and Rego documents. In document C the trust declaration encompasses "the said mortgage", but the document does not make it clear whether "the said mortgage" is the underlying mortgage referred to in para. 1, or the mortgage of the mortgage referred to in para. 2. Paragraph 4 states that W.M.H. shall remit "the above mortgage payment", and that, quite clearly, refers to the monthly payment under the mortgage of the mortgage.
5. In document D, para. 3 is more specific, and indicates that the trust res is simply the mortgage of the mortgage, and not the underlying mortgage. To say the least, the language is garbled. Paragraph 3 states that W.M.H. "holds and stands possessed of part of the said mortgage of mortgage ... ". I think it is obvious that the phrase should read that W.M.H. "holds and stands possessed of the said mortgage of mortgage as trustee for the said Madeline Rego and Antonio Rego".

> Paragraph 4 of document D makes it clear that there is no trust embracing monies received by W.M.H. under the underlying mortgage. The covenant is simply to remit monies owing to the customer-investors under the mortgage of the mortgage, which is nothing more than a covenant to repay a loan.

34 The variations in the documentation made no practical difference to the customers of W.M.E. All of them continued to receive their regular monthly payments, oblivious to any underlying difficulties facing W.M.E. In the late 1970's W.M.E. encountered investment problems. Some of the mortgage investments, particularly those located in British Columbia, began to go sour. W.M.E. abandoned a policy which had served it well, of acquiring mortgages on residential property only. In order to obtain a better interest rate, W.M.E. purchased commercial mortgages, - many of them second or third mortgages. In British Columbia W.M.E. used an agent who received payment, thus reducing the profit factor, and perhaps necessitating riskier commercial mortgages. Defaults occurred, but in spite of those defaults W.M.E. maintained its policy of making regular monthly payments to all of its customer-investors. The money had to come from somewhere. W.M.E. borrowed money to be used to pay regular monthly payments to its customer-investors. It obtained revenues from W.M.E.'s own profit margin, from monies paid in by investor-customers but not yet allocated to a specific mortgage, from monies unexpectedly prepaid on a mortgage owned by W.M.E. (Some customer-investors accepted the invitation of W.M.E. to leave the payments due to the customer-investor on deposit for reinvestment when an "approved" mortgage became available. These monies were to be held by Pyramid Investment Corporation Limited, a subsidiary of W.M.E. Money from Pyramid was used to keep existing accounts up to date. Pyramid was placed into receivership and ultimately into bankruptcy along with W.M.E. and W.M.H.)

35 It is obvious, looking at the situation in retrospect, that sooner or later the bubble had to burst, and it did. An application was made to the Manitoba Court of Queen's Bench by the Manitoba Securities Commission, and pursuant to that application Thorne Riddell Inc. was appointed receiver and manager of W.M.E. on August 16, 1979. It did not take long for the receiver-manager to determine that W.M.E. was in a financial mess. The claims of customer-investors, together with other creditors, amounted to around $16,000,000.00. The probable value of the assets owned by W.M.E. might amount to approximately two-thirds of that sum.

36 It was found that many of the mortgages owned by W.M.E. were, and remain, sound. But other mortgages were in default. In some instances there was little expectation that the investment would be preserved by mortgage sale or foreclosure proceedings. W.M.E. had simply made bad investments.

37 The management of W.M.E. had also taken some bizarre steps which were prejudicial to its customer-investors. In the Fourth Interim Report of the receiver-manager the process of "double layering" of mortgages is discussed and explained. In the following quotation reference is made to Thompson Valley Properties Ltd. (T.V.P. Ltd.), which was acting as agent for W.M.E. in the province of British Columbia.

Reference has been made from time to time during examinations for discovery and otherwise to 'double layer' mortgages. This is a term which has been used to refer to mortgages acquired by Winnipeg Mortgage Holdings Ltd. usually for no consideration, to be sold to investors, thus producing cash to refund prior mortgage payouts and/or other foreclosure costs on a mortgage(s) previously held on the same property. For example, when a first mortgagee on a property which WMH Ltd. in second position foreclosed and the redemption date arrived either without the property being sold (or where a sale of the property could only be made for a price sufficient to pay out the first mortgage thus wiping out the equity of WMH Ltd.) WMH Ltd. would pay out the first mortgagee, thus obtaining an assignment of their foreclosure proceedings and their right to apply for Order Absolute vesting title. Title would be placed in the name of WMH Ltd., and transferred to Thompson Valley Properties Ltd. or registered directly in the name of TVP Ltd. TVP Ltd. would then execute and register a new mortgage in favor of WMH Ltd. for an agreed amount, usually equal to the first mortgage paid out plus an amount described as, 'to bring the mortgage current'.

The result of this foreclosure procedure was that the second mortgage formerly held by WME Ltd. and allocated to a group of investors was extinguished. The investors to whom that mortgage had been allocated do not appear to have been notified and continue to hold trust certificates with registration numbers referring to the mortgage which no longer exists, the property having been acquired by WMH Ltd. by foreclosure. A new set of investors was allocated to the new first mortgage placed by TVP Ltd. as registered owner in favor of WMH Ltd. Often no funds were disbursed for this mortgage, but the proceeds received from investors would be used to replace the cash which had been paid out of the trust account to redeem the first mortgage. WME Ltd. would now show two 'mortgage' accounts, one designated with the original name of the extinguished mortgage and still allocated to the same investors, and the new first mortgage designated with the same name followed by 'No. 2'. This mortgage would be allocated to a new set of investors, from whom cash equal to its declared value would have been obtained.

38 The internal management of W.M.E. was almost as bad as its external investment policy. W.M.E. maintained a single bank account into which all monies were indiscriminately mixed. It was designated as a "trust" account, but in practise it was anything but a trust account. The money of the customer-investor was put into that account. So was the income of W.M.E. So were the mortgage payments received by W.M.E. on the mortgages owned by W.M.E. So were monies borrowed by W.M.E. from its banker. By the same token, money was paid out of this mixed fund for a variety of purposes; - to acquire new mortgages for W.M.E., to pay the monthly payments to

W.M.E.'s investor-customers, and to pay office overhead and salaries.

39 As soon as receivership occurred, W.M.E.'s investor-customers became alarmed. Each of them was armed with documentation, including the trust agreement, which contained reference to an underlying mortgage owned by W.M.E. In some instances that mortgage was healthy. In many instances the mortgage was in default and based upon shaky security. In some instances, as when double layering had taken place, the underlying mortgage had been extinguished without notice to the investor-customer.

40 Where the underlying mortgage remained healthy, the investor-customer demanded that he continue to receive full payment from the receiver as indicated in his 'trust agreement'. Where the mortgage was in default, or non-existent, the customer-investor urged the receiver to pool all mortgage assets and divide them rateably among all customer-investors. The receiver was uncertain as to how to proceed, and accordingly, in November, 1979, the receiver brought a motion before Wright, J., of the Court of Queen's Bench seeking advice and direction on a number of specific questions. The major question presented to the court for advice was whether the "trust declarations" issued to customer-investors entitled them to the proceeds of the underlying mortgages identified therein.

41 That, and other lesser questions, were considered by Wright, J., who delivered written reasons in response to the questions on March 28, 1980. Wright, J., answered the major question with "a qualified 'yes'". In the course of his opinion Wright, J., expressed his view that the relationship between W.M.E. and customer-investors was not that of debtor and creditor. He was of the view that each investor was entitled to a trust interest of some kind, but he did not determine the precise nature of that trust interest. He said that each investor should be given the opportunity to establish the precise nature of the trust in his favour.

42 An appeal from the advice and direction of Wright, J., was then brought before a panel of this court, consisting of the Chief Justice, O'Sullivan, J.A., and Huband, J.A. On July 24, 1980, reasons for decision, authored by O'Sullivan, J.A ., on behalf of the court, were handed down. The appeal was allowed and the order of Wright, J., was set aside. It was the view of this court that, W.M.E. being insolvent, it should be put into bankruptcy. The claims of creditors could then be dealt with in the context of bankruptcy proceedings. Creditors claiming a trust would be entitled to claim their entitlement to specific trust property and to assert that such property did not form part of the bankrupt estate. Creditors claiming to be secured would be allowed to value and prove their security in the normal course of bankruptcy proceedings. Bankruptcy provided an orderly mechanism for the determination of the individual claims in preference to the broad brush approach of obtaining advice and directions. The judgment of the Court of Appeal, however, goes beyond the procedural desirability of dealing with claims in the context of a bankruptcy. O'Sullivan, J.A., on behalf of the court, disagrees with the opinion expressed by Wright, J.

> The learned trial judge gave a qualified 'yes' to the question submitted by

> the receiver. In my opinion this qualified yes is not a satisfactory response to the question since it leaves the determination of the alleged trust interests to further proceedings.
>
> I must say on the face of it that, on the basis of the evidence adduced to this point, I see little indication of any trust relationship. In most of the 'trust' declarations, the investor is described as the mortgagee of a specific mortgage. It seems to me obvious that investors must have known the companies were going to make a profit of some kind. There was no provision in their arrangement with the companies for commissions on collection. The only way the companies could make profit was by having a differential between the interest rate on their mortgages and the interest rate on the mortgage of mortgage which were given to investors. The trust declaration appears to have reference to the mortgage of mortgage document rather than to the holding in trust of a property interest. I think it is well settled that the relationship of a mortgagee and mortgagor is that of debtor and creditor. Hence, the mortgagor, whether of a fee simple or of a mortgage, is not a trustee for his mortgagee.
>
> It seems evident that most of the investors were or were intended to be secured creditors but that does not make them beneficiaries of a trust. A mortgagee of a mortgage lends money to the mortgagor of the mortgage and expects to be secured. It may be that in some cases the security is worthless but that does not in itself turn the mortgagee into a trust beneficiary.

43 This court gave a warning in the clearest possible terms that customer-investors holding an equitable mortgage of a mortgage were in a most precarious position. On the face of it their relationship with W.M.E. was that of creditor-debtor. To the extent that the trust agreement established an express trust, the trust res would be the equitable mortgage of a mortgage, not the underlying mortgage nor the monies being paid to W.M.E. under that mortgage. In terms of claiming security, the security might consist of no more than the documentation, and the right of the investor-customer to do with it what he might in order to effect collection under the equitable mortgage of a mortgage.

44 In the bankruptcy proceedings approximately 650 persons filed proof of claim. Of those, 345 filed as secured creditors, and about 90 filed a claim under s. 59(1) of the Bankruptcy Act, R.S.C. 1970, c. B-3, claiming a trust interest in certain mortgage assets taken over by the trustee in bankruptcy. A number of those claims were then tested in court before Wright, J.

PROCEEDINGS IN THE COURT OF QUEEN'S BENCH, IN BANKRUPTCY

45 The first test case which came before Wright, J., was that of Ranjoy. The pleadings consisted of an originating notice of motion seeking an order of the court that the trustee in bankruptcy turn over to Ranjoy certain assets of the bankrupt "which have been encumbered to the applicant herein by virtue of a mortgage of a mortgage pertaining to the following ... ". Reference was then made to three mortgages ostensibly owned by W.M.H. relative to land located in British Columbia. When the matter came before Wright, J., for hearing, counsel for Ranjoy raised two arguments, - the one being an alternative to the other. It was argued that the trust agreement had created an express trust of which Ranjoy was the beneficiary. The subject matter of that trust cannot be included in the bankrupt estate. Section 47 of the Bankruptcy Act states that the property of a bankrupt, divisible among his creditors, shall not comprise property held by the bankrupt in trust for any other person. Counsel for Ranjoy further argued that the trust res was, in each of three instances, the underlying mortgage legally owned by W.M.H., relating to real property in British Columbia.

46 The alternative argument pressed by counsel for Ranjoy is that Ranjoy is a secured creditor under the Bankruptcy Act, and is entitled to the rights and remedies of a secured creditor.

47 Wright, J., held in favour of Ranjoy on both grounds. He held that Ranjoy was a secured creditor and as such "may then exercise its rights against the main mortgage security in the ordinary course as permitted by the Bankruptcy Act". He also held that Ranjoy had established a trust. It is evident that Wright, J.. proceeded on the assumption that the trust res was the underlying mortgage, not the mortgage of a mortgage. He held that monies already paid to the receiver-manager and subsequently the trustee in bankruptcy under the underlying mortgage, and monies still to be paid under that mortgage, were impressed with a trust in favour of Ranjoy, at least up to the amount owing to Ranjoy.

48 There is a feature of the Ranjoy claim which is different from the other claims which were tested before Wright, J., in that Ranjoy, from the outset, requested of Mr. Reid of W.M.E. that he be allowed to purchase whole mortgages. Four investments were made by Ranjoy, three of which were still outstanding at the date of receivership, and all of them were in that category. The face value of the underlying mortgage matched the amount of each investment made by Ranjoy, although in each instance there was a mortgage differential which was the factor by which W.M.E. hoped to make a profit. Although Ranjoy spoke of purchasing whole mortgages, in fact the ultimate documentation, to Ranjoy's knowledge, referred to a mortgage of a mortgage rather than the sale of a mortgage.

49 The second test case which came before Wright, J., involved four clients represented by the law firm of Pollock and Company. Those four clients were Seavers, Alward, Rudnik and Rego. A statement of claim had been filed on behalf of each of the claimants. The pleadings are all similar in form. Each statement of claim asserts a trust, or alternatively, a declaration that the plaintiff is a secured creditor. Using the Alward statement of claim as an example, the essential parts of the prayer for relief read as follows:

> The plaintiffs therefore claim:

(a) a declaration that the document entitled Trust Agreement, together with other documents, representations, or undertakings received by the plaintiffs created a trust entitling the plaintiffs to claim the property described in the document entitled Trust Agreement;

(b) alternatively, for a declaration that the plaintiffs are secured creditors as defined by the Bankruptcy Act.

50 Wright, J., held that claims based upon documentation such as that in the Seavers case (document A) give rise to a trust which provided protection to the claimant. He reached a similar conclusion concerning claims comparable to the Rudnik claim supported by a trust agreement in the form of document B. So too with documentation in the form of the Alward trust agreement, document C. He held, however, that the documentation supporting the Rego claims was insufficient to support an express trust. More specifically, he held that the description of the trust res was too uncertain. Rego had acquired an equitable mortgage of a mortgage. Paragraph 3 of the trust agreement declares that W.M.H. "holds and stands possessed of part of the said Mortgage of Mortgage as Trustee for the said Madeline Rego and Antonio Rego". In particular, the words "part of" made the subject matter of the trust uncertain in the opinion of Wright, J.

51 Wright, J., held, however, that it made no practical difference, because in any event the Regos were protected because they were secured creditors. Wright, J., also held that documentation in the form of document B, and document C, gave those claimants the status of secured creditors.

THE POSITION OF CLAIMANTS AS SECURED CREDITORS

52 Bankruptcy does not affect the right of a secured creditor to enforce his security. When a receiver-manager was appointed, those who claimed as secured creditors were free to enforce their security as they saw fit. That situation was not interrupted by the bankruptcy. But in point of fact none of the claimants whose cases came before Wright, J., had realized upon their security.

53 It seems to me that there are formidable difficulties in doing so, - other than in conjunction with a trust arrangement.

54 In the Seavers claim, document A, the claimant purchased a mortgage, but W.M.H. never provided a transfer of the mortgage, and consequently no transfer of the mortgage was ever registered in the appropriate Land Titles Office. It was open to Seaver to demand a transfer of one-third of the mortgage and collaborate with the other co-owners of the mortgage to register their security and make the necessary arrangements to have the mortgagor pay the monies to them rather than to W.M.H. But these steps were not taken. I can understand why. If monies paid to W.M.H. with respect to the underlying mortgage are impressed with a trust, then it becomes unnecessary to enforce the security because the monies in the hands of the receiver or trustee in bankruptcy will be impressed with that same trust in favour of the claimant. Seavers relies upon a trust to make it unnecessary for him to enforce his security. The point to be made, however, is that in the absence of a trust, having been granted the status of a secured creditor may be a pyrrhic victory. The status of secured creditor entitles the creditor to take enforcement proceedings. It is the establishment of a trust which permits the creditor to remain passive, but with the confidence that monies coming into the hands of the receiver or the trustee in bankruptcy are, and will remain, identifiable as trust funds belonging to that particular creditor. In the absence of a trust, or if the trust does not extend to and impress the particular monies paid to the receiver or the trustee in bankruptcy pursuant to the underlying mortgage, then the secured creditor is still entitled to try and enforce his security now, - if he knows how to go about it, - but he will not be able to claim the monies already paid to the receiver or trustee in bankruptcy. Unless impressed with a trust, those funds would be divisible among all creditors.

55 Sections 98 and 99 of the Bankruptcy Act deal with the rights of secured creditors.

> 98. (1) Where a secured creditor realizes his security, he may prove for the balance due to him after deducting the net amount realized.
>
> (2) Where a secured creditor surrenders his security to the trustee for the general benefit of the creditors, he may prove for his whole claim.
>
> 99. (1) Where a secured creditor does not either realize or surrender his security he shall, within thirty days after demand in writing made upon him by the trustee, or within such further time as may be allowed by the court, file with the trustee an affidavit stating therein full particulars of his security or securities, the date when each security was given and the value at which he assesses each.
>
> (2) A creditor is entitled to receive a dividend in respect only of the balance due to him after deducting the assessed value of his security.
>
> (3) The trustee may redeem a security on payment to the secured creditor of the debt or the value of the security as assessed by the secured creditor.

56 None of the creditors has realized on his security. On the other hand, the creditors in the test cases before us have not surrendered their security, nor have they valued their security. We are told that there is an understanding among all creditors, secured and unsecured, with the trustee in bankruptcy, that creditors will be given an option. depending upon the court's determination of these test cases. Creditors who have claimed as secured creditors will be entitled to re-file as unsecured creditors, or vice versa, as the legal decision in this case might dictate. That choice is dependent upon whether there is a trust in favour of the creditor which is effective in protecting the creditor's interest in an underlying mortgage.

THE POSITION OF CLAIMANTS AS BENEFICIARIES UNDER AN EXPRESS TRUST.

57 All of the claimants in the test cases contend that they are beneficiaries under an express trust.

58 In the proceedings before Wright, J., in the factums, and in the oral argument in this court, counsel for the unsecured creditors contended that a trust had not been established in any of the test cases. Fundamentally, the attack was that there was no intention to create a trust on the part of Winnipeg Mortgage Exchange. In each instance the initial documentation consisted of a purchase agreement and a letter of allocation which spoke of purchase and sale rather than a trust relationship. W.M.E. sales publicity was to the effect that all customer investments were guaranteed, which seems inconsistent with an individual trust relating to each investment. The conduct of Messrs. Reid and White in the management of W.M.E. was not the conduct of a trustee. The double layering of mortgages was evidence that W.M.E. did not consider the underlying mortgages to be the subject matter of a trust. The fact that all W.M.E. monies were pooled in a single bank account constituted conduct negativing the creation of individual trusts. The trust agreement was no more than a sales gimmick and did not manifest a true intention to bring about a trust relationship.

59 At the outset of the appeal hearing, counsel for all parties were reminded of the comments of O'Sullivan, J.A., in his reasons for judgment when the cause had been in the Court of Appeal before. It was suggested that counsel for the unsecured creditors might more profitably argue that, even if a trust were intended, the subject matter of the trust would not embrace the underlying mortgage, or the payments made thereunder, in those instances where the trust agreement referred to an investment by way of a mortgage of a mortgage, rather than the purchase of a mortgage. Counsel for the unsecured creditors happily adopted the argument emanating from the court, but without abandoning his more sweeping attack based on lack of intention to create trusts. If that more general argument prevailed, then all of the so-called trusts would be invalid. I therefore intend to explore that area at the outset.

60 In my opinion, counsel for the unsecured creditors undertakes a formidable task attempting to show that there was no genuine intention to create a trust, - in the face of trust declarations provided to each and every investor-customer. When a company provides a document, signed by its proper officers, under corporate seal, earnestly declaring that it "holds and stands possessed" of certain property as trustee for its customer-investor, and invites the customer-investor to rely upon that declaration of trust, it would take a powerful argument to convince me that the supposed trusts are all invalid for lack of certainty of intention to create the trusts. Counsel for the unsecured creditors musters these points:

1. Except for the Seavers transaction, all of the other investments in the test cases involved situations where W.M.E., as the supposed donor of the trust, and the trustee, has retained an interest in the trust property (namely, the interest

> differential from which W.M.E. hoped to make its profit). Counsel for the unsecured creditors contended that a trustee can have a beneficial interest in the trust property only if the trust agreement gives or reserves that to him. Accordingly, it is argued, the arrangement between W.M.E. and its customer-investors is inconsistent with a true trustee beneficiary relationship.

61 I cannot agree. The argument, of course, only applies where the underlying mortgage is the subject matter of the trust, rather than a mortgage of a mortgage. In the Rego investments (document D), it is clear that the trust res is the mortgage of the mortgage, in which W.M.E. retained no interest for itself. But aside from that argument, the sweeping proposition advanced by counsel for the unsecured creditors is simply not tenable. Consider the case of Cochrane v. Moore (1890), 25 Q.B.D. 57. In that case one Benzon owned several racehorses. He wished to make a gift of a one-quarter interest in one of his horses to a friend, one Moore. He so advised Moore, but the intended gift was not accompanied by delivery. Later Benzon sold several horses, including the one in question, to a purchaser, one Cochrane. Before the sale was consumated, Benzon told Cochrane of Moore's one-quarter interest in the horse, and Cochrane replied that it would be "all right". Subsequently, when Moore attempted to claim his one-quarter interest, it was resisted by Cochrane. The Court of Appeal held that while the intended gift might fail, Cochrane's statement that it would be "all right" amounted to a trust declaration, which constituted Cochrane a trustee of a one-quarter interest in the horse for Moore. Fry, L.J., simply stated (at p. 73):

> ... in our judgment what took place between Benzon and Cochrane before Benzon executed the bill of sale to Cochrane, constituted the latter a trustee for Moore of one-fourth of the horse Kilworth.

62 Cochrane was both grantor and trustee, and he also retained an interest in the trust res himself. All of this arose out of a simple and informal conversation. I do not see any substantial difference between Cochrane declaring a trust of one-quarter of a horse owned by him, or Winnipeg Mortgage Exchange declaring a trust of a certain proportion of a mortgage owned by it.

2. Counsel for the unsecured creditors argued that the conduct of Messrs. Reid and White, as officers of W.M.E., negated any intention to create a trust. W.M.E. exercised complete control over the underlying mortgages. The investor-clients were not informed of any problems relating to the underlying mortgages. The customer-investors relied upon a guarantee that they would receive their monthly payments regardless of the status of the underlying mortgage. The customers were aware that practices such as "double layering" were taking place. Although they were provided with a trust declaration, all monies were pooled indiscriminately, in lieu of establishing individual trust accounts. In short, it is alleged that W.M.E. was in constant and serious violation of the normal duties of a trustee, - to such an extent that a question is raised as to whether there was any intention to create a trust in the first place.

63 In my opinion, this is a circular argument. It is not appropriate to say that because the creator of the trust, who is also trustee, committed breach of trust, therefore there could not have been a trust in the first place. Whether there is an intention to create a trust is to be determined at the time the declaration of trust is made. In each instance, it seems to me that when the declaration was made the intention was to provide the customer with security by way of a trust declaration. In the absence of such security customers who had purchased mortgages, (such as Seavers in document A, or Rudnik in document B), could have insisted on receiving a transfer of part of the underlying mortgage which could then been registered in the appropriate Land Titles office. Those who had bargained for a mortgage of a mortgage (such as Alward in document C, or Rego in document D), could have insisted on receiving a registerable mortgage of the underlying mortgage. To avoid that paper work, W.M.E. wished to provide equivalent or better security to each customer, and accordingly W.M.E. struck upon the device of a trust declaration.

64 It is clear that Messrs. Reid and White had a grossly inadequate perception of the responsibilities of a trustee. But that does not detract from the intention at the time each "trust agreement" was executed to provide security by way of a trust to each customer.

65 I should add the observation that, where the transaction is in the nature of a mortgage of a mortgage, and if the trust res does not extend to the underlying mortgage and the payments made thereunder, then W.M.E. would be entitled to exercise control of the underlying mortgages without violating trustee responsibilities to the extent asserted by counsel for the unsecured creditors.

> 3. Counsel for the unsecured creditors claims that W.M.E., as a so-called trustee was earning a "secret commission" which was constituted by the interest differential. Once again, it is argued that this is inconsistent with the trustee's responsibilities, and thus negates an intention to create a trust initially.

66 I cannot agree. This argument relates to only a small proportion of the transactions. Investments such as the Seavers transaction, (document A), did not involve the retention of an interest differential, so there was no "secret commission" in such situations. Nor is there a "secret commission" in those transactions where the investor-customer obtains a mortgage of a mortgage. The customer has loaned money to W.M.E. to be repaid at an agreed rate of interest, the loan to be secured by way of an equitable mortgage of a mortgage. The fact that the underlying mortgage carries a different interest rate is incidental.

67 The argument has application, if at all, only in situations such as the Rudnik investment, (document B). There, the Rudniks purchased part of a mortgage and the interest rate under the underlying mortgage was higher than the interest rate which the Rudnik's were to receive. I do not think, however, that this can fairly be described as a "secret commission". Customer-investors in the position of the Rudniks were aware that W.M.E. was in business to make a profit, and that the profit was generated either by purchasing mortgages at discount and reselling them, or by retaining an interest differential on the purchase and sale of a mortgage. Perhaps the customer did not know the precise magnitude of the differential, but there was no attempt to hide from the customer the fact that W.M.E. earned its profit by this mechanism.

4. Counsel for the unsecured creditors argued that the allocation of mortgage investments to one customer or to another was a matter of sheer luck. It is argued that an arbitrary allocation of security is contrary to a trustee's duty to act with impartiality among beneficiaries, and again, the violation of this duty tends to negate an intention to create a trust in the first place.

68 Once again, I see no attraction in the argument presented. The duty to act with impartiality arises once the trust has come into being, not at the time that the trust is declared. For example, suppose that a man purchases two lottery tickets. He is entitled, if he chooses, to declare himself trustee of one of the lottery tickets on behalf of his child "A", and as trustee of the second lottery ticket for his other child "B". Suppose that the first lottery tickets bears the winning number for a million dollar prize. There can be no doubt that the proceeds would be held by him as trustee for child "A", and child "A" alone, even though it may be manifestly unfair to child "B". There is no violation of the trustee's duty to act with impartiality in the example cited, nor in the manner by which W.M.E. allocated underlying mortgages among its customer-investors.

5. It was pointed out by counsel for the unsecured creditors that, with some accidental exceptions, there was and could be no identification of investors' money being used to acquire an interest in a particular underlying mortgage. The customer-investor would contact the offices of W.M.E. and indicate interest in making an investment of say $10,000.00. W.M.E. would acquire the customer's cheque. The cheque would go into the only bank account which W.M.E. maintained, and the money would form part of a general pool of funds available for all purposes. It might be days or weeks later that W.M.E. acquires a particular mortgage and "allocates" a portion of it to the customer in question. When that mortgage is acquired by W.M.E. there is nothing to indicate that it was purchased, in whole or in part, with the $10,000.00 deposited with W.M.E. by the customer.

69 The lack of identification of the monies paid in by a customer with a particular mortgage acquired by W.M.E. does not affect the validity of the trust. The question of identifying or tracing trust property arises only after the declaration of trust has been made. It matters not that the customer's money has become "lost" prior to the declaration being made. Up to the time the declaration is made the customer is simply a creditor of W.M.E. But W.M.E. has assets, and in recognition of its financial obligation to the customer, W.M.E. is entitled to declare that it holds some part of its assets as trustee for the customer, from whom W.M.E. had received funds.

6. Counsel for the unsecured creditors claims that the relationship between W.M.E. and its investor-customers was a debtor-creditor relationship, which in turn is

> inconsistent with a trustee-beneficiary relationship. Once again it is urged that, because the relationship is that of debtor-creditor, it negates any true intention of creating a trust.

70 The decision of the House of Lords in Barclays Bank Ltd. v. Quistclose Investments Ltd., [1970] A.C. 567, reaffirms the view that a debtor-creditor relationship and a trustee-beneficiary relationship can co-exist. In that case, a company, Rolls Razor Ltd., negotiated a sizeable loan from Quistclose Investments Ltd., which loan was made on condition that it be used to pay a proposed dividend to shareholders. The money was placed in a special bank account with Barclays Bank, and the bank was aware that the money was earmarked for the purpose of paying a dividend. But before the dividend was paid out to shareholders Rolls Razor Ltd. went into voluntary liquidation. Quistclose Investments sought the return of the monies, since the condition under which the loan was made could no longer be fulfilled. Barclays Bank, which was also a creditor of Rolls Razor Ltd., sought to retain the monies, and litigation ensued. On behalf of Barclays Bank it was argued that the transaction between Quistclose and Rolls Razor was a loan, giving rise to a debtor-creditor relationship, and it was argued that there would not be a parallel trust relationship. The unanimous judgment was pronounced by Lord Wilberforce, who rejected the bank's argument, and said that there should be "... no difficulty in recognizing the co-existence in one transaction of legal and equitable rights and remedies", (p. 581). Lord Wilberforce writes at p. 582:

> ... I can appreciate no reason why the flexible interplay of law and equity cannot let in these practical arrangements, and other variations if desired: it would be to the discredit of both systems if they could not. In the present case the intention to create a secondary trust for the benefit of the lender, to arise if the primary trust, to pay the dividend, could not be carried out, is clear and I can find no reason why the law should not give effect to it.

71 So, in the instant case, I see no reason why W.M.E., in order to provide its investor-customers with security exceeding the normal debtor-creditor relationship, should not provide some additional protection by way of a parallel trust. The evidence reveals that although the officers of W.M.E. had an imperfect perception of trust responsibilities, nevertheless they did intend to provide a trust as a form of additional assurance to the customer.

> 7. Counsel for the unsecured creditors points to the documentation preceding the trust declaration, namely, the purchase agreement and the letter of allocation, both of which referred to the purchase of a mortgage, not to the establishment of a trust. Once again the argument is that the transaction was an intended sale, not an intended trust.

72 With reference to the Seavers transaction, document A, and the Rudnik transaction as evidenced in document B, a sale of a mortgage did take place. In the one case, Seaver, and in the other case, the Rudniks, became the equitable owners of a portion of the underlying mortgage. But instead of transferring the legal ownership of the underlying mortgage to its customers, W.M.E. retained legal ownership but provided a trust declaration. I see nothing in these arrangements which would in any way negate the necessary intent on the part of W.M.E. to create a trust. It is correct to observe that in the Alward and Rego investments, documents C and D, there is an obvious inconsistency, because the trust declaration refers to a mortgage of a mortgage, rather than the purchase of a mortgage. That inconsistency may present problems in determining the subject matter of the trust, but it does not detract from the undoubted intention of W.M.E., manifested in all of the trust declarations, to create express trusts.

73 I therefore agree with Wright, J., that the trust arrangements between W.M.E. and its clientele cannot be impeached for want of certainty of intention to create them.

74 The learned trial judge said that even if the trust declarations suffered from lack of certainty of intent, W.M.E. (and hence its trustee in bankruptcy speaking for its unsecured creditors) is barred by estoppel from denying the trusts as set forth in the "trust agreements". Since I see no basis for impeaching the trusts for want of certainty of intent, I do not find it necessary to consider this area of argument.

75 There must also be certainty as to subject matter. The subject matter must be ascertainable. In most instances the documentation speaks of the purchase of part of a mortgage, or the mortgaging of part of a mortgage. But in all instances, one can go to the internal records maintained by W.M.E. and determine with precision precisely what part of the underlying mortgage has been sold or mortgaged.

76 An additional difficulty presents itself with respect to the wording of the trust agreements with reference to the Rego transaction. The trust agreement recites that part of a mortgage was mortgaged to the Regos for a specified amount of money. If clause 3, of document D, had simply stated that W.M.H. holds and stands possessed of the said mortgage of mortgage as trustee for the Regos, there would be no difficulty in terms of certitude of trust property. I am convinced that the insertion of the additional two words, "of part", in para. 3 is an unintended clerical error. Rectification would seem to be appropriate, but even if a trust be established, I do not think that it assists the Regos and investors with like documentation.

77 I turn now to what I have always felt to be the major stumbling block in the path of those who would rely upon a trust relationship.

WHAT CONSTITUTES THE SUBJECT MATTER OF THE TRUST?

78 There can be little doubt as to the subject matter of the intended trust. In cases where the documentation is comparable to that in the Seavers claim, document A. Seavers purchased one-third of a mortgage which was owned by W.M.H. Under para. 3 of the trust declaration, W.M.H. "holds and stands possessed of the said mortgage" as trustee for Seavers. Paragraph 4 commits W.M.H. to remit one-third of the mortgage payments which it receives to Seavers. In my opinion, when read together, one-third of each mortgage payment is impressed with a trust in favour of Seavers when it comes into the hands of W.M.H. Upon a receivership, or upon a bankruptcy, the receiver or the trustee in bankruptcy receives funds under the mortgage subject to the same trust. All monies paid on the mortgage, post receivership, are identifiable. Seavers is entitled to his proportionate share of those funds.

79 Documentation of the type provided to the Rudniks as evidenced by document B, leads to a similar result. The Rudniks purchased a part of a mortgage, but the extent of the part being purchased was expressed in terms of the dollar value of the purchase, rather than a stated proportion of the face value of the mortgage. Unlike the Seavers documentation, the beneficial interest in a portion of the mortgage was retained by W.M.H., - namely an interest differential. As in the Seavers documentation, para. 3 declares that W.M.H. "holds and stands possessed of part of the said mortgage" as trustee for the Rudniks. Paragraph 4 is less precise than in the Seavers documentation. There is a covenant on the part of W.M.H. to remit part of all monies received by it pursuant to the mortgage to the Rudniks. Unlike the Seavers documentation the precise proportion which is to be remitted to the Rudniks is not stated. It is, to be sure, a purchase of an unusual nature. The Rudnik purchase is not of a whole mortgage, or even a fraction of it, but rather a proportion of the face value less the interest differential. While it is strange to contemplate a purchase in such terms, I am not prepared to set aside the intended purchase on that ground. As in the Seavers case, so in the Rudnik claim of the type demonstrated by document B, the mortgage payments are received by the receiver or the trustee in bankruptcy subject to a trust. The monies which have been accumulated in the hands of the receiver or the trustee in bankruptcy to the credit of the Rudniks should be paid over to them.

80 I will pass now to the documentation utilized with respect to the Rego investments, as shown in document D. It is clear by para. 2 of the trust agreement that the Regos have obtained a mortgage of a mortgage in return for $5,000. The nature of the transaction is that of a loan, repayable at $45.00 per month and bearing interest at 10 1/2%. Paragraph 3 makes it painfully clear that the trust res is not the mortgage having a face value of $67,500.00 owned by W.M.H., but rather the trust res is the mortgage of the mortgage in favour of the Regos, having a face value of $5,000.00. The wording of para. 3 is unsatisfactory from two standpoints. As previously noted, the words "of part" have been inserted into the clause in error. In addition, para. 3 speaks of W.M.H. holding and standing possessed of a mortgage of a mortgage. In fact, no registerable mortgage of a mortgage was in existence. Paragraph 3 gives the Regos an equitable right to a mortgage of a mortgage.

81 The wording of para. 4 of the Rego document is also inappropriate. W.M.E. covenants to remit part of all monies received by W.M.E. pursuant to the mortgage of a mortgage. But W.M.E. will be receiving no monies pursuant to a mortgage of a mortgage. W.M.E. will be receiving monies under the underlying mortgage, and there is no covenant to remit any portion of those monies to the Regos under their mortgage of a mortgage. Since the trust res identified in para. 3 is clearly a mortgage of a mortgage, I can see no basis in law or equity for suggesting that the mortgage payments received by W.M.H. on the underlying mortgage are impressed with a trust. After receivership, and after bankruptcy, the monies obtained by the receiver or the trustee in bankruptcy by way of mortgage payments on the underlying mortgage are not impressed with a trust. They go into the general revenues of the bankrupt companies for division among unsecured.

82 The most contentious documentation is that provided to Alward, document C. Like document D, the second paragraph identifies the nature of the transaction. It is a loan secured by a mortgage of a mortgage, rather than the purchase of a mortgage. The loan is repayable by way of specified monthly payments at a specified interest rate, and a termination date. As in all the trust agreements, it is para. 3 that establishes the subject matter of the trust, but unlike documents A, C, and D, the wording is ambiguous. Para. 3 states that W.M.H. now holds and stands possessed of "the said mortgage", as trustee for "the said purchaser". The preceding paragraph has specified that the nature of the transaction is a loan to be secured by a mortgage of a mortgage and if that be so, it is wrong to refer to the investor-customer as a "purchaser" in para. 3. That error is repeated in paras. 4 and 5. That aside, the crucial issue is what is intended by the words "the said mortgage" in para. 3. Does it mean the underlying mortgage owned by W.M.H., or does it mean the mortgage of the mortgage to which the investor-customer is entitled as security for his loan?

83 I am of the view that the words "the said mortgage", as used in para. 3, refers to the mortgage of the mortgage, not the underlying mortgage. I find some support for that conclusion by the wording of para. 4. Under para. 4 W.M.H. covenants to remit "the above mortgage payment" on a monthly basis. "The above mortgage payment" necessarily refers to the payment under the mortgage of the mortgage. This is of significance for two reasons. Firstly, the word "mortgage" as used in para. 4 refers to the mortgage of the mortgage, rather than the underlying mortgage. It would be consistent that the word "mortgage" in para. 3 should also relate to the mortgage of the mortgage. Secondly, in documents A, B, and D, paras. 3 and 4 are linked together, in that para. 3 identifies the trust res, and para. 4, by implication, extends that trust to monies related to the trust res. It would seem appropriate that in document C as well, the two paragraphs should be interrelated. To put it in the negative, if the mortgage mentioned in para. 3 was intended to be the underlying mortgage, it would be consistent for para. 4 to refer to the remission of monies received by W.M.H. pursuant to the underlying mortgage.

84 Paragraph 5 of document C is also of some significance. Paragraph 5 deals with the possibility of the "purchaser" assigning his interest in the "said mortgage of mortgage". If the trust res was intended to be the underlying mortgage, then surely the potential assignment would cover the underlying mortgage, not the mortgage of a mortgage.

85 I would therefore hold that the Seavers claim, as evidenced by document A, and the Rudnik claim, as evidenced by document B, are both protected by a trust. I would hold that the Alward claim and the Rego claims, as evidenced by documents C and D, are not protected by a trust. The Ranjoy claims fall within the same category as the Alward claim. Those claimants who are not protected by a trust may, nonetheless, proceed as secured creditors under the Bankruptcy Act by valuing their security, obtaining the documentation that belongs to them, and taking whatever steps seem appropriate to enforce their respective rights to the extent that they are able to do so. I would be surprised if they would choose that course, for they would not be entitled, as secured creditors, to claim monies collected by the receiver or trustee in bankruptcy on the underlying mortgages between the time of receivership to the present date. Whether and how they might intercept the flow of further payments on the underlying mortgages to the trustee in bankruptcy is a matter that the creditors would have to ponder if they elect to follow that course.

THE ISSUE OF FAIRNESS

86 Incredibly, the disposition at which I have arrived is not markedly different from that arrived at by my colleagues, Freedman, C.J.M., and Monnin, J.A. I use the word "incredibly" because their approach to the matter is the antithesis of my own. Yet, except for investor-creditors with documentation in the form of documents A or B, which I understand to be a small proportion of the investor-customers, we reach a common conclusion that the investor-customers are unsecured.

87 I have concluded that there were valid enforceable contracts coupled with valid enforceable trust declarations, but that in those cases where a mortgage of a mortgage was acquired, the trust res does not extend to the underlying mortgage or the payments made thereon. Where there was a purchase of a mortgage, however, the subsequent trust declaration is broad enough to encompass the underlying mortgage and the payments made to W.M.E. pursuant to it.

88 My colleagues now say that the rights which might be enjoyed by the investor-customer under the contract/trust arrangement can be set aside under the rubric of "unfairness". They do not suggest that the contracts are illegal or invalid, nor is it postulated that a trust was not intended, or that the trust property is uncertain. It is simply stated that the rights should be diminished in order to achieve equity.

89 It is a strange kind of equity when viewed from the vantage point of Seavers. He entered into a transaction with W.M.E. in which he purchased a one-third interest in a mortgage, and the vendor of that interest then made a trust declaration that he would hold that interest in trust for the purchaser. He seeks to enforce the rights and remedies available under the contract, and the trust declaration. He is now told that, in the name of equity, his rights under that documentation are to be swept aside because of other subsequent transactions with different documentation entered into between W.M.E. and other customer-investors. To diminish Seavers' right under the documentation he received on this basis, is to perpetuate the wildest kind of unfairness in the name of fairness.

90 If the day before the bubble burst, Seavers had been asked whether he stood on the same level as the others, he would not have said "yes", particularly if it meant a diminution of his legal rights and remedies. He would have said, - "I think I am secured. I have made a purchase and that purchase is protected by a valid trust. If there are others who entered into similar arrangements, and are protected by similar documentation, then they enjoy comparable rights and remedies". Seavers would not for a moment have imagined that his security would be arbitrarily reduced in value in order to decrease the potential financial loss for some stranger.

91 My colleagues refer to the evidence of Mr. White as establishing an intention on the part of W.M.E. to treat all of its investor-customers in the same way. The issue of intention must be explored in order to determine the validity of the trust declarations, for certainty of intent to create a trust is a crucial element. But the concern is the intent at the time of the transaction, not several years later. When the Seavers transaction took place in 1969, as an example, W.M.E. was operating on a profitable basis. Mr. White was not thinking of the position of creditor-customers should the company suffer a financial collapse in the future. Only one type of security documentation was being provided at that time. It is difficult for me to imagine that in 1969 Mr. White had formed an intention, contrary to the written documentation provided to Seavers, that upon an unanticipated bankruptcy at some future time, Seavers' rights and remedies should diminish to that of an unsecured creditor. When an individual purchases bonds issued for sale by a public corporation, and a second individual acquires shares in the same corporation, and a bankruptcy subsequently occurs, they are not to be treated in the same way, and it makes no difference if the proprietor of the company says that he intended that bondholders and shareholders should be treated in the same fashion.

92 Of course it is a matter of luck as to whether a particular underlying mortgage is good or bad. But the evolution of the different forms of documentation was not a matter of luck. In the late 1960's W.M.E. was still able to purchase mortgages at a discount and was reselling them, either in whole or in fractions, to its customers. W.M.E. made its profit in the discount. That was the situation which prevailed at the time of the Seavers transaction, evidenced by document A.

93 When mortgages could not be obtained at a discount, W.M.E. nevertheless continued to sell fractional interests in mortgages, but took its profit from an interest differential rather than a discount. The documentation necessarily changed. Messrs. Reid and White must have had some difficulty with the concept of selling fractions of the face value of a mortgage, but retaining a residual share in the mortgage by way of interest differential, - a scheme which I confess is new to me. Hence, W.M.E. moved to a more logical concept in terms of making a profit from the interest differential, which was to simply borrow money from customers at a lower rate of interest than that of the underlying mortgage, and securing the customer by way of a mortgage of the underlying mortgage. Hence, the documentation evolved to document C.

94 That documentation in turn required further clarification as to what constituted the trust res, which in turn led to document D.

95 It was not a matter of luck that Seavers received documents which placed him in a totally different position than Rego. When Seavers invested, the nature of the business which was being conducted by W.M.E. was entirely different, and for entirely understandable reasons. To grant Seavers no higher rights than Rego does not make the law a slave to contingency.

96 I confess my absolute astonishment at the suggestion that variation between the different kinds of documents do not warrant a difference in treatment. There is all the difference in the world between the documentation. It is the difference between a purchase coupled with an effective trust and a loan coupled with an ineffective trust, and those differences necessarily bring about a different result.

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1991 CarswellOnt 193, 6 C.B.R. (3d) 216

Can Corp Financial Services Ltd., Re

Re CAN CORP FINANCIAL SERVICES LTD.

Ontario Court of Justice (General Division), In Bankruptcy

Chadwick J.

Judgment: June 21, 1991
Docket: Doc. 051165

Counsel: *Peter Genzel*, for Deloitte Touche, trustee.

Peter Thompson, Q.C., for Ministry of Financial Institutions.

Gilles Guénette, Q.C., for investors Rosalind Boyd, Esther Ballon and Fred Ballon.

Subject: Corporate and Commercial; Insolvency; Public

Bankruptcy --- Priorities of claims — Secured claims — Forms of secured interests — Mortgages and hypothecs.

Professions and Occupations --- Mortgage brokers.

Secured creditors — Mortgages — Bankruptcy of mortgage broker — Investors providing funds under "Mortgage Participation Agreement" — Terms of agreement and parties' conduct determinative — Agreement constituting deposit scheme, not trust — Investors unsecured creditors sharing pari passu under provisions of Bankruptcy Act, R.S.C. 1985, c. B-3.

Dividends and distribution — Distribution — Approval of court — Distribution of funds according to pooling arrangement approved where such arrangement being most equitable distribution.

The bankrupt corporation, a mortgage broker, provided investors with a "Mortgage Participation Agreement," which set out terms and conditions of the investment. Some investors had good mortgages, some bad. Some investors had been moved from good mortgages to bad mortgages without their consultation or approval. The broker could transfer the investors' participation between mortgages with only the obligation to report the transfer after the fact. The investors were entitled to redeem their investment on a 30-day written notice notwithstanding the terms of the mortgage in which their investment moneys were placed. Interest from all the mortgages was pooled in one account, which included funds from a general account, and interest was paid on the investment upon its receipt and before it was ever placed in a mortgage. The trustee in bankruptcy brought a motion for the direction from the court with respect to a proposed distribution plan based on a pooling arrangement that 78 per cent of the investors had approved. Certain investors brought a cross-motion for a declaration that certain investments made by the broker created a trust on their behalf.

Held:

The motion was allowed and the cross-motion was dismissed.

In attempting to determine whether the broker was holding the mortgages in trust for the investors or whether the investors were part of a deposit scheme, the conduct of the parties involved and the documentation were considered. The facts established that the investors' funds were treated more as a deposit than a true trust arrangement.

The proposed pooling arrangement was in the best interest of all of the investors. The intention of the parties when the transactions were entered into and the necessity for fairness in the ultimate result were taken into account. It would be grossly unfair to give a preferred position to those investors who happened to have a "good" mortgage, and subordinate positions to those who were allocated a bad mortgage.

Cases considered:

Urman, Re (1983), 48 C.B.R. (N.S.) 129, 44 O.R. (2d) 248, 30 R.P.R. 57, 24 B.L.R. 179, 3 P.P.S.A.C. 191, 1 O.A.C. 339, 3 D.L.R. (4th) 631 — *distinguished*

Winnipeg Mortgage Exchange Ltd. v. Mortgage Holdings Ltd., 43 C.B.R. (N.S.) 119, [1983] 1 W.W.R. 213, 19 Man. R. (2d) 1 (C.A.) — *considered*

Statutes considered:

Bankruptcy Act, R.S.C. 1985, c. B-3 —

s. 34

s. 67(a)

Mortgage Brokers Act, R.S.O. 1980, c. 295.

Personal Property Security Act, R.S.O. 1980, c. 375.

Motion for approval of distribution; Cross-Motion for declaration that investments creating trust.

***Chadwick J.*:**

1 Deloitte Touche Inc., the trustee in bankruptcy of Can Corp Financial Services Ltd., a bankrupt, brings this motion for the opinion, advice and direction of the Court with respect to a proposed distribution plan. In addition, they seek an order declaring that the said distribution plan is binding on all investors.

2 The application is brought pursuant to s. 34 of the *Bankruptcy Act*, R.S.C. 1985, c. B-3.

3 The investors Rosalind Boyd, Esther Ballon and Fred Ballon bring a cross-motion. They seek in part a declaration that certain mortgage investments made by Can Corp on their behalf created a trust entitling the investors to claim the property described in the documents.

4 Both motions were heard together.

Background

5 The bankrupt, Can Corp Financial Services Ltd., was incorporated in 1984 and carried on business in the Ottawa area as a mortgage broker and was licensed pursuant to the provisions of the *Mortgage Brokers Act*, R.S.O. 1980, c. 295.

6 In the fall of 1989, the Ministry of Financial Institutions commenced an investigation into the business practices of Can Corp. As a result, an undertaking was entered into between the share owners of Can Corp and the Ministry.

7 In October 1990, Coopers and Lybrand was appointed a monitor by the Ministry for the purpose of overseeing the operation of the company and the compliance with the undertaking.

8 In December 1990, Coopers and Lybrand brought a motion to the court to have themselves appointed as a court-appointed monitor pursuant to the provisions of the *Mortgage Brokers Act*. Before such appointment could take place, a petition in bankruptcy was filed on December 13, 1990. On January 7, 1991, a receiving order was issued against Can Corp, and Deloitte Touche was appointed as trustee in bankruptcy.

9 At the first meeting of creditors, an investors committee was appointed consisting of five inspectors and five alternates. The committee had a number of meetings and discussions relating to the distribution of the assets of the bankrupt company.

10 The committee concluded that there were only two possible distribution schemes, namely, a specific distribution or a pooling. The committee supported the pooling scheme and made this recommendation to the second meeting of creditors held on February 28, 1991.

11 There was a vote of the investors with reference to the distribution scheme, and 77.96 per cent voted for the pooling arrangement, 13.89 per cent voted against, 4.40 per cent abstained and 3.75 per cent did not vote. Votes were cast and valued according to their investment in Can Corp.

12 The trustee, Deloitte Touche Inc., prepared a detailed report dated April 9, 1991. The report sets out the background and also their considerations with reference to the fairness of the pooling arrangement as opposed to a specific distribution scheme.

13 The investors Rosalind Boyd, Esther Ballon and Fred Ballon filed affidavit material and documentation with reference to their investments. This was in support of their position that Can Corp held their mortgages in trust for them, and they are therefore entitled to their percentage interest in the mortgage. They are opposed to any pooling arrangement.

14 The investors' affidavits are similar in nature in that they all claim that they insisted upon investments in

first mortgages. In addition, Rosalind Boyd indicated her previous investment experience, as a result of which she was extremely cautious in how she invested her money.

15 The documentation received by these investors from Can Corp was similar to what all the other investors received.

Operational Procedure

16 Investors interested in investing with Can Corp would provide Can Corp with a sum of money which Can Corp in turn would invest as a percentage of a mortgage. Can Corp paid interest on the moneys received from the investor from the date of receipt and continued to pay each month whether a mortgage was in default or not.

17 Prior to July 1990, Can Corp guaranteed the payment performance of all of the mortgages.

18 After the moneys had been invested Can Corp would forward to the investor a document entitled "Declaration of Trust". This document would show the amount of the investment and the percentage interest in the mortgage invested in and they normally attached a copy of the mortgage in question.

19 In addition, Can Corp would forward a reporting letter describing once again the percentage ownership in the mortgage, particulars of the mortgage including the interest rate due to the investor, and the monthly payments.

20 If the mortgage term expired and there was to be a renewal, then Can Corp would forward to the investor a renewal agreement.

21 Can Corp also provided the investor with a document entitled "Mortgage Participation Agreement" which set out the terms and conditions of the investment.

22 In attempting to determine whether in fact Can Corp was holding the mortgages in trust for the investors or whether the investors were part of a deposit scheme, the documentation and conduct becomes very important.

23 It is easy for an investor, after the bankruptcy, to take the position that all of the investments were held in trust and that was the investor's original intention.

24 The documentation evidence becomes more important in determining the true relationship between the investor and the investment company.

Mortgage Participation Agreement

25 This agreement was provided to all of the investors and was incorporated in one document with the Collection and Administration Agreement.

26 The agreement set out the details of the mortgage investment and provides as follows:

> AND WHEREAS the Investor is desirous of acquiring a proportionate share equal to __% of the principal and interest of the said Mortgage (hereinafter called 'the proportionate share'.)
>
> NOW THEREFORE THE PARTIES AGREE AS FOLLOWS:

1. The Investor does hereby pay to CANCORP the sum of $_____ to purchase the said proportionate share in the said Mortgage.

2. CANCORP shall apply the monies of the Investor to the purchase of the proportionate share in the said Mortgage and for no other purpose.

3. CANCORP shall receive a management fee out of payments of interest and of principal, subject to the terms and provisions contained in an Administration and Collection Agreement.

4. The said Mortgage shall be registered by CANCORP in the appropriate Land Registry Office in the name of the Investor to the extent only of the proportionate share of the Investor.

5. The Investor herein acknowledges and agrees that his rights under the said Mortgage shall extend to and include only the right to receive his proportionate share of payments of interest and principal under the said Mortgage. The Investor shall receive his proportionate share as and when the mortgagor shall make payments under the said mortgage.

6. The Investor and CANCORP enter into this Agreement with the intention of declaring the proportionate share of the Investor in the said Mortgage.

7. The parties attach to this Agreement a copy of the said Mortgage and a copy of the Reporting Letter from a Barrister and Solicitor of the Law Society of Upper Canada certifying that CANCORP owns a good and valid title to the said Mortgage, subject only to the Prior Encumbrances, if any, set out in this Agreement.

Collection and Administration Agreement

27 Under this agreement the particulars of the mortgage are specified and the agreement goes on to provide as follows:

NOW THEREFORE THE PARTIES AGREE AS FOLLOWS:

1. CANCORP will collect all amounts on account of principal, interest and bonuses as shall come due on the said Mortgage, from time to time, for and on behalf of THE INVESTOR and shall act on the INVESTOR's behalf in the collection and general administration of the said Mortgage.

2. The interest rate of __% percent, in the mortgage shall be allocated as follows: __% percent management fee to be paid to or retained by CANCORP for collection of payment on the said mortgage and general administration services; __% percent to be paid forthwith upon receipt CANCORP may deduct and retain the said management fee out of all amounts received on account of interest at such time or times as interest shall be paid, by the mortgage with respect to the said Mortgage.

3. CANCORP shall remit to the INVESTOR the INVESTORS [sic] proportionate share of the principal and interest, less the management fee, received from time to time in respect of the said Mortgage forthwith upon receipt of the amount from the mortgagor.

4. In the event of any default occurring under the said Mortgage, CANCORP may, in its absolute discretion, extend the time for payment, compromise, deal in or with the said Mortgage as it may determine and the INVESTOR herein specifically authorizes CANCORP, as its power of attorney, to act in its place and stead in

extending the time for payment, compromising, dealing in or with the said Mortgage.

5. The INVESTOR herein acknowledges that his rights under the said Mortgage shall extend to and include only the right to receive his proportionate share of principal and interest payments under the said Mortgage.

6. In the event the mortgagor shall prepay, in whole or in part, the principal balance of the said Mortgage, CANCORP shall be entitled to retain any bonus received on the prepayment.

7. In the event the mortgagor under the said Mortgage shall pay the whole balance of the said Mortgage, CANCORP shall forthwith pay, without delay, the balance owing on the principal sum due to the INVESTOR plus accrued interest thereon to the Investor herein.

Investors Renewal Agreement

28 The Investors Renewal Agreement sets out the principal amount renewed, interest rate and monthly payment and also provides the following terms and conditions:

Can Corp policy states all maturing investments will be automatically renewed for the same term as originally selected and at current interest rates, unless otherwise notified in writing prior to maturity.

The investor expressly agrees that in the event that Can Corp must change the mortgage, s/he shall be notified within five (5) days of such change.

The above investor hereby agrees to abide by the terms and conditions set forth in the original investment agreement dated __________ except as amended herein.

29 The use of the above-mentioned forms may have varied from time to time; however, the manner in which Can Corp carried on business appears to be uniform as it relates to all of the investors.

Trust Issue

30 Section 67 of the *Bankruptcy Act* provides in part as follows:

The property of a bankrupt divisible among his creditors shall not comprise

(*a*) property held by the bankrupt in trust for another person, ...

31 There is no dispute between the trustee and the investors that if I find mortgages in question were held in trust by Can Corp for benefit of the three named investors, then they are excluded from the assets of the bankrupt estate.

32 D.W.M. Waters, *The Law of Trusts in Canada* (Toronto: Carswell, 1974), p. 5, defines trust as follows:

Among common lawyers the following definition is generally regarded as being one of the best: 'All that can be said of a trust, therefore, is that it is the relationship which arises whenever a person called the trustee is compelled in Equity to hold property, whether real or personal, and whether by legal or equitable title, for the benefit of some persons (of whom he may be one, and who are termed cestuis que trust) or for some object permitted by law, in such a way that the real benefit of the property accrues, not to the trustee, but to the beneficiaries or other objects of the trust'.

33 Mr. Guénette, counsel for the investors, argues that the way the three named investors conducted their affairs, namely, in specifying first mortgages; not allowing the switching of any mortgages; inspecting the properties; not allowing any discretion to vest with Can Corp; would confirm that the mortgages were being held in trust.

34 In *Re Urman* (1983), 48 C.B.R. (N.S.) 129, 44 O.R. (2d) 248, 30 R.P.R. 57, 24 B.L.R. 179, 3 P.P.S.A.C. 191, 1 O.A.C. 339, 3 D.L.R. (4th) 631, Weatherston J.A., on behalf of the majority of the Court, considered a similar issue with reference to Urman, who was a mortgage broker who had gone bankrupt. The issue in that case related to the priorities between a general assignment of book debts registered under the *Personal Property Security Act*, R.S.O. 1980, c. 375, and the question as to whether the mortgages in question were held in trust for the various investors. Urman's business involved the acquisition of mortgages, usually for the resale to his clients, either by direct assignment or by syndication under trust agreements.

35 At p. 639 [D.L.R.] he comments as follows:

> In the present case there is a far more formal acknowledgement by Urman as to the interests of the trust beneficiaries.

36 From the material filed by the trustee in bankruptcy it is apparent that of the 102 investors, some had good mortgages and some had bad. Some investors were moved from good mortgages to bad mortgages without consultation or approval.

37 The facts in this situation can be distinguished from the facts in the *Re Urman* decision. In this case, interest was paid on the investment upon its receipt and before it was ever placed in a mortgage. In addition, if the mortgage went into default Can Corp continued to pay the monthly payments from other financial sources.

38 Under the terms of the renewal agreement, Can Corp was given the right to automatically renew the investment for the same terms as originally selected and at the then current interest rate.

39 In addition, under the participation agreement, Can Corp had the right to transfer the investors' participation to another mortgage in place of the original mortgage with an obligation to report to the investor after the fact but not before.

40 It would also appear from the material filed by the trustee and, in particular, in reference to the Boyd mortgage, that Can Corp paid a higher interest rate to the investors than they were collecting on the mortgage.

41 Under the terms of the collection administration agreement Can Corp was entitled to any bonus received by way of prepayment of the mortgage and did not have to account to the investor.

42 Likewise, under the terms of the mortgage participation agreement, the investor could redeem their investment on 30 days' written notice notwithstanding the terms of the mortgage in which the moneys were placed for participation.

43 Can Corp did not segregate the interest paid on the mortgages but pooled all of the interest in one account and also mixed funds from their general account in order to meet their monthly commitments.

44 I am satisfied on these facts that the investors' funds were treated more as a deposit than a true trust arrangement.

45 Under the circumstances, three named investors will be unsecured creditors of the bankrupt estate and will share pari passu under the provisions of the *Bankruptcy Act*.

Distribution Scheme

46 The three named investors oppose the distribution scheme as proposed by the trustee in bankruptcy.

47 Approximately 78 per cent of the investors voted in favour of the pool arrangement. If one disregards the absentee vote, it brings the percentage to 84.88 per cent.

48 In considering whether a pooling arrangement or a specific distribution scheme should be imposed upon the other 15.12 per cent who are opposed, there are many factors to be considered.

49 In exercising equitable jurisdiction, the Court has to be cautious not to be arbitrary or to seek out solution because one solution is easier to impose than the other.

50 My reasons for finding that there was not a trust have equal application to the question of pooling versus specific distribution.

51 If there was a specific distribution, then those persons holding good mortgages of course would receive full value of their investment. From that would have to be deducted the various administration fees attributed to those mortgages.

52 In addition, if there has been overpayment of interest by Can Corp, then this would have to be recovered by the trustee.

53 The trustee in his report views both scenarios and recommends the pool distribution.

54 Some investors just deposited their money and took no further interest in where the money was being invested. Other depositors such as the three investors in this case were more concerned and attempted to follow the investment.

55 It would become an impossible task to attempt to classify the various 102 investors into categories of participation.

56 The leading case dealing with the question of pooled distribution is *Winnipeg Mortgage Exchange Ltd. v. Mortgage Holdings Ltd.*, 43 C.B.R. (N.S.) 119, [1983] 1 W.W.R. 213, 19 Man. R. (2d) 1 (C.A.). The facts in that case are somewhat similar to the facts in the case at Bar. Once again, it was a question of some investors holding good mortgages and others holding bad mortgages. One of the differences in the fact situation was that the majority of the investors appeared to have very little interest in following their investments. At pp. 120-121 [C.B.R.] Freedman C.J.M., on behalf of the majority of the Court, stated as follows:

> The evidence is clear that prospective investors in the present case exhibited a massive unconcern on the value or location of the property on which their mortgage would be placed, or on whether there was an adequate margin of safety between the amount of their mortgage and the value of the property. Nor did they give even a momentary thought to the worth of the mortgagor's covenant, since they did not have the slightest idea who that mortgagor might be.

Why then did they enter this trackless unknown to become investors? For the answer to this question we must turn our attention to the two companies here involved — Winnipeg Mortgage Exchange Ltd. ('WME') and Winnipeg Mortgage Holdings Ltd. ('WMH') — and to the two men who ran these companies, namely, Donald W. Reid and John Ross White.

57 Further on Freedman C.J.M. found a similar pattern of operation that had been developed by the Winnipeg Mortgage companies. The procedure is similar to that of Can Corp and can be identified as follows:

(1) They paid investors interest on their money at a rate that was at least 2 per cent higher than was currently available at other institutions;

(2) their cheques came to the investor every month without fail; and

(3) the two companies guaranteed the investors that the monthly cheques would continue to be paid even if the mortgagor fell behind in his payments to them.

58 At p. 123 he concludes:

In the light of the facts emerging from that extract, it would be grossly unfair to give a preferred position to those who happened to have been allocated 'good' mortgages, and a subordinate position to those who were allocated 'bad' mortgages. Our disposition of the controversy should reflect two things — (1) the intention of the parties when the transactions were entered into, and (2) *the necessity for fairness in the ultimate result*. Concerning the first, it cannot be doubted that if, on the day before the bubble burst, the investors had all been asked whether each of them stood on the same level as the others, the answer would assuredly have been in the affirmative. An answer suggesting that the investors stood on different levels would have been inconsistent with the intention both of the investors and of the companies. As for the second, to make preferred creditors out of those who by sheer luck received 'good' mortgages would be to make ourselves slaves to contingency and to deny ourselves the power to do justice in accordance with the maxim that equality is equity. I would treat all the investors equally by pooling the available assets and dividing them among the investors according to their respective claims as proved.

[Emphasis added.]

59 The remarks of Freedman C.J.M. have equal application to the fact situation in the case at Bar. In my view, considering all of the equities, it is in the best interest of all of the investors that the assets of the bankrupt estate be distributed by way of a pooling arrangement.

60 For these reasons, the application of the trustee with reference to the pooling distribution scheme is approved and the application by the three investors is dismissed.

61 In view of the novelty of the issue, there will be no order as to costs.

Motion allowed; cross-motion dismissed.

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Can Corp. Financial Services Ltd., Re, 6 C.B.R. (3d) 216, 1991 CarswellOnt 193 (Ont. Bktcy.,Jun 21, 1991)

History

Direct History

=> 1 **Can Corp. Financial Services Ltd., Re,** 6 C.B.R. (3d) 216, 1991 CarswellOnt 193 (Ont. Bktcy. Jun 21, 1991) **(Judicially considered 2 times)**

Negative and Cautionary Citing References (Canada)

Distinguished in

2 Eron Mortgage Corp., Re, 70 B.C.L.R. (3d) 381, 10 C.B.R. (4th) 257, 1999 CarswellBC 307, [1999] B.C.J. No. 347 (B.C. S.C. Feb 17, 1999) **(Judicially considered 9 times)**

TAB
6

Indexed as:

Eron Mortgage Corp. (Trustee of) v. Eron Mortgage Corp.

Between
Eron Mortgage Corporation, in its capacity as Trustee, and others, petitioners, and
Eron Mortgage Corporation, Her Majesty the Queen in Right of the Province of British Columbia, Eron Financial Services Limited and all investors as set out in Schedule "A" attached to the petition, respondents

[1999] B.C.J. No. 347

70 B.C.L.R. (3d) 381

10 C.B.R. (4th) 257

86 A.C.W.S. (3d) 263

Vancouver Registry No. A972569

British Columbia Supreme Court
Vancouver, British Columbia

Tysoe J.

Heard: February 4 and 5, 1999.
Judgment: filed February 17, 1999.

(24 pp.)

Trusts -- Creation of trust -- Requirements -- Certainty of subject matter of trust -- Transactions creating trusts -- Money advanced for loan purposes -- Termination of trusts -- Distribution of property.

Hearing to determine questions relating to the method of distribution of assets under the control of the Judicial Trustee. Eron carried on the business of a mortgage broker. It arranged for numerous investors to pool their funds for the purpose of making a single loan to a borrower. The mortgage or other security was taken in the name of Eron which signed a declaration that it held the security for the investors. The investors were asked to choose a particular loan in which to participate. Eron administered the loans on behalf of the investors and made monthly interest payments to the investors. Typically, Eron gave an investor several choices of financing opportunities. The investors would receive a term sheet in return for their funds. The heading of the term sheet identified the borrower and the amount of financing. In signing the term sheet, the investors agreed to the terms under which they were participating, including the amount of principal advanced by them, the interest rate, the term of the participation and the amount of the monthly payments. The term sheet also contained a description of the security taken in respect of the loan. The investors' funds were normally collected in a Pooled Trust Account from which Eron advanced the loans. There were, however, other methods by which funds were collected from investors. Approximately 25 of the loans utilized separate bank accounts in a name of the numbered company which was used to hold the security for the investors. Often the investors would make their cheques payable to Eron, which deposited them into the Pooled Trust Account and then forwarded a like amount from the Pooled Trust Account to the separate bank account. A number of investors invested their funds through a registered retirement savings plan. Some investors advanced their funds to their legal counsel for Eron. The funds were generally released when it was acknowledged that the investor was participating in the loan. Various forms of undertaking were imposed in connection with the release of the funds. Finally, in some cases an investor would replace an existing investor. When Eron had its mortgage broker's licence suspended and ceased to carry on business, Judicial Trustees were appointed in respect of the security over which Eron had been trustee. The principal Judicial Trustee was directed to prepare a report providing information to assist the court in determining the appropriate scheme of distribution to the investors. This hearing was held to answer a series of questions relating to the method of distribution posed by the report.

HELD: Judicial Trustee directed to distribute the monies recovered on each mortgage in accordance with the trust declarations relating to the mortgage irrespective of the account into which the investors' funds were deposited. In the typical case where Eron or its numbered company issued a declaration of trust after it had taken security and advanced the loan to the borrower, valid trusts were created as there was sufficient certainty of intention, subject matter and objects. Tracing of investors funds from the Pooled Trust Account to the loan made to the borrower was not necessary in order to create a trust. In the cases where no such declaration was issued, the principal Judicial Trustee would have to assess whether a trust was created. The intention of the parties when they entered into the transactions was that the investors would have an interest in the mortgage loan they selected and that all investors would not stand on the same footing. There was no equitable reason to deprive them of their choices. Equality among investors in this case would constitute an inequity because it would represent a variation of the contracts and trust arrangements between Eron and the investors without proper justification at law or in equity.

Counsel:

Allan P. Seckel, for PricewaterhouseCoopers Inc., Judicial Trustee in respect of all Eron investments except the Fort McMurray investment.
Peter C. Lee, for Manning Jamison Ltd., Judicial Trustee in respect of the Fort McMurray investment.
David A. Hobbs, for investors Eron Mortgage Corporation favouring pooling.
David G. Fredricksen, for investors in Eron Mortgage Corporation opposed to pooling.
Bruce B. Clark, for certain investors claiming an interest in the Fort McMurray investment.
Karen S. Thompson, for certain investors claiming an interest in the Gateway investment.
Various investors on their own behalves.

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1 **TYSOE J.**:-- Eron Mortgage Corporation ("Eron") ceased carrying on business on October 3, 1997 when the Registrar of Mortgage Brokers suspended its mortgage broker's licence and I appointed Price Waterhouse Limited (now Pricewaterhouse-Coopers Inc.) as Judicial Trustee in respect of security over which Eron or its related companies had been trustee. Manning Jamison Ltd. subsequently became Judicial Trustee in respect of one of the Eron mortgages covering a commercial building located in Fort McMurray.

2 The issues presently before the Court relate to the distribution of the assets under the control of the

Judicial Trustees to the investors who provided funds to Eron (or numbered companies incorporated by it) for investment in loans arranged by Eron. The subject issues were not considered to be in question until the hearing of a distribution issue last June involving one of the related companies, Eron Investment Corporation, when the decision in Holden Financial Corp. v. 411454 Ontario Ltd.[1] was relied upon in support of the position that funds in Eron Investment Corporation should be pooled and distributed to investors on a pro rata basis. Until that time, the Judicial Trustees had been acting on the basis that funds collected on a loan would be distributed to those investors who had contracted with Eron Mortgage Corporation to participate in that loan. The Holden Financial case raised the issue of whether the ability of the investors to trace their funds to the loans in which they intended to participate would make a difference to the method of distributing the monies recovered by the Judicial Trustees on the loans.

3 By Reasons for Judgment issued on July 13, 1998[2], I ordered that all investors who had advanced monies to Eron Investment Corporation should be pooled and should share on a pro rata basis in the assets of Eron Investment Corporation. In making my ruling I followed the approach taken by the Manitoba Court of Appeal in Re Winnipeg Mortgage Exchange Ltd.,[3] which I preferred over the reasoning in Holden Financial. In addition, I appreciated the potential impact of Holden Financial on the distribution of the recoveries on loans made through Eron Mortgage Corporation and I did not want to make a ruling in connection with Eron Investment Corporation which could affect all of the remaining Eron investors without giving them an opportunity to be heard.

4 On September 11, 1998 I directed PricewaterhouseCoopers Inc., the principal Judicial Trustee, to prepare a report providing information to assist the Court in determining the appropriate scheme of distribution to the Eron investors. The report was issued in December 1998 and it posed 40 sets of questions relating to the method of distribution. At a hearing on December 18, 1998, after counsel were appointed pursuant to my direction to represent the two main points of view, I ordered that there be a hearing for the determination of six of the 40 sets of questions. Counsel agreed that many of the remaining 34 sets of questions could be resolved easily once these six sets of questions were answered and that it would be too cumbersome to attempt to deal with all 40 sets of questions at one hearing. These six sets of questions relate to the main pooling issue and I will set them out after I have reviewed Eron's factual background (which is derived from the report of the principal Judicial Trustee or statements by counsel for the principal Judicial Trustee).

BACKGROUND FACTS

5 Eron carried on the business of a mortgage broker. The traditional function of a mortgage broker is to match up one borrower with one lender. The lender makes a loan to the borrower on the security of a mortgage against real estate granted by the borrower to the lender. The mortgage broker is paid a brokerage fee by the lender and often has no other involvement. The borrower makes the payments due on the mortgage directly to the lender (unless the mortgage broker has agreed to administer the mortgage on behalf of the lender).

6 Eron took the role of mortgage broker to a more sophisticated level. It acted as broker for large syndicated loans. It arranged for numerous lenders (or investors) to pool their funds for the purpose of making a single loan to a borrower. The borrowers were usually developers of commercial real estate. The loan was funded through Eron or a numbered company which Eron incorporated for this purpose. The mortgage or other security was taken in the name of Eron, or the numbered company, which signed a declaration stating that it held the security for the investors. Eron administered the loans on behalf of the investors and made monthly interest payments to the investors. Approximately 4,000 people invested monies through Eron and its related companies in this fashion. At the time Eron's mortgage broker's licence was suspended, there were 76 outstanding loans with financing provided by Eron's investors in

the aggregate of approximately $222 million.

7 Eron typically gave an investor several choices of financing opportunities. It gave each potential investor a "hot sheet" for each of several projects giving details such as the proposed mortgage amount, term of the loan, rate of return and value of the project. The investors did varying degrees of due diligence with respect to the proposed loan. In some cases the investor did nothing more than pick from the various "hot sheets" provided by Eron. In other cases the investor viewed the properties and requested additional information from Eron. In all cases involving investment through Eron (as distinct from Eron Investment Corporation) the investor was requested to choose a particular loan in which to participate.

8 Once an investor had decided to participate in a loan, the investor provided his or her funds in return for a term sheet. The heading of the term sheet identified the borrower and the amount of the financing. In signing the term sheet, the investor was agreeing to participate in the loan which was acknowledged to be a syndicated loan. The investor agreed to the terms under which he or she was participating - those terms usually included the amount of principal advanced by the investor, the interest rate, the term of the participation and the amount of monthly payments. The term sheet also contained a description of the security to be taken in respect of the loan.

9 As the loans were syndicated, it was necessary for Eron to collect all of the funds from the investors and to then advance the loan to the borrower. The funds were normally collected in an account which Eron maintained with Bank of Montreal. The account was denoted as a trust account on the bank statements and Eron did not deposit any of its general funds into the account. There was not a separate account for every loan and funds relating to many of the loans were deposited and withdrawn from this account, which I will refer to as the "Pooled Trust Account" (there was a separate account for U.S. dollar investments, which I will refer to by the same term for the sake of convenience).

10 The other methods by which funds were collected from investors are as follows:

1. Approximately 25 of the loans utilized separate bank accounts in the name of the numbered company which was used to hold the security for the investors. The funds were collected from the investors and deposited into the separate account, and the loan was then advanced to the borrower from the account. However, investors often made their cheques payable to Eron, which deposited them into the Pooled Trust Account and then forwarded a like amount from the Pooled Trust Account to the separate bank account.
2. A number of investors wanted to invest funds in their registered retirement saving plans ("RRSP") and this was done through Laurentian Bank of Canada. Laurentian established an RRSP account for the investor and forwarded the monies to a lawyer. The lawyer did one of three things with the monies: (i) he or she advanced it as part of the loan to the borrower; (ii) he or she caused it to be deposited into the separate account of the numbered company, from which it was then advanced to the borrower; and (iii) he or she provided it to Eron which deposited it into the Pooled Trust Account. Sometimes the investor made his or her cheque payable to Eron, which deposited the cheque into the Pooled Trust Account and then sent a cheque in like amount to Laurentian.
3. Some investors advanced their funds to their own lawyer or Eron's legal counsel. The funds were generally released when it was acknowledged that the investor was participating in the loan. Various forms of undertaking were imposed in connection with the release of the funds.
4. An investor sometimes participated in a loan by replacing an existing investor.

> The incoming investor advanced his or her monies directly to the outgoing investor. In other cases, despite the absence of replacement investors, existing investors were paid out by Eron prior to the expiry of their terms or were allowed to transfer to other loans.

11 After the loan was funded to the borrower and the security was taken in the name of Eron or one of its numbered companies, Eron would typically send to the investors a declaration or a declaration of trust stating that Eron or the numbered company held the security as agent for the use, benefit and advantage of the investors (who were listed on a schedule) as tenants-in-common in accordance with the interests as set forth in the schedule or as determined by the amount of principal advanced by each investor as set out in the schedule. The amounts stated in the declaration would generally conform to entries made in project ledgers maintained by Eron in respect of each of the loans. The declaration stated that Eron or the numbered company could only deal with the security in accordance with a majority vote of the investors (determined by dollar value).

12 Several deficiencies have been noted by the principal Judicial Trustee with respect to the declarations. One example is that declarations were not always completed for a loan. Another example is that the declarations were not always updated when an investor was paid out and replaced by another investor.

13 The reason giving rise to the potential applicability of Holden Financial is that Eron committed many breaches of trust with respect to the Pooled Trust Account. The first breach occurred a very short time after the account was opened in 1993. The nature of the breaches of trust included the following:

(a) most of Eron's loans were non-performing in the sense that the borrower was not making the stipulated monthly interest payments and Eron made monthly interest payments to the investors from the Pooled Trust Account (i.e., from monies contributed by other investors in respect of other loans);
(b) loan advances were made to a borrower before the necessary funds had been collected from the investors in respect of that loan (which meant that the loan was being partially funded with monies contributed by investors in respect of other loans);
(c) investors were paid out from monies in the Pooled Trust Account when no replacement investor had been found; and
(d) expenses such as brokerage and legal fees, which are normally payable by the borrower, were paid from monies in the Pooled Trust Account.

14 Eron loans were both underfunded and overfunded. They were underfunded in the sense that the amount of the loan advanced to the borrower exceeded the amount collected from investors in respect of that loan. The difference was made up from monies collected from investors in respect of other loans. Loans were overfunded in the sense that Eron collected more monies from investors in respect of a loan than the amount advanced to the borrower. These excess funds were used by Eron for other purposes, primarily the payment of interest to investors in respect of other non-performing loans.

15 The loans outstanding at the time of the suspension of Eron's mortgage broker's licence do not appear to have been very prudently made. Some of the loans will be repaid in full but there will be little, if any, recovery on many of the loans. It is presently estimated that of the $222 million invested through Eron, approximately $40 million will be recovered. The return to the individual investors will range from 0% to 100% unless all of the investors are pooled and the distribution to them is made on a pro rata basis.

ISSUES

16 The six sets of primary questions posed in the report of the principal Judicial Trustee are as follows:

1. Prima facie, are the investors whose funds were deposited to the Pooled Trust Account entitled to (or limited to) a return on their advance based on the recovery on the specific mortgage to which their advance was credited in the project ledger, or are all proceeds from projects that received funds from the Pooled Trust Account to be pooled and paid pro rata to all investors regardless of the term sheet they received or the accounting in the project ledgers?
2. Prima facie, are the investors whose funds were deposited directly to the separate accounts maintained by the trustees of the security entitled to (or limited to) a return on their advance based on the recovery of the specific mortgage? Do these investors rank in priority to investors who advanced their funds to the Pooled Trust Account?
3. Prima facie, are the RRSP investors whose funds were forwarded to Laurentian, along with project-specific lists, entitled to (or limited to) a return on their advance based on the recovery on the specific mortgage?
4. Are RRSP investors whose funds were initially deposited into the Pooled Trust Account or separate accounts maintained by the trustees of the security entitled to (or limited to) a return on their advance based on the recovery of the specific mortgage?
5. Prima facie, are the investors whose funds were advanced by their own legal counsel directly to the project with their advances being recorded on the project ledger entitled to (or limited to) a return on their advance based on the recovery on the specific mortgage?
6. Prima facie, are the investors who by a direct payment to another investor in substitution for their own advance to a project entitled (or limited to) a return on their advance based on the recovery on the specific mortgage? Do the new investors assume the priority of the investor they replaced?

DISCUSSION

17 Counsel made more detailed submissions and relied upon more authorities than was the case at the hearing involving Eron Investment Corporation. Briefly stated, Mr. Hobbs advocated pooling on the basis of the authority of Holden Financial and other decisions, and he also took the position that no valid trusts were created in favour of the investors. Mr. Fredricksen opposed pooling on the basis that the trusts were valid and that the reasoning in Holden Financial was in error. The other counsel all supported the position of Mr. Fredricksen and made additional arguments against pooling.

(a) Validity of the Trusts

18 Mr. Hobbs challenged the validity of the trusts claimed by the investors over the Eron mortgages. If there are no valid trusts of the mortgages created by the documentation issued by Eron or its numbered companies, there would have to be pooling of the loan recoveries unless investors are able to trace their funds into particular investments. Mr. Hobbs submitted that all funds which were deposited into the Pooled Trust Account cannot be traced as a result of Eron's breaches of trust.

19 It is common ground that three essential elements of a trust are (i) certainty of intention, (ii) certainty of subject matter and (iii) certainty of objects. In my view, all three elements were satisfied in the typical case where Eron or its numbered company issued a declaration or declaration of trust after it had taken the security and advanced the loan to the borrower. In the cases where no such declaration was issued, the principal Judicial Trustee will have to assess whether a trust was created and, if necessary, it may apply to Court for further directions in that regard.

20 Mr. Hobbs effectively conceded that it was the common intention of Eron (or its numbered company) and each investor that Eron (or its numbered company) would hold an interest in the mortgage or other security in trust for the investor. Huband J.A. discussed the requirement for certainty of intention at length in his dissenting judgment in Winnipeg Mortgage and he concluded in similar circumstances that there was an intention to create trusts. Although the majority in Winnipeg Mortgage decided to disregard the trusts and to pool all of the mortgage assets because the allocation of the mortgages to the investors was arbitrary, the majority did not disagree with the general principles relied upon by Huband J.A. with respect to the creation of trusts.

21 Mr. Hobbs submitted that there was no certainty of subject matter because (i) the term sheets were not sufficiently specific in identifying the security to be held in trust and (ii) one of the forms of trust declaration stated that the interest of each investor was to be based on the principal funded by them and the breaches of trust by Eron in the operation of the Pooled Trust Account prevented any investor whose money was deposited into the Pooled Trust Account from proving that their money was advanced to the borrower.

22 I agree that there were deficiencies in the term sheets. However, the trusts were created by the trust declarations, not the term sheets. The mortgages and other security were sufficiently described in the trust declarations. Typically, the mortgage was described by reference to the legal description of the mortgaged property and the number under which the mortgage was registered in the appropriate Land Title Office.

23 The initial trust declaration generally contained an accurate list of the investors who were to be beneficiaries of the trust, and the trust was validly created at the time the trust declaration was issued. The entire trust was not made invalid as a result of the fact that some investors were paid out and other investors joined in the loan. There may be issues as to whether subsequent investors became beneficiaries of the trust, particularly when a loan was overfunded, but these issues will not cause the trust to become invalidated.

24 Although it is unlikely that many, if any, of the investors whose funds were deposited into the Pooled Trust Account will be able to trace their monies to the loan made to the borrower, such tracing is not required in order to create a trust. I will discuss this issue in greater detail when I deal with the decision in Holden Financial. Further, the schedule to the trust declaration set out the amount funded by each investor and it is possible to ascertain the interest of each investor by referring to the amounts set out in the schedule.

25 Mr. Hobbs submitted that there was no certainty of objects because the trust beneficiaries cannot be ascertained with certainty. In some cases the trust declaration was updated each time an investor was paid out and a new investor took his or her place. However, in many cases, the trust declarations were not updated as the investors changed. In addition, many of the loans were overfunded, with the aggregate amount collected from investors in respect of the loan exceeding the sum advanced on the loan to the borrower.

26 In Law of Trusts in Canada,[4] the author discusses the requirement for the certainty of objects:

> Persons, human or incorporated, are the familiar objects of trusts, and the problem of

> certainty which they present is whether it is possible to say that the persons intended as objects are ascertainable. Ascertainable is a somewhat ambiguous word, but in this context it means two things: first, that it is possible to determine, if the intended beneficiaries are not referred to by name but by a class description, whether any person is a member of that class, and, secondly, that the totality of the membership of that class is known. Ascertainment means certainty, and it is certainty on both those matters that must be established if the trustees have no discretion as to distribution among the class members, but hold the property for beneficiaries who have interests whose amount or quantum is set out in the instrument creating the trust. (pp. 122 - 3)

27 The topic is also discussed in Law Relating to Trusts and Trustees:[5]

> A fixed trust is void unless at the outset it can be seen clearly that all the beneficiaries thereunder are then ascertainable or will be ascertainable when the time comes under the trust to distribute capital or income. Just as a trust for A for life remainder to B absolutely is valid, so is a trust for A (a bachelor) for life remainder to his children equally and a trust to divide a fund equally between such persons as shall on X's death be his statutory next of kin or his dependants. However, a trust to divide a fund equally between next of kin and dependants of persons currently or formerly employed by ICI Ltd or by any company on the board of which an ICI Ltd director currently sits will be void unless a comprehensive list of such beneficiaries can be drawn up so as to enable an equal division to be made. Except where the potential number of beneficiaries is very high and the value of the trust fund relatively low it will usually be possible to draw up a comprehensive list of the persons ranking as beneficiaries at the time for distribution of the trust fund. (pp. 46 - 7)

28 In the present case, the beneficiaries are ascertainable. The Judicial Trustees have prepared lists for all of the loans showing the investors for each loan based on documentation in Eron's records. This is not a situation where the beneficiaries are named by a class description which is uncertain. Here, the beneficiaries were listed in schedules to the trust declarations with the result that the beneficiaries were ascertainable when the trust was created. Despite the fact that the trust declarations were often not updated when investors were changed or added, the Judicial Trustees believe that they have been able to ascertain all of the beneficiaries at the present time. While there may be some issues which will have to be resolved regarding the identity of beneficiaries, they will not be sufficiently insurmountable so as to make the beneficiaries unascertainable.

29 As there is sufficient certainty of intention, subject matter and objects, I find that the trusts created by the declarations are valid unless there is an overriding equitable principle which should cause the Court to disregard the trusts.

(b) Equitable Considerations

30 In support of his argument for pooling, Mr. Hobbs relied on the general principles of equitable tracing discussed at length in Re Diplock[6] and other authorities dealing with situations which have some resemblance to the present case. Mr. Fredricksen countered that the law of tracing is not relevant to the issue of pooling in this case and that the Court should not interfere with the trusts established by Eron and its numbered companies.

31 In Holden Financial, Rosenberg J. based his decision in favour of pooling on the inability of the investors to trace their funds. Holden Financial was a mortgage broker which held mortgages for its investors. The vast majority of investors left the investment of their funds entirely with Holden Financial and played no part in selecting mortgages allocated to them; nor did they receive any documentation evidencing an allocation of their investment to any particular mortgage. However, one investor, a Mr. Harnden, did play an active role in the selection of the mortgages in which his funds were to be invested. He inspected the property to be mortgaged and made his own risk assessment before agreeing to invest. Three mortgages related to Mr. Harnden. One was registered directly in his name and was considered to fall outside of Holden Financial's trust assets. The second mortgage was registered in the name of Holden Financial in trust for Mr. Harnden. The third mortgage was registered in the name of Holden Financial with no reference to Mr. Harnden.

32 Rosenberg J. stated that Mr. Harnden had the strongest case of all of the investors. However, as funds were improperly removed from Holden Financial's trust account between the time Mr. Harnden's funds were deposited into the account and the time the mortgage transaction was closed, Mr. Harnden was not able to trace his funds to the investments in question. Rosenberg J. concluded that it was necessary for Mr. Harnden to trace his funds to the investments in order to have a valid trust and that, as neither Mr. Harnden nor any other investor could trace their funds, the "trust assets" of Holden Financial were to be treated as being acquired by a single common fund and should be distributed on a pro rata basis among the investors. The reasoning of Rosenberg J. was as follows:

> While the Manitoba Securities case differs with respect to the form of the proceedings, it is a precedent with regard to the legal problem arising in the HFC case in that it defines the requirements to establish a trust. At p. 260 O'Sullivan J. stated:
>
>> It may be that there are some few persons who may be able to establish some trust such as a trust arising out of the collection of money in those rare cases where an investor took an assignment of a mortgage and appointed the company as their agent to collect, but there would be in any event formidable difficulties in the way of tracing such trust money.
>
> These words apply even more strongly to the present case where no investor, even Mr. Harnden, can establish that their funds were the specific funds used to advance under a specific security. In every case money was removed from the trust account between the time that their cheque was deposited and the document indicating the trust was created ... Once the trust fund and trust investments have been improperly dealt with and monies improperly taken each of the investors is in the position of being unable to trace their specific funds and therefore the trust with regard to that specific amount attributable to each investor has been mixed and cannot be traced. HFC cannot reinstate the trust relationship in favour of some investors against other investors by then registering assignments in favour of some investors in trust and designating some securities on the books of HFC as belonging to certain investors.

33 With the greatest of respect to Rosenberg J., it is my view that his reasoning is flawed (although the result reached by him is probably the right decision for the vast majority of Holden Financial's investors). Tracing of funds is not a requirement to establish a trust. Trusts are commonly created with no payment of funds from the beneficiary to the trustee. Tracing is not an ingredient of a trust but, rather, it is an equitable remedy available in respect of trust assets.

34 As an example, suppose that A gives money to B for the purpose of acquiring an asset which B is to hold for A and that B uses the money for some other purpose and absconds. A will have to rely on the remedy of tracing if he or she wants to recover their funds or some other asset acquired with the funds. By contrast, suppose that A gives money to B for the purpose of acquiring an asset which B is to hold for A and that B does acquire that asset and holds it for A (whether using A's funds or otherwise). A is entitled to the asset because it is held in trust by B for A, and A does not need to rely of the doctrine of tracing to establish entitlement to the asset. The latter is what occurred in Eron, with the asset being an interest in a mortgage.

35 In stating that tracing is a requirement for the establishment of a trust, Rosenberg J. relied on comments made by O'Sullivan J.A. in Re Manitoba Securities Commission v. Winnipeg Mortgage Exchange Ltd.[7] That was the first decision of the Manitoba Court of Appeal dealing with Winnipeg Mortgage ("Winnipeg Mortgage No. 1"). The decision to which I referred in paragraph 3 of these Reasons for Judgment in connection with Eron Investment Corporation was the second decision of the Manitoba Court of Appeal dealing with Winnipeg Mortgage ("Winnipeg Mortgage No. 2").

36 I believe that Rosenberg J. misunderstood the comments of O'Sullivan J.A. in Winnipeg Mortgage No. 1. O'Sullivan J.A. did not think that the documents created a trust in respect of the mortgages because they made reference to the creation of mortgages of mortgages, which is not consistent with the creation of trusts in respect of the mortgages themselves (which is essentially what Huband J.A. concluded in Winnipeg Mortgage No. 2 for all but a few of the trust documents). In making the comments quoted by Rosenberg J., O'Sullivan J.A. was referring to a form of trust other than one created by the documentation and he was giving as an example a trust arising out of the collection of money by Winnipeg Mortgage which the investor would have to trace in order to successfully claim.

37 Ironically, the argument which Rosenberg J. accepted in Holden Financial (based on the comments of O'Sullivan J.A. in Winnipeg Mortgage No. 1) was expressly rejected by Huband J.A. in Winnipeg Mortgage No. 2:

> The lack of identification of the moneys paid in by a customer with a particular mortgage acquired by W.M.E. does not affect the validity of the trust. The question of identifying or tracing trust property arises only after the declaration of trust has been made. It matters not that the customer's money has become "lost" prior to the declaration being made. Up to the time the declaration is made the customer is simply a creditor of W.M.E. But W.M.E. has assets, and in recognition of its financial obligation to the customer, W.M.E. is entitled to declare that it holds some part of its assets as trustee for the customer, from whom W.M.E. had received funds. (p. 144)

38 I agree with the submission of Mr. Fredricksen that when a trustee has been given monies to acquire an asset and the trustee appropriates or ear marks such an asset for the beneficiary, the beneficiary will have a trust interest in the asset without the necessity of tracing his or her money to the asset. In addition to the above comments of Huband J.A., this proposition is demonstrated in cases involving insolvent stock brokers: see, for example, Re Stobie-Forlong-Matthews, Limited[8] and Re Waite, Reid & Co. Ltd.[9]

39 In the Waite, Reid decision, while the Court held that the customers were entitled to securities appropriated to them, the Court did order a pro rata division of the securities which had not been appropriated to customers. A similar example is the case of Barlow Clowes International Ltd. (in liquidation) v. Vaughan.[10] In that case, the Court held that shares acquired with investors' monies were intended to form a common fund and were not to be allocated to individual investors. The Court held that the application of the rule in Clayton's Case[11] (i.e., first in, first out) would be impractical and would result in injustice between the investors, with the result that the assets were ordered to be shared by the investors pari passu in proportion to the amounts owed to them. This resembles the initial situation in Eron Investment Corporation where the investors gave the money to Eron Investment Corporation with the intention that all investor funds would be pooled and invested in numerous Eron mortgages without allocation among the investors. However, it is distinguishable from the situation in Eron Mortgage

Corporation where it was the intention at all times that the mortgages (or interests therein) would be appropriated to the investors in accordance with their agreements with Eron.

40 In Re Urman,[12] a trust between a mortgage broker and multiple investors was upheld without requiring the investors to trace their funds. The Court did not specifically deal with the issue of tracing but, in holding that there had been a sufficient appropriation, it relied on the decision in Taylor v. London & County Banking Co.[13] In that latter case, a solicitor had misappropriated trust money and on his trust ledger he made a note that a mortgage which he held in his own right was to cover the amount he had defrauded from the trust. This notation was held to be a sufficient appropriation of the mortgage to create a trust in favour of the defrauded trust estate. The defrauded trust estate was obviously unable to trace its trust funds into the mortgage because the funds were not used by the solicitor to acquire the mortgage.

41 In addition to Winnipeg Mortgage No. 2 and the other decisions which I have discussed above, the authorities relied upon by Mr. Hobbs in support of his position for pooling were (i) Re Ontario Securities Commission and Greymac Credit Corp.,[14] (ii) Chering Metals Club Inc. (Trustee of) v. Non-Discretionary Cash Account Trust Claimants,[15] (iii) Ontario (Securities Commission) v. Consortium Construction Inc.,[16] (iv) Re Major Trust Co.,[17] (v) Re Winsor and Bajaj[18] and (vi) Re Can Corp. Financial Services Ltd.[19] Other than Can Corp. Financial (and Winnipeg Mortgage No. 2), I do not find these authorities to be of assistance because they involve situations where the trust corpus was mixed and had not been allocated to beneficiaries.

42 In Greymac Credit, the contest was between four beneficiaries who had provided monies to the trustee which had mixed the funds and then dissipated part of them. The Court held that the rule in Clayton's Case (i.e., first in, first out) did not apply and that the funds should be distributed on a pro rata basis to the beneficiaries.

43 In Chering Metals, the trust corpus was bullion which had been purchased with monies provided by investors. The bullion was not appropriated among the investors and the Court directed that there be a pro rata distribution.

44 Consortium Construction Inc. was a decision by Rosenberg J., the judge in Holden Financial. The investors provided monies for the purchase of real estate projects. The Consortium Group did not account for revenues and expenses on a project-by-project basis, and funds were combined and commingled. Rosenberg J. approved a scheme of distribution proposed by the Receiver-Manager of the Consortium Group which provided that investors in certain projects would be paid pro rata from the realization of those projects and that the remaining investors would be treated as unsecured creditors. Rosenberg J. concluded that all of the investors' monies in respect of certain projects were deposited into separate bank accounts in two instances and, therefore, those investors collectively had a constructive trust with respect to those projects. The remaining investors could not establish a constructive trust and they were held to rank as unsecured creditors.

45 In Re Major Trust Co., a trust company accepted monies for the purchase of guaranteed investment certificates. These monies were mixed in a common fund with other monies of the trust company. The Court held that although the monies paid by the holders of the investment certificates were held in trust by the trust company, the holders of the certificates were not entitled to be paid from the mixed fund in preference to the other claimants because they could not trace their monies once they were mixed with the other funds.

46 Re Winsor and Bajaj involved a shortfall in a solicitor's mixed trust account. The Court ruled that the clients whose monies were deposited into the trust account should share in the remaining funds on a pro rata basis.

47 That brings me to Winnipeg Mortgage No. 2, the case which I followed in connection with Eron Investment Corporation, and Can Corp. Financial, which also followed Winnipeg Mortgage No. 2. As I mentioned above, Huband J.A. found that the documentation created valid trusts of the mortgages (except where they made reference to the creation of mortgages of mortgages) but the majority choose to disregard the trusts on the basis that the allocation of the mortgages had been done arbitrarily. The investors had put their faith in Winnipeg Mortgage and they had no input as to the mortgages allocated to them by the trust agreements.

48 The reasoning of Freedman C.J.M., speaking for the majority, was thus:

> In light of the facts emerging from that extract [i.e., that the investors had no control over the mortgages allocated to them], it would be grossly unfair to give a preferred position to those who happened to have been allocated "good" mortgages, and a subordinate position to those who were allocated "bad" mortgages. Our disposition of the controversy should reflect two things - (1) the intention of the parties when the transactions were entered into, and (2) the necessity for fairness in the ultimate result. Concerning the first, it cannot be doubted that if, on the day before the bubble burst, the investors had been asked whether each of them stood on the same level as the others, the answer would assuredly have been in the affirmative. An answer suggesting that the investors stood on different levels would have been inconsistent with the intention both of the investors and of the companies. As for the second, to make preferred creditors out of those who by sheer luck received "good" mortgages would be to make ourselves slaves to contingency and to deny ourselves the power to do justice in accordance with the maxim that equality is equity. I would treat all the investors equally by pooling the available assets and dividing them among the investors according to their respective claims as proved. (p. 123)

49 I followed this reasoning in relation to Eron Investment Corporation. The investors gave their money to Eron Investment Corporation with the knowledge that their funds would be mixed with the money received from other investors and that the mixed funds would be invested in Eron mortgages at the discretion of Eron Investment Corporation. There was no allocation of investors to particular mortgages and no trust declarations were completed. When the governmental regulators raised questions and legal advice was obtained, Eron Investment Corporation unilaterally allocated its interests in Eron mortgages to most of the investors, while giving some of the investors a choice between various mortgages. There were other defects in the allocation process. I ruled that the initial pooled character of the investment should prevail over the flawed allocation of the mortgage interests.

50 This approach was also followed in Can Corp. Financial, which was not cited to me when I made my decision in connection with Eron Investment Corporation. That case involved a mortgage broker which used investors' monies to make mortgages. The mortgage broker provided the investors with documents entitled "Declarations of Trust" and "Mortgage Participation Agreements". However, the mortgage broker was authorized to transfer an investor's participation from one mortgage to another with no consultation. Chadwick J. concluded that the above quoted comments of Freedman C.J.M. in Winnipeg Mortgage No. 2 had equal application to the case before him and he ordered that the assets of the mortgage broker be distributed by way of a pooling arrangement.

51 Should I likewise utilize this approach in the present situation and order a pro rata distribution despite the existence of the trust declarations? The answer to this question, in my view, is found in the second paragraph of Freedman C.J.M.'s reasons in Winnipeg Mortgage No. 2:

> Central to an understanding of this case is the recognition that the investors became such under circumstances that were markedly different from the usual case of this kind. Ordinarily, a person wishing to invest his money in a mortgage will be concerned with the nature of the mortgage - What property is it on? What is the value of that property? Is there a sufficient margin between the amount of the proposed mortgage and the total value of the property? Is the personal covenant of the mortgagor reliable as an added protection in the event that things go sour and resort to that covenant becomes necessary? These are the kinds of questions which will engage the attention of a prospective investor in the ordinary case. But not so here; and that is what makes this case unique, that is why it must be uniquely treated. (p. 120)

While the typical Eron investment may not represent the ordinary case in view of the syndicated nature of the loans, it is the ordinary case in the sense that the investor made a risk assessment at some level and made a conscious decision to invest his or her money in a particular mortgage (which was subsequently appropriated to the investor by way of the trust declaration). Mr. Fredricksen made the distinction between obtaining an interest in a mortgage by choice or by chance, and I agree with this distinction.

52 The Eron investors choose to invest in the mortgages allocated to them by way of the trust declarations and there is no equitable reason to deprive them of their choices. There are "good" mortgages and "bad" mortgages but the investors were the ones who made the choices to invest in them. There is no reason why they should not enjoy the benefits or bear the adverse consequences of their decisions. The intention of the parties when they entered into the transactions was that the investors would have an interest in the mortgage loan which they selected and that all investors would not stand on the same footing. In this case, equality among the investors would constitute an inequity because it would represent a variation of the contracts and trust arrangements between Eron (or its numbered companies) and the investors without proper justification at law or in equity. Accordingly, the reasoning in Winnipeg Mortgage No. 2 does not apply to the present situation.

53 The last authority to which I will refer is Yorkshire Trust Company v. Empire Acceptance Corporation Limited,[20] another decision which was not cited to me when I made my decision in relation to Eron Investment Corporation. In that case, this Court held that there was no triable issue with respect to a pooling of investors who were allocated to mortgages by the mortgage broker as a matter of chance. Although this case supports my conclusion, I choose not to rely on it because its reasoning is not reconcilable with Winnipeg Mortgage No. 2, which I consider to be a more fully reasoned and authoritative decision.

CONCLUSION

54 The Judicial Trustees are directed to distribute the monies recovered on each mortgage in accordance with the trust declarations relating to the mortgage irrespective of the account into which the investors' funds were deposited. An incoming investor who directly paid out an outgoing investor will be in the same position as was the outgoing investor. The Judicial Trustees are at liberty to apply for further directions if there is no trust declaration for a mortgage (or other security) or if there are issues relating to the identity of the beneficiaries under the trusts. The Judicial Trustees are also at liberty to apply for directions with respect to any of the remaining 34 questions posed in the report of the principal Judicial Trustee which have not been answered or rendered moot by these Reasons for Judgment.

TYSOE J.

cp/d/lmt/DRS

1 Holden Financial Corp. v. 411454 Ontario Ltd., [1992] O.J. 1783 (Q.L.) (Ont. Gen. Div.), overturned in part [1993] O.J. 3048 (Q.L.) and affirmed in part [1993] O.J. 3999 (Q.L.) (Ont. C.A.).

2 Now reported at (1998), 2 C.B.R. (4th) 184.

3 Re. Winnipeg Mortgage Exchange Ltd. (1982), 43 C.B.R.(N.S.) 119 (Man. C.A.).

4 D.W.M. Waters, Law of Trusts in Canada, 2d ed. (Toronto: Carswell, 1984).

5 Underhill and Hayton, Law Relating to Trusts and Trustees, 14th ed. (London: Butterworths, 1987).

6 Re Diplock, [1948] Ch. 465 (Eng. C.A.).

7 Re Manitoba Securities Commission v. Winnipeg Mortgage Exchange Ltd. (1980), 113 D.L.R. (3d) 257 (Man. C.A.).

8 Re Stobie-Forlong-Matthew, Limited, [1931] 1 W.W.R. (Man. C.A.).

9 Re Waite, Reid & Co. Ltd. (1969), 5 D.L.R. (3d) 229 (Ont. S.C.).

10 Barlow Clowes International Ltd. (in liquidation) v. Vaughan, [1992] 4 All ER 22 (Eng. C.A.).

11 Clayton's Case, Devaynes v. Noble, [1814-23] All ER Rep. 1.

12 Re Urman (1983), 44 O.R. (2d) 248 (Ont. C.A.).

13 Taylor v. London & County Banking Co; London & County Banking Co. v. Nixon, [1901] 2 Ch. 231.

14 Re Ontario Securities Commission and Greymac Credit Corp. (1986) 55 O.R. (2d) 673 (Ont. C.A.).

15 Chering Metals Club Inc. (Trustee of) v. Non-Discretionary Cash Account Trust Claimants (1991), 7 C.B.R. (3d) 105 (Ont. Gen. Div.).

16 Ontario (Securities Commission) v. Consortium Construction Inc., [1993] O.J. No. 1408 (Q.L.) (Ont. Gen. Div.).

17 Re Major Trust Co. (1972), 33 D.L.R. (3d) 481 (P.E.I.S.C.).

18 Re Winsor and Bajaj (1990), 75 D.L.R. (4th) 198 (Ont. Gen. Div.).

19 Re Can Corp. Financial Services Ltd. (1991), 6 C.B.R. (3d) 216 (Ont. Gen. Div.).

20 Yorkshire Trust Company v. Empire Acceptance Corporation Limited (1978), 28 C.B.R.(N.S.) 225 (B.C.S.C.).

TAB
7

290 F3d 80 Securities and Exchange Commission v. Credit Bancorp Ltd H

290 F.3d 80

SECURITIES AND EXCHANGE COMMISSION, Plaintiff-Appellee,
Stephenson Equity, Co., Intervenor-Plaintiff-Appellant,
Robert Praegitzer, et al., Intervenors-Plaintiffs-Appellees,
v.
CREDIT BANCORP, LTD., et al., Defendants-Intervenors-Defendants,
Carl H. Loewenson, Jr., Receiver-Appellee.

Docket No. 00-6376.

United States Court of Appeals, Second Circuit.

Argued: October 11, 2001.

Decided: May 9, 2002.

Donald L. Kahl, Hall, Estill, Hardwick, Gable, Golden & Nelson, P.C., Tulsa, OK (T. Lane Wilson, Tulsa, OK; William A. Maher, Frederick R. Kessler, Daniel S. Goldsmith, Wollmuth Maher & Deutsch, LLP, New York, N.Y. on the brief), for Intervenor-Plaintiff-Appellant.

Carl H. Loewenson, Jr., Morrison & Foerster, LLP, New York, N.Y. (Charles L. Kerr, Oliver Metzger, Andrew J. Fields, Eleonore Dailly, New York, N.Y., on the brief), for Receiver-Appellee.

Tom Karr, Securities and Exchange Commission, Washington, D.C. (David M. Becker, Gen. Counsel, Richard M. Humes, Assoc. Gen. Counsel, Melinda Hardy, Asst. Gen. Counsel, Meyer Eisenberg, Deputy Gen. Counsel, Washington, D.C., on the brief), for Plaintiff-Appellee.

Joel W. Sternman, Rosenman & Colin LLP, New York, N.Y.; Joel A. Mullin, Stoel Rives LLP, Portland, OR, submitted a brief for Intervenors-Plaintiffs-Appellees Robert Praegitzer, et al.

Before WALKER, Chief Judge, JON O. NEWMAN, and KEARSE, Circuit Judges.

JON O. NEWMAN, Circuit Judge.

1

The issue on this appeal is whether shares of stock transferred to a company that defrauded the transferor and numerous other victims can be included in the receivership estate of the defrauding company for purposes of a *pro rata* distribution to the defrauded victims. Stephenson Equity Company ("SECO") appeals from opinions and orders of the District Court for the Southern District of New York (Robert W. Sweet, District Judge), dated November 29, 2000, and January 19, 2001, the combined effect of which approved a distribution plan in the receivership of Credit Bancorp, Ltd. ("CBL") and modified an injunction freezing CBL's assets. *SEC v. Credit Bancorp, Ltd.,* No. 99 CIV. 11395-RWS, 2000 WL 1752979 (S.D.N.Y. Nov.29, 2000) ("*Credit Bancorp (Plan) I*"); *SEC v. Credit Bancorp, Ltd.,* 129 F.Supp.2d 259 (S.D.N.Y.2001) ("*Credit Bancorp (Plan) II*").1 We conclude that a *pro rata* distribution was within the equitable discretion of the District Court, and we therefore affirm.

Background

2

SECO is a partnership substantially owned and controlled by Charles C. Stephenson, Jr. Stephenson is also founder and chairman of the board of Vintage Petroleum, Incorporated ("Vintage Petroleum"), a publicly traded oil and gas company. In March 1999, an agent of CBL contacted Stephenson to solicit SECO's participation in CBL's "insured credit facility program." Under this program, investors transferred cash or securities to CBL and received a promise of a quarterly dividend based on the value of the unencumbered assets transferred by the investor. The assets were to be used as collateral in the event that the investor drew upon a line of credit offered by CBL. The assets also served an additional purpose: in order to generate revenue from what CBL called "`riskless' arbitrage transactions" with European banks,2 CBL reflected the assets off its normal balance sheet, and the shares transferred by the investors into CBL accounts increased the amount of off-balance sheet assets available to generate the "`riskless' arbitrage transactions."3 CBL implied that it would be able to pay the investors their promised dividends from the profits earned on the arbitrage transactions. In reality, CBL, running a classic Ponzi scheme, paid investors a return out of the assets transferred by later investors.

3

The SECO CFA and the SECO TEL. The principal documents executed in contemplation of the asset transfer were the "CBL Credit Facility Agreement" ("SECO CFA") and what the parties refer to as the "Trustee Engagement Letter" ("SECO TEL"). The SECO CFA was executed on June 22, 1999, by Stephenson, as general partner of SECO, Richard Blech, as President and CEO of CBL, Douglas C. Brandon, as Trustee, and J. Frederick Storaska, president of Corporate Executive Services, Inc., the managing general partner of SECO. It contemplated the transfer of eight million shares of SECO's Vintage Petroleum stock and a quarterly dividend to SECO of 1.25 percent of the value of the unencumbered assets. The SECO TEL was executed the same day by Blech, Brandon, and Storaska. The SECO TEL incorporated the terms of the SECO CFA.

4

According to the SECO CFA, "CBL will engage Douglas C. Brandon ... to act as Trustee, to hold the Assets [the eight million Vintage Petroleum shares] ... in a CBL account for the benefit of SECO and CBL." SECO CFA, ¶ 1.1; *id.* ¶ 2.1. SECO "will deliver to Trustee the specified fungible Assets ... to serve as collateral for the credit facility" and to be held by United States brokerage firms "for the Credit Bancorp Ltd. account." *Id.* ¶ 2.3. Under the same paragraph, however, "CBL ... retains the sole right to transfer some or all of the Assets to other Accounts...." *Id.*

5

"[B]eneficial ownership to the Assets shall at all times remain with SECO," *id.,* ¶ 4.1, and "CBL and Trustee represent and warrant that the Trustee shall have legal title to the Assets and that SECO shall retain equitable title and beneficial ownership at all times, including following the deposit of the Assets into the Account, and that the Assets remain an asset of SECO and do not become an asset of CBL," *id.* ¶ 4.2.

The SECO TEL provides in relevant part:

6

I [Brandon] am the signing attorney-in-fact for all CBL Trustee accounts. These [Vintage] securities are to be held by me in a CBL account and may not be sold, pledged, assigned, margined, liened, hypothecated, or otherwise disposed of except as provided for in the CFA.... At no time am I to release the securities to any third party. As the securities are being delivered solely as collateral for any advance SECO may obtain under the credit facility with CBL, beneficial ownership is retained by SECO.

7

SECO's transfer of shares into CBL accounts. As described above, the SECO CFA provided that SECO would "deliver *to Trustee* the specified fungible Assets." ¶ 2.3 (Emphasis added). However, in a letter dated June 21, 1999, Stephenson authorized SECO's brokerage firm, Merrill Lynch, to transfer eight million shares of Vintage Petroleum into four separate CBL accounts, none of which was identified as a trust account. The first, at Alex Brown and Sons, is a CBL account identified by account number only. The second and fourth accounts, at Swiss American Securities, Inc. and Brown Brothers Harriman, respectively, are described as "FFC: [for further credit of] Credit Bancorp." The third account, with National Financial Services, is described as "FBO: [for benefit of] Credit Bancorp."

8

In early July 1999, CBL began transferring the Vintage shares out of the first group of accounts and into a variety of its other accounts at financial institutions such as Ameritrade, Charles Schwab, Chase Investment, and Credit Suisse Private Banking. None of these accounts was identified as a trust account. In both the first and subsequent groups of accounts, the investors' assets, including SECO's, were commingled with the assets of CBL's other investors.

9

CBL's fraudulent activity. CBL was operational from some time in 1997 until November 17, 1999, when the SEC filed suit and obtained a TRO freezing the assets of CBL and its related entities. By that time, CBL had victimized more than 200 investors. Most investors had transferred assets to CBL as contemplated by CFA and TEL agreements similar to those executed by SECO. Approximately 93 investors — referred to in this litigation as "the Bob Mann customers" — directed their deposits of cash and mutual funds under advice from Advisor's Capital Investments into the CBL "Insured Securities Strategy" program.

10

Contrary to its claims that it was engaging in "riskless" arbitrage, CBL's only material source of revenue was the deposit of cash and securities by its investors. CBL's primary business, other than attracting new investors, was to engage in currency futures and options trading that led to substantial losses. CBL financed its trading with cash and securities taken directly from its accounts and with money borrowed by pledging deposited securities as collateral for margin loans. CBL has encumbered a substantial portion of the securities deposited by customers, including a majority of the Vintage Petroleum shares, to secure its margin loans. CBL also used its investors' funds to pay the cash "dividends" to its investors, such as the dividends paid to SECO approximating $1.26 million dollars.

11

CBL shifted funds and securities regularly among brokerage accounts, and neither segregated customer deposits nor earmarked a particular customer's deposited assets to be used to pay that customer's custodial dividend. SECO's claim is distinguishable from that of many of CBL's customers only in that the eight million Vintage Petroleum shares it deposited were not converted to cash and are currently being held in CBL's brokerage accounts.4

12

The proposed plans of distribution and the District Court's approval. The District Court appointed a receiver, Carl H. Loewenson, Jr. ("the Receiver") to marshal CBL's assets and to prepare a distribution plan. Interim distribution plans were proposed by the Receiver, the SEC, and certain CBL customers as intervenors—SECO and Dr. Gene Ray (collectively the "SECO Intervenors") and Thomas Stappas *et al.* (the "Stappas Intervenors").5 Under SECO's proposed plan, those CBL clients, like SECO, who had executed CFAs, would be given priority over clients who had deposited cash directly into CBL accounts. Under the SEC's plan, the Receiver would liquidate all of CBL's assets—including the Vintage Petroleum shares in CBL's accounts—and distribute the resulting cash on a *pro rata* basis, based on the amounts of initial investments.

13

The Receiver's proposed plan ("the Compromise Plan") was designed to achieve the SEC's objective that all investors benefit from the distribution on a *pro rata* basis (according to the amount of their investments) and also meet SECO's preference that the Vintage Petroleum shares not be liquidated.6 Under the Compromise Plan, the Vintage Petroleum shares are returned to SECO, but SECO is required to pay into the receivership estate a cash "undertaking" determined primarily from a percentage of the value of the shares (the percentage reflecting the portion of all victims' investments that were lost). The cash undertaking will be included in the receivership estate for purposes of the *pro rata* distribution.7

14

In a comprehensive Order and Opinion dated November 29, 2000, the District Court approved the Compromise Plan, *Credit Bancorp (Plan) I,* 2000 WL 1752979, at *48, and, acting on the Receiver's request, in an Opinion dated January 19, 2001, amended the Compromise Plan, *Credit Bancorp (Plan) II,* 129 F.Supp.2d at 263. Also on January 19, 2001, the Court entered an Order directing the Receiver, among other things, to "use his best judgment to effectuate" the Compromise Plan. SECO filed a notice of appeal from the Order and Opinion dated November 29, 2000, and an amended notice of appeal from the November 29, 2000, Order and Opinion, the January 19, 2001 Opinion, and the January 19, 2001, Order.8

Discussion

I. Jurisdiction

15

SECO, in its appeal, and the Receiver, in opposition, primarily join issue on whether the District Court's confirmation of the Compromise Plan was within the Court's equitable authority. The Court resolved that issue in the Receiver's favor both in approving the Compromise Plan and in denying SECO's motion for partial summary judgment to obtain return of the Vintage shares. The latter ruling is not independently appealable, and the former ruling ordinarily is not independently appealable unless the doctrine of "practical finality," *see* 19 *Moore's Federal Practice* § 202.08 (3d ed.2001), or the collateral order doctrine, *see SEC v. Forex Asset Management LLC,* 242 F.3d 325, 330 (5th Cir.2001) (applying collateral order doctrine to approval of receiver's distribution plan), applies. *See also SEC v. Elliott,* 953 F.2d 1560 (11th Cir.1992) (exercising appellate jurisdiction over order establishing final plan of distribution, without explicit discussion of jurisdiction). We need not consider either doctrine, however, because the effect of the District Court's ruling was a modification of the freeze order that had been initially entered as a TRO and continued as a preliminary injunction, and "[i]nterlocutory orders of the district courts ... modifying... injunctions" are appealable. 28 U.S.C. § 1292(a)(1). Appellate review under section 1292(a)(1), moreover, extends to " `all matters inextricably bound up with the [preliminary injunction],'" including, in this case, SECO's motion for partial summary judgment. *SEC v. Black,* 163 F.3d 188, 194 (3d Cir.1998) (quoting *Energy Action Educational Foundation v. Andrus,* 654 F.2d 735, 745 n. 54 (D.C.Cir.1980)) (alterations in original).

II. Standard of Review

16

We review the District Court's application of law with regard to its denial of SECO's motion for partial summary judgment *de novo. Black,* 163 F.3d at 195 (citing *AT & T v. Winback & Conserve Program, Inc.,* 42 F.3d 1421, 1427 (3d Cir. 1994)). We review the District Court's decision relating to the choice of distribution plan for the receivership estate for abuse of discretion. *See SEC v. Fischbach Corp.,* 133 F.3d 170, 175 (2d Cir.1997); *SEC v. Wang,* 944 F.2d 80, 85 (2d Cir. 1991).

17

III. The Ownership Interest in the Vintage Petroleum Shares

18

SECO contends that CBL never obtained an ownership interest in the Vintage Petroleum shares and, therefore, that including the shares (or cash paid in to represent their value) in the receivership estate violates various provisions of state law. SECO asserts that the SECO CFA and TEL created an express trust, whereby legal title was transferred to the Trustee, with SECO retaining a beneficial interest. SECO contends that CBL's only interest in the transferred shares was a security interest contingent upon SECO's availing itself of the line of credit offered by CBL. Because SECO never drew upon the line of credit, the argument continues, CBL never acquired a security interest or any other ownership interest.

19

If SECO's shares had been transferred pursuant to an express trust, we would confront the issue of whether the equitable interests of the settlor of an *inter vivos* trust may be adjusted by a *pro rata* distribution ordered by a district court, exercising its equitable jurisdiction in an SEC-initiated receivership proceeding, to remedy fraud perpetrated upon the settlor and other victims. We need not resolve that issue, however, because, although CBL solicited investments with documents indicating in some respects the anticipated use of a trust arrangement, the documents knowingly executed by SECO to transfer its Vintage shares in fact and in law accomplished an outright transfer of share ownership from SECO to CBL.

20

The documentation preparatory to the transfer of assets from SECO to CBL indicated that a trust arrangement was contemplated, yet also included provisions inconsistent with a trust. For example, consistent with a trust arrangement, a trustee was designated, SECO was expected to deliver the Vintage shares to the trustee, the trustee was to hold the shares in a CBL account over which he had signing authority,9 and the trustee was not to release the shares to any third party. On the other hand, inconsistent with a trust arrangement, CBL retained the right to transfer the assets out of the initial account(s) into which they were transferred. *See Restatement (Second) of Trusts* § 175 (1959) ("The trustee is under a duty to the beneficiary to take reasonable steps to take and keep control of the trust property"); *id.* cmt. f ("The duty of the trustee is not only to take and keep control, but to take and keep exclusive control.").

21

The documents accomplishing the transfer of assets are entirely inconsistent with a trust arrangement. None of the transfer documents executed by SECO required the shares to be transferred into trust accounts, and in fact the shares were not transferred into trust accounts. *See id.* cmt. c ("Where securities are held in trust the trustee is under a duty to take and keep possession of the securities, and to earmark them as trust property."). It is undisputed that on June 21, 1999, SECO authorized its broker, Merrill Lynch, to transfer the eight million Vintage Petroleum shares into three CBL brokerage accounts either "for the benefit of" CBL or "for the further credit of" CBL and a fourth CBL account identified only by account number. These accounts were under the exclusive control of Richard Blech, CBL's President and CEO, not Brandon, the putative trustee. Whether the transfer complied with the CFA, as SECO contends, or violated the CFA, as the Receiver contends, the transfer made by SECO effectively moved the shares into CBL accounts without trust restrictions.

22

Thus, SECO transferred its shares into CBL accounts and gave CBL the "sole right" to transfer those shares into other accounts, a right CBL exercised. Moreover, the papers CBL furnished to its investors, including SECO, explicitly informed them of the purpose of placing the transferred shares under the sole control of CBL: to reflect assets off its normal balance sheet that would increase the amount of assets available to generate "riskless" arbitrage transactions.

23

IV. The Receivership Court's Authority to Order a *Pro Rata* Distribution

24

SECO's transfer of the shares to the defrauders without the protection of an express trust does not, however, necessarily defeat SECO's claim. Under state law, assets acquired by fraud are subject to a constructive trust for the benefit of the defrauded party. *Restatement (First) of Restitution* § 166 (1937). *See Counihan v. Allstate Insurance Co.,* 194 F.3d 357, 361 (2d Cir.1999) (assets are held subject to constructive trust when "a party ... is holding property `under such circumstances that in equity and good conscience he ought not to retain it'") (quoting *Miller v. Schloss,* 218 N.Y. 400, 407, 113 N.E. 337 (1916)); *Koreag, Controle et Revision S.A. v.* Refco *F/X Associates, Inc. (In re Koreag, Controle et Revision S.A.),* 961 F.2d 341, 352 (2d Cir.1992) (applying New York law of constructive trust in a bankruptcy case).

25

In assessing the significance of whatever constructive trust might have arisen in this context, we note preliminarily that CBL's fraud concerned the false promises made with respect to CBL's sources of income, not with respect to the arrangements under which the shares would be transferred from SECO to CBL. Thus, just as we do not have a case involving shares transferred under an express trust, we also do not have a case where a party is fraudulently deceived into signing transfer papers that it was entitled to believe would have accomplished a transfer under an express trust. The actual transfer documents executed by SECO made clear on their face that SECO was transferring the shares to CBL accounts-not to Brandon and not in trust.

26

In any event, whatever beneficial interest SECO might have in the transferred shares, arising from a constructive trust, does not defeat the equitable authority of the District Court to treat all the fraud victims alike (in proportion to their investments) and order a *pro* *rata* distribution. Courts have favored *pro rata* distribution of assets where, as here, the funds of the defrauded victims were commingled and where victims were similarly situated with respect to their relationship to the defrauders. *See Cunningham v. Brown,* 265 U.S. 1, 13, 44 S.Ct. 424, 68 L.Ed. 873 (1924) (original Ponzi scheme case suspending tracing fiction in context where receivership fund consisted of money acquired by fraud perpetuated against many victims); *Forex,* 242 F.3d at 331-32 (affirming District Court's approval of *pro rata* distribution plan where party's assets were held by defrauder in segregated accounts); *Commodity Futures Trading Commission v. Topworth International, Ltd.,* 205 F.3d 1107, 1115-16 (9th Cir.1999) (affirming District Court's approval of *pro rata* distribution plan where assets were commingled); *United States v. 13328 and 13324 State Highway 75 North,* 89 F.3d 551, 553-54 (9th Cir.1996) ("*Real Property*") (same); *United States v. Durham,* 86 F.3d 70, 73 (5th Cir.1996) (affirming District Court's approval of *pro rata* distribution plan even though the majority of funds were traceable to specific claimants); *Elliott,* 953 F.2d at 1569-70 (affirming District Court's approval of *pro rata* distribution plan even though securities were traceable to claimants).

27

As the District Court noted, the use of a *pro rata* distribution has been deemed especially appropriate for fraud victims of a "Ponzi scheme," *see Cunningham,* 265 U.S. at 7-9, 44 S.Ct. 424 (describing the scheme of Charles Ponzi), in which "earlier investors' returns are generated by the influx of fresh capital from unwitting newcomers rather than through legitimate investment activity." *Credit Bancorp (Plan) I,* 2000 WL 1752979, at *13; *see also Hirsch v. Arthur Andersen & Co.,* 72 F.3d 1085, 1088 n. 3 (2d Cir.1995) (describing characteristics of Ponzi schemes). In such a scheme, whether at any given moment a particular customer's assets are traceable is "a result of the merely fortuitous fact that the defrauders spent the money of the other victims first." *Durham,* 86 F.3d at 72 (internal quotation marks omitted).

28

SECO points out that three of the decisions relied on by the District Court, *Topworth, Durham,* and *Real Property,* all involved cash, which is fungible, whereas the pending case involves identifiable shares. But *Elliott,* also relied on by the District Court, involved identifiable shares, and the cash at issue in *Durham* and *Forex* was traceable to particular customers. *Pro rata* distributions were approved in all three cases.

29

Elliott is the case most analogous to ours. The investors there executed written agreements "loaning" the securities to the defrauders. They delivered the securities with a power of attorney, in return for a promissory note, which was equal to the market value of the securities and which stated that monthly interest payments would be made. *Elliott,* 953 F.2d at 1568-69. The Eleventh Circuit concluded that "what in fact transpired was that the investors unwittingly transferred legal title in the securities" to the fraudulent investment scheme. *Id.* at 1569. Our case is at least as strong for *pro rata* distribution as *Elliott* because the transfer documents executed by SECO directed its agent at Merrill Lynch to transfer the shares into CBL accounts, SECO agreed that CBL would have authority to transfer the shares out of those accounts, and SECO was informed why CBL (and ultimately the investors) would benefit from having the shares included as off-balance-sheet assets of CBL. Thus, the facts putting SECO on notice that it was not transferring its shares in trust were fully known to SECO, even if it was "unwittingly," *Elliott,* 953 F.2d at 1569, unaware of the legal consequences of these facts.

30

The cases relied on by SECO that involved Ponzi schemes and permitted the return of identifiable assets to particular victims are distinguishable. In those cases the reason the assets were returned was not merely because they were traceable, but because the assets had somehow been segregated in the manner of true trust accounts and/or had never been placed in the defrauder's control. *See Black,* 163 F.3d at 196-97 (affirming District Court order allowing return of assets held in custodian accounts that were never pooled or in the control of the defrauder, but noting that District Court had not finally adjudicated distribution and had left open possibility that victims whose assets were pooled might have a cause of action against non-pooled victims); *Anderson v. Stephens,* 875 F.2d 76, 80 (4th Cir.1989) (ordering return of assets that were deposited in defrauder's account after account had been frozen by the district court, on the ground that the asset freeze precluded the bank from conducting further transactions); *City of Philadelphia v. Lieberman,* 112 F.2d 424, 426 (3d Cir.1940) (ordering return of assets that had been placed in actual trust account beyond the control of the insolvent). Also inapposite are cases relied on by SECO that preferred the interests of defrauded victims over the interests of general creditors, *see Gorman v. Littlefield,* 229 U.S. 19, 25, 33 S.Ct. 690, 57 L.Ed. 1047 (1913) (Court refused to allow wrongfully converted property to be used to pay general creditors), or that recognized the claim of the holder of a perfected security interest, *Foothill Capital Corp. v. Clare's Food Market, Inc. (In re Coupon Clearing Service, Inc.),* 113 F.3d 1091, 1098-99 (9th Cir.1997).10

V. SECO's Opposing Contentions

31

SECO advances several contentions to defeat the authority of the District Court to order a *pro rata* distribution. None has merit.

32

U.C.C. claim. SECO contends that its claim should be governed by U.C.C. [Rev.] § 8-503 (a) (1996), which states that "all interests ... held by the securities intermediary ... for the entitlement holders, *are not property of the securities intermediary,* and are not subject to claims of creditors of the securities intermediary" (emphasis added). But as the District Court noted in rejecting SECO's U.C.C. claim, U.C.C. [Rev.] § 8-503, Official Comment 1, states that in "insolvency proceedings" the applicable "insolvency law" governs. *Credit Bancorp (Plan) I,* 2000 WL 1752979, at *22. An "insolvency proceeding" is "any assignment for the benefit of creditors or other proceedings intended to liquidate or rehabilitate the estate of the person involved." U.C.C. § 1-201(22) (1996). We agree with the District Court that receiverships are "insolvency proceedings," and that the law of federal equity receiverships applies.

33

Bailment claim. SECO characterizes its transactions with CBL as involving the delivery of securities for the purpose of securing future loans or advances. Based on this characterization, SECO contends that its relationship with CBL was that of bailor and bailee, or pledgor and pledgee. SECO notes that under the law of bailment, as the District Court recognized, a bailee acquires only a possessory interests in the property pledged, while the bailor retains legal and equitable title. *See Credit Bancorp (Plan) I,* 2000 WL 1752979, at *26 (" `In a bailment relationship, title to the property remains in the bailor.'") (quoting *Ralph A. Veon, Inc. v. Hinks (In re Ralph A. Veon, Inc.),* 12 B.R. 186, 189 (Bankr.W.D.Pa.1981)); *Cornelius v. Berinstein,* 183 Misc. 685, 50 N.Y.S.2d 186, 188 (N.Y.Sup.Ct.1944). SECO's argument fails, however, because, as described above, SECO transferred legal title to the Vintage Petroleum shares to CBL, and the law of bailment therefore does not apply.

34

Takings Clause claim. Whether or not a court's action in ordering a *pro rata* distribution among fraud victims is even cognizable under the Takings Clause, *see Corporation of the Presiding Bishop v. Hodel,* 830 F.2d 374, 381 (D.C.Cir.1987) ("The question of whether courts, as opposed to legislative bodies, can ever `take' property in violation of the Fifth Amendment is an interesting and by no means a settled issue of law."), SECO has no such claim here. SECO transferred its shares into CBL accounts. It was that action that ultimately permitted the District Court to include the shares in the *pro rata* distribution.

Conclusion

35

The District Court was entitled to include the Vintage Petroleum shares in the receivership estate (with SECO allowed to recover its shares upon payment of a cash undertaking), and approval of the Compromise Plan was within the Court's equitable discretion. The Orders appealed from are affirmed.

Notes:

1

For prior opinions of the District Court, see*SEC v. Credit Bancorp, Ltd.,* 194 F.R.D. 457 (S.D.N.Y.2000); *SEC v. Credit Bancorp, Ltd.,* 93 F.Supp.2d 475 (S.D.N.Y.2000); *SEC v. Credit Bancorp, Ltd.,* 96 F.Supp.2d 357 (S.D.N.Y.2000); *SEC v. Credit Bancorp, Ltd.,* 103 F.Supp.2d 223 (S.D.N.Y.2000); *SEC v. Credit Bancorp, Ltd.,* 109 F.Supp.2d 142 (S.D.N.Y.2000); *SEC v. Credit Bancorp, Ltd.,* 194 F.R.D. 469 (S.D.N.Y.2000); *SEC v. Credit Bancorp, Ltd.,* No. 99 Civ. 11395(RWS), 2000 WL 968010 (S.D.N.Y. Aug.8, 2000); *SEC v. Credit Bancorp, Ltd.,* No. 99 Civ. 11395(RWS), 2000 WL 1170136 (S.D.N.Y. Aug.16, 2000); *SEC v. Credit Bancorp, Ltd.,* 124 F.Supp.2d 824 (S.D.N.Y.2000).

2

The quoted phrase is from a CBL promotional document entitled "THE CBL INSURED CREDIT FACILITY," obtained by the Receiver from SECO's files, and attached as an exhibit to the Receiver's June 28, 2000, Declaration to the District Court

3

As explained in CBL's promotional materials, "Credit Bancorp has established private banking relationships with many of the largest banks in the world, most of which have branch offices in Geneva or Zurich," "[t]hese Swiss banks grant Credit Bancorp an off-balance sheet trading line of credit, which on average will be about five times the value of the unencumbered assets placed on deposit with a major New York bank (or brokerage firm)," and "[t]he Swiss bank[ ] ... can only execute `riskless' arbitrage transactions."

4

The SECO Intervenors are the only parties to have made a formal motion for recovery of their securities. Some of CBL's other customers, however, have made similar claims pursuant to comments regarding the proposed plans for partial distribution*See, e.g.,* Letter from Karla G. Sanchez, Patterson, Belknap, Webb & Tyler on behalf of Compositech, Ltd. of June 28, 2000 (adopting SECO Intervenors' arguments in support of claim that Compositech should be entitled to trace the shares it deposited with Credit Bancorp); Letter from James Wesley Kinnear on behalf of John Dillon to the Court of July 14, 2000 (same).

5

The various plans are described in detail by the District Court*See Credit Bancorp (Plan) I,* 2000 WL 1752979, at *29-47.

6

The SEC and Intervenor-Plaintiff-Appellee Robert Praegitzer have submitted briefs*amici curiae* on this appeal stating their acceptance of the District Court's choice of distribution plan. Praegitzer transferred shares into CBL accounts according to an agreement closely similar to the one executed by SECO. Pursuant to an agreement among Praegitzer, the SEC, and the Receiver (at the time, under the title of "Fiscal Agent"), the Receiver tendered Praegitzer's shares and deposited the cash proceeds into the accounts that had held the stock. In defiance of a Freeze Order imposed by the SEC, the depository institutions seized the proceeds of the sale of Praegitzer's stocks, and applied them to pay down CBL's margin loans.

The District Court ordered that in any plan of distribution Praegitzer was entitled to be treated as if the depository institutions had not seized the proceeds of its assets. Praegitzer alleged that, under the Compromise Plan, he will receive less than if the proceeds of his shares had not been seized. The District Court considered and rejected Praegitzer's objections to the Compromise Plan. *Credit Bancorp (Plan) I,* 2000 WL 1752979, at *44-46. Praegitzer has not appealed.

7

The District Court estimated the current market value of all customer claims based on deposits of securities, defined as the number of shares deposited minus the total number of shares returned prior to the asset freeze, at approximately $265 million*Credit Bancorp (Plan) I,* 2000 WL 1752979, at *11. The Court estimated the value of the claims based on cash deposits by the 93 "Bob Mann" customers at $10 million. *Id.* The outstanding margin loans on various brokerage accounts totaled approximately $30 million. SECO estimated the current market value of the eight million Vintage Petroleum shares on July 6, 2001, at $150 million.

8

SECO contends that it is also appealing the District Court's Order dated May 16, 2001, which, among other things, implemented an Opinion dated April 6, 2001, adjudicating tax issues. However, neither SECO's original nor its amended notice of appeal refers to the District Court's May 16, 2001, Order or its April 6, 2001, Opinion. The tax issues are the subject of a separate appeal taken by the United States in No. 01-6158

9

In the SECO TEL, Brandon represented that he had signing authority for "all CBL trustee accounts," but in the very next sentence asserted that the transferred assets would be held "in a CBL account."

10

We decline to follow*Oler v. Lester Harding, Inc.,* 127 F.2d 963, 965 (3d Cir.1942), where the Court, in a diversity action, after noting that *pro rata* distribution might seem more appropriate, felt obliged by state law to order securities returned to customers.

Source URL: http://openjurist.org/290/f3d/80

TAB
8

In re BUILDERS CAPITAL AND SERVICES, INC. Debtor; THOMAS J. GAFFNEY, CHAPTER 7 TRUSTEE OF BUILDERS CAPITAL AND SERVICES, INC., Plaintiff v. ILGA RUBINO, WILLIAM GORDON, DIANE GORDON, MIKE FOX, CARL J. GALANTE, ELAINE CANNER, SYLVIA WIESENFELD, SID BARSHTER, SUSAN MARSCH, FRANK E. BORK III, FRANK STRIGL, ERIC BILLES, RONALD COHEN, AND MARTIN ROTHSCHILD, Defendants

01-13929 B, AP 02-1261 B

UNITED STATES BANKRUPTCY COURT FOR THE WESTERN DISTRICT OF NEW YORK

317 B.R. 603; 2004 Bankr. LEXIS 1904; 43 Bankr. Ct. Dec. 276; 55 U.C.C. Rep. Serv. 2d (Callaghan) 447

December 1, 2004, Decided

DISPOSITION: Plaintiff trustee's motion for partial summary judgment granted in proceeding to determine bankruptcy estate's rights to disputed assets.

CASE SUMMARY:

PROCEDURAL POSTURE: Plaintiff Chapter 7 trustee brought an adversary proceeding against defendant individual investors to determine the rights of the bankruptcy estate to eight **mortgages** that had been given to secure the repayment of loans that the debtor had advanced from commingled funds in the debtor's possession. The investors counterclaimed, alleging that the **mortgage** loans were held in trust for their benefit. The parties cross-moved for summary judgment.

OVERVIEW: The bankruptcy court concluded that the notes and **mortgages** were properly assets of the bankruptcy estate. The investors did not hold a legal position that superseded the trustee's equitable rights because even though they may have designated the debtor to serve as their agent, they had not established any such relationship with the two individuals listed as mortgagees. Thus, the **mortgages** created no legal interest for the benefit of any named investor. Moreover, the investors had no legal interest in the notes as the notes designated the same individuals as payees. Any constructive trust that might have arisen in the underlying obligations was for the benefit of all of the debtor's investors, not just the investors involved in the adversary proceeding, because the debtor had commingled all investments into its general accounts and had funded the disputed loans from those accounts. The bankruptcy court declined to enforce such a trust because equity to all investors, including those investors who were not parties to the suit, was best served by a bankruptcy administration rather than a collective trust.

OUTCOME: The trustee's summary judgment motion was granted. The investors's cross motions were denied.

CORE TERMS: mortgage, investor, constructive trust, disputed, bankruptcy estate, equitable interest, equitable, purported, commingled, legal interest, mortgagee, beneficiary's, present instance, designated, fulfill, agency relationship, equitable right, individual investor, holder, invested, present dispute, underlying obligations, equitable remedies, administer, fiduciary, designate, corpus, funded, rata, summary judgment

LexisNexis(R) Headnotes

Bankruptcy Law > Estate Property > Content
[HN1] An interest in property may be either legal or equitable in nature. Accordingly, 11 U.S.C.S. § 541(a) of the Bankruptcy Code states the general rule, that a bankruptcy estate includes all legal or equitable interests of the debtor in property as of the commencement of the case.

Real Property Law > Financing > Mortgages & Other Security Instruments > Definitions & Interpretation
[HN2] A **mortgage** may be rendered ineffective because of the absence of authority of the person executing or taking the **mortgage** on behalf of the mortgagor or mortgagee.

Business & Corporate Law > Agency Relationships > Authority to Act > Actual Authority > Oral & Written Authority
Business & Corporate Law > Agency Relationships > Duties & Liabilities > Authorized Acts of Agents > Unauthorized Acts
Contracts Law > Statutes of Frauds > General Overview
[HN3] New York's Statute of Frauds renders invalid any discharge of lien without written authority from an agent's principal. N.Y. Gen. Oblig. Law § 5-703 (2001).

Commercial Law (UCC) > General Provisions (Article 1) > General Overview
Commercial Law (UCC) > Negotiable Instruments (Article 3) > Enforcement > General Overview
Commercial Law (UCC) > Negotiable Instruments (Article 3) > Negotiation, Transfer & Indorsement > General Overview
[HN4] When notes are never delivered into the individuals' possession or into the possession of their duly authorized agent, the individuals never become holders of the instruments. N.Y. U.C.C. Law § 3-202(1) (2001). Not being holders, the individuals cannot qualify as holders in due course under N.Y. U.C.C. Law § 3-302. Thus, their interests are subject to defenses, N.Y. U.C.C. Law §

3-306(b), and to the claims of third parties, N.Y. U.C.C. Law § 3-306(a).

Commercial Law (UCC) > General Provisions (Article 1) > Definitions & Interpretation > General Overview
Commercial Law (UCC) > Negotiable Instruments (Article 3) > General Provisions & Definitions > General Overview
Commercial Law (UCC) > Negotiable Instruments (Article 3) > Negotiation, Transfer & Indorsement > Indorsement
[HN5] See N.Y. U.C.C. Law § 3-117.

Estate, Gift & Trust Law > Trusts > Constructive Trusts
Governments > Fiduciary Responsibilities
[HN6] Although the constructive trust doctrine is not rigidly limited, New York law generally recognizes a constructive trust upon a showing of four factors: (1) a confidential or fiduciary relation, (2) a promise, express or implied, (3) a transfer made in reliance on that promise, and (4) unjust enrichment.

Real Property Law > Ownership & Transfer > Equitable Interests
[HN7] An equitable interest is an interest recognized in equity. Under New York law, such recognition occurs whenever necessary to satisfy the demands of justice.

Bankruptcy Law > Estate Property > Content
[HN8] 11 U.S.C.S. § 541(d) applies only to instances in which the debtor holds only legal title and not an equitable interest.

Bankruptcy Law > Estate Property > Content
Civil Procedure > Remedies > Constructive Trusts
Estate, Gift & Trust Law > Trusts > Constructive Trusts
[HN9] A constructive trust is the formula through which the conscience of equity finds expression. But where equity is better served by a bankruptcy administration, equity commands rejection of a constructive trust.

Civil Procedure > Remedies > Constructive Trusts
Estate, Gift & Trust Law > Trusts > Constructive Trusts
Real Property Law > Trusts > General Overview
[HN10] The United States Bankruptcy Court for the Western District of New York agrees with the United States Bankruptcy Appellate Panel for the Ninth Circuit: if property is excludable from the bankruptcy estate because of state constructive trust law, in order to assert control over the property, the debtor must demonstrate that bankruptcy's policy of ratable distribution outweighs the constructive trust beneficiary's right to the res. In the event that circumstances warrant the remedy of a constructive trust, however, this equitable remedy must be weighed against bankruptcy's equitable policy of ratable distribution, to which end the point in time when the remedy is imposed may become critical.

Bankruptcy Law > Estate Property > Content
Civil Procedure > Remedies > Constructive Trusts
Estate, Gift & Trust Law > Trusts > Constructive Trusts
[HN11] The imposition of a constructive trust for the benefit of a particular creditor is not necessarily inconsistent with bankruptcy administration. Unique and egregious circumstances may justify a constructive trust for the benefit of an injured party with respect to assets in which other creditors should rightly share no interest.

COUNSEL: [1]** Thomas J. Gaffney, Esq., Trustee, Buffalo, New York.

Attorneys for Trustee/Plaintiff: Harter, Secrest & Emery, Raymond L. Fink, Esq., Buffalo, New York.

Attorneys for Ilga Rubino: Watson, Bennett, Colligan, Johnson & Schechter, LLP, Mark R. Walling, Esq., Buffalo, New York.

Attorneys for Sylvia Wiesenfeld: Bouvier, O'Connor, John P. Luhr, Esq., Buffalo, New York.

JUDGES: CARL L. BUCKI, United States Bankruptcy Judge.

OPINION BY: CARL L. BUCKI

OPINION

[*605] Bucki, U.S.B.J.

The present dispute involves conflicting claims of ownership in notes secured by **mortgages** given to an ostensible agent for investors of the debtor. Both the debtor and certain investors now claim rights to the underlying obligations. To resolve this dispute, the court must turn to basic principles of agency law and equity.

While it conducted business, Builders Capital & Services, Inc., ("Builders Capital") purported to provide investment opportunities to its customers. In concept, the company would pool the money of investors for the purpose of funding short term construction loans. In reality, Builders Capital operated a Ponzi scheme. While promising to generate high yields, the principal officers caused the company **[**2]** to squander its resources on frivolous expenditures and imprudent loans. As a **[*606]** consequence, earnings soon became insufficient to satisfy income expectations. In order to fulfill the promised distribution of high interest, Builders Capital induced other customers to invest additional sums of money. For the short term, these new investments provided the cash that the debtor needed to maintain its operations and to fund distributions. Eventually, however, the scheme collapsed. When Builders Capital stopped paying interest, several investors commenced litigation in state court. The state court then appointed a temporary receiver. Meanwhile, three creditors filed an involuntary bankruptcy petition. Pursuant to that petition, this court granted an order for relief under chapter 7 of the Bankruptcy Code on August 9, 2001.

The three principals of Builders Capital were William S. Gordon, David Corbett and Lawrence Schiff. Ultimately, each was convicted of criminal charges arising from his participation with the debtor. For purposes of the present decision, the court does not need to examine the details of their fraudulent activity. It suffices to note that numerous investors have incurred financial **[**3]** loss. Nonetheless, upon the filing of the involuntary petition, the debtor still held claim to significant assets. As with other failed ventures of this type, the liquidation of those assets fell to a chapter 7 trustee, who must work toward a fair and equitable distribution for the benefit of creditors. Although each particular investor has suffered personally, the trustee owes a duty to all creditors to maximize the recovery of assets for the estate.

The chapter 7 trustee commenced the present adversary proceeding to determine the rights of the bankruptcy estate to eight disputed **mortgages**. Each of these **mortgages** had been given to secure the repayment of loans that the debtor had advanced from commingled funds in the debtor's possession. In each instance, however, the note and **mortgage** identified the lender as "William S. Gordon or Diane Gordon, as agents for" one or more named individuals who had invested money with Builders Capital. William S. Gordon is one of the principals of Builders Capital, and Diane Gordon is his daughter. In his complaint, the trustee seeks judgment declaring that the disputed notes and **mortgages** are property of the debtor's estate, and that the defendants **[**4]** hold only unsecured claims with no interest in the disputed obligations. Named as defendants are William Gordon, Diane Gordon, and each of the individuals for whom William and Diane Gordon purported to serve as agents.

Of the fourteen defendants in this adversary proceeding, eleven have defaulted. William S. Gordon filed an answer which denies certain of the allegations, but otherwise does not seek judgment for the defendants. Ilga Rubino and Sylvia Weisenfeld, both of whom were investors, filed more extensive answers with counterclaims. Essentially, these counterclaims seek a declaration that the **mortgage** loans are not property of the estate, but are instead held in trust for the benefit of the named investors. After the completion of some discovery, the trustee filed his present motion for summary judgment. Ilga Rubino then filed a cross-motion for summary judgment, and Sylvia Weisenfeld has joined in that motion.

Ilga Rubino exemplifies the sad state of investors in this case. In 1998, a friend introduced Mrs. Rubino to David Corbett, who gave her a copy of the prospectus or offering memorandum for Builders Capital. Based upon that memorandum and upon her communications with Corbett, **[**5]** Rubino understood that Builders Capital would arrange construction loans for which she would be designated as mortgagee, **[*607]** and that she could anticipate a rate of return of approximately 13 %. Without performing any independent investigation or due diligence, Rubino relied upon the debtor's representations and endorsed to the debtor a check in the amount of $ 130,000. Builders Capital then commingled these funds into its general account and issued a letter confirming Rubino's investment. Thereafter, she received quarterly reports indicating the accrual and reinvestment of interest. The reports, however, did not show any allocation of her investment among particular **mortgages**. In truth, payments on the **mortgages** were also commingled into the debtor's general account. Eventually, Rubino inquired about the specific application of her money. In January of 2000, Builders Capital provided her with a list and copies of the **mortgages** that were purportedly attributable to her investment. Each note and **mortgage** listed the lender as "William S. Gordon or Diane Gordon as agent for" a group of investors that included Ilga Rubino. At no time did Rubino execute any agency agreement with, or even a **[**6]** power of attorney in favor of either of the Gordons. Despite the unauthorized designation of mortgagee, Rubino made no further inquiry about her investment until the spring of 2001, after Builders Capital had stopped all dividends. Mrs. Rubino asserts that by reason of the debtor's bankruptcy, she risks the loss of her entire life savings.

Joining in the Rubino motion, Sylvia Weisenfeld has filed only limited papers that fail to assert any distinguishing circumstances that might impact her own rights. Like Rubino, Weisenfeld invested her personal assets into the same type and form of program. Accordingly, the court will apply the same treatment to the claims of both Rubino and Weisenfeld.

The trustee contends that the disputed **mortgages** are property of the bankruptcy estate and that the nature and substance of the transactions compel a conclusion that the defendants hold an investment in the debtor, rather than a participation in any particular loan. In suggesting this outcome, the trustee directs the court's attention to the following facts: that the defendants infused funds that Builders Capital then held in commingled bank accounts until disbursed to borrowers or for payment of **[**7]** expenses; that the defendants did not know how their funds were being used or to whom their funds were lent; that Builders Capital allowed its investors to withdraw principal without regard to the status, maturity date, or other disposition of any particular loan; that the defendants performed no underwriting or credit analysis with regard to any borrower; that all investors shared risks for the entire pool of loans; and that investors looked to Builders Capital rather than to specific mortgagees for payment of principal and periodic interest.

Ilga Rubino responds that the disputed notes and **mortgages** grant rights to William and Diane Gordon as agents for specified individuals. Rubino contends, therefore, that the notes and **mortgages** cannot constitute property of the bankruptcy estate, but instead belong only to the designated beneficiaries.

With its unique facts, the present dispute is readily distinguishable from the various cases that the parties have cited. For example, the trustee urges comparison with decisions that have found investments to be in the nature of loans to the debtor rather than a participation in loans to a third party. *See In re Sprint **Mortgage** Bankers Corp.*, 164 B.R. 224 (Bankr. E.D.N.Y. 1994), **[**8]** *aff'd* 177 B.R. 4 (E.D.N.Y. 1995). Alternatively, the trustee would rely on a precedent that disregarded the form of participation under circumstances where the debtor had committed fraud and **[*608]** improper business practices. *Corporate Fin. v. Fidelity Nat'l Title Ins. Co. (In re Corporate Fin.)*, 221 B.R. 671 (Bankr. E.D.N.Y. 1998). On the other hand, Rubino cites decisions that a bankruptcy estate did not include an investor's participating interest in a note and **mortgage**. *See In re Fidelity*

Standard Mortgage Corp., 36 B.R. 496 (Bankr. S.D. Fla. 1983). None of these cases, however, involved notes and **mortgages** given to a purported agent acting without authority from the investor. Therein lies the distinguishing factor that compels the present ruling.

In the view of this court, the notes and **mortgages** are properly assets of the bankruptcy estate. Like all of the other investors, the designated beneficiaries enjoy only an equitable interest in the notes and **mortgages**. As a fiduciary for all creditors, the trustee may properly administer these assets for the benefit of every claimant.

Analysis

[HN1] An interest in property may be either legal or equitable in nature. Accordingly, **[**9]** section 541(a) of the Bankruptcy Code states the general rule, that a bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." In the present instance, the disputed notes and **mortgages** fail to designate Builders Capital as a mortgagee. For this reason, the trustee can claim no legal interest in these instruments. At most, he enjoys only an equitable right. The essential premise of Rubino's argument is that she holds a legal position that supercedes any equitable rights of the trustee. Despite a purported grant of rights to an agent for Rubino, however, the lack of an agency relationship belies the creation of a legal interest in any **mortgage** or note.

[HN2] "A **mortgage** may be rendered ineffective because of the absence of authority of the person executing *or taking* the **mortgage** on behalf of the mortgagor or *mortgagee*." 77 N.Y. jur. 2D ***Mortgages*** § 53, (2003) (emphasis added). The investors may have designated Builders Capital to serve as their agent, but they did not establish any such relationship with either William or Diane Gordon. In an affidavit submitted in support of her cross-motion, Ilga Rubino acknowledges **[**10]** that she "did not authorize either William or Diane Gordon as my specific agent." Nor do any of the investment agreements even suggest such an agency relationship. Essentially, therefore, the disputed **mortgages** grant a lien to purported agents who lack any authority to act in that capacity. Failing to designate an extant mortgagee, the **mortgages** create no legal interest for the benefit of any named investor.

Rubino argues alternatively that even if William or Diane Gordon did not serve as her agents, they qualify as subagents for her true agent, Builders Capital. Again, no written instrument creates any such subagency relationship. To the contrary, William Gordon represents that he designated himself and his daughter as agents without any written authority from Builders Capital, in order to handle and control any discharge of lien. The purported subagency could never fulfill this purpose, however, because [HN3] New York's Statute of Frauds would render invalid any discharge of lien without written authority from an agent's principal. N.Y. gen. OBLIG. law § 5-703 (McKinney 2001). With respect to the acceptance of delivery of the disputed **mortgages**, William and Diane Gordon lacked authority **[**11]** to serve either as an agent of Builders Capital or as agent of any investor. As a consequence, no individual investor could acquire a legal interest in any **mortgage** ostensibly given to William and Diane Gordon as agent.

The defects of a **mortgage** do not necessarily speak to the validity of any **[*609]** note that the **mortgage** may secure. Despite their lack of a legal interest in the disputed **mortgages**, Rubino and Weisenfeld may also assert rights under the disputed notes. [HN4] These notes, however, were never delivered into their possession or into the possession of their duly authorized agent. Hence, Rubino and Weisenfeld never became holders of the instruments. N.Y. U.C.C. § 3-202(1) (McKinney 2001). Not being holders, Rubino and Weisenfeld cannot qualify as holders in due course under N.Y. U.C.C. § 3-302. 2 james J. white & robert S. summers, uniform commercial code § 17.3 (4th ed. 1995). Thus, their interests are subject to defenses, N.Y. U.C.C. § 3-306(b), and to the claims of third parties, N.Y. U.C.C. § 3-306(a). Included among these claims are any equitable rights of the chapter 7 trustee and of any of the other investors.

As with the **mortgage** instruments, the disputed notes designate **[**12]** the payee as "William S. Gordon or Diane Gordon, as agent" for a specified investor. In this form, the notes grant such rights as are defined by the following text of U.C.C. § 3-117: [HN5] "An instrument made payable to a named person with the addition of words describing him (a) as agent or officer of a specified person is payable to his principal but the agent or officer may act as if he were the holder. . . ." In the present instance, however, William or Diane Gordon held the disputed notes pursuant to a purported agency relationship that simply did not exist. Thus, these purported agents have no principal to whom the notes can be payable. Not being principals of any valid agency relationship with William or Diane Gordon, Rubino and Weisenfeld can hold none of the rights granted to a principal under U.C.C. § 3-117(a).

Neither the debtor nor any individual investor holds a valid legal interest in the disputed notes and related **mortgages**. [1] Instead, the present controversy becomes a dispute among equitable interests and a choice between equitable remedies.

1 Because the present dispute involves only the rights of the trustee as against investors, the court need not now decide rights as against any mortgagor, whether under a theory of equitable **mortgage** or otherwise.

[13]** Ilga Rubino argues that the underlying obligations have become the corpus of a constructive trust that inures to her benefit. I accept the rationale for this argument, but with different consequences for the defendants. The problem for Rubino and Weisenfeld is that the beneficiaries of the trust would include all investors, not just those named on a particular instrument. Because all of the relevant transactions occurred in New York State, the law of New York will define the terms of any constructive trust. [HN6] Although "constructive trust doctrine is not rigidly limited," Simonds v. Simonds, 45 N.Y.2d 233, 241, 380 N.E.2d 189, 408 N.Y.S.2d 359

(1978), New York law generally recognizes a constructive trust upon a showing of four factors: "(1) a confidential or fiduciary relation, (2) a promise, express or implied, (3) a transfer made in reliance on that promise, and (4) unjust enrichment." *Bankers Security Life Insurance Society v. Shakerdge*, 49 N.Y.2d 939, 940, 406 N.E.2d 440, 428 N.Y.S.2d 623 (1980). All of the investors enjoyed a fiduciary relationship with Builders Capital, which promised to all the same investment opportunity. Even if they might be deemed to have acted as subagents of Builders Capital, William and Diane **[**14]** Gordon owed identical duties to every investor. In reliance upon the promises of Builders Capital and of its agents, each investor transferred funds to Builders Capital. Each of these transfers enriched Builders Capital unjustly. **[*610]** Essentially, therefore, each of the investors is similarly entitled to assert a constructive trust with respect to the proceeds of his or her own investment. In the present instance, however, no particular investment can be traced to any particular **mortgage**.

Although individual investors provided capital to the debtor, Builders Capital never segregated those investments but commingled them into its general accounts. The disputed loans were funded from moneys that the debtor held on deposit in its own name. Without authority from the debtor, William Gordon then prepared documents designating mortgagees other than Builders Capital. Nonetheless, Builders Capital continued to administer the loans. Borrowers repaid the loans directly to Builders Capital, which again deposited receipts into commingled accounts for use by Builders Capital to meet all of its obligations, without regard for the source of those funds. Consequently, any constructive trust must arise **[**15]** for the benefit of all investors and no individual investor may assert a preeminent claim to any of the disputed notes. [2]

2 This conclusion accords fully with the maxim: *Prima pars aequitatis aequalitas* (The first part of equity is equality).

Although investors collectively share grounds to assert a constructive trust, a more difficult issue is whether a constructive trust should be enforced. Before enforcement of any constructive trust, this court must weigh all other equitable considerations. Chief among these considerations are the equitable interests of the trustee.

As successor to Builders Capital, the chapter 7 trustee also holds an equitable interest in the disputed notes and **mortgages**. [HN7] An equitable interest is an interest recognized in equity. Under New York law, such recognition occurs "whenever necessary to satisfy the demands of justice." *Latham v. Father Divine*, 299 N.Y. 22, 27, 85 N.E.2d 168 (1949). In the present instance, the notes were funded from accounts in the debtor's name. Thus, **[**16]** the debtor held a legal interest in the money which Gordon used to fund the improper notes given to purported agents acting without authority. After the moneys were misapplied, the debtor retained a continuing equitable interest in the disputed notes and **mortgages**, for the purpose of enabling the debtor to effect a proper distribution of proceeds. Indeed, the debtor exercised its equitable rights after execution of the notes and **mortgages**, during the time that it continued to service the underlying obligations. To the extent that Builders Capital could best fulfill its responsibilities to investors, the "demands of justice" would recognize an equitable interest to administer the notes and **mortgages**. Pursuant to 11 U.S.C. § 541(a), this equitable interest became an asset of the debtor's bankruptcy estate and is subject to the trustee's administration. [3]

3 Counsel have presented argument regarding the application of 11 U.S.C. § 541(d). [HN8] That section applies, however, only to instances in which the debtor holds only legal title and not an equitable interest. Here, the opposite circumstance occurs. The debtor holds no legal title to the notes and **mortgages**. Nonetheless, in furtherance of its duty to investors, the debtor retains an equitable interest with respect to the proper management of these assets.

[17]** The parties to this dispute assert competing claims in equity. Like the imposition of a constructive trust, bankruptcy is an inherently equitable proceeding. Seeking to do equity, this bankruptcy court must select the more appropriate process for distribution of proceeds from **[*611]** disputed notes and **mortgages**. In deciding whether the disputed obligations are to remain an asset of the bankruptcy estate or are to become the corpus of a trust for the benefit of select investors, the court must fulfill the underlying goals of equity. As Justice Cardozo stated in *Beatty v. Guggenheim Exploration Company*, 225 N.Y. 380, 386, 122 N.E. 378 (1919), [HN9] "a constructive trust is the formula through which the conscience of equity finds expression." But where equity is better served by a bankruptcy administration, equity commands rejection of a constructive trust. To do equity, therefore, this court must balance the likely impact of a constructive trust against the consequences of bankruptcy administration.

In the present context, a constructive trust is an inappropriate remedy for at least three reasons. First, similarly injured investors comprise essentially the entire list of scheduled creditors. **[**18]** Therefore, a constructive trust for the benefit of Rubino and Weisenfeld would accord special rights at the expense of others who are similarly injured. Second, potential trust beneficiaries are unable to trace the funding for any particular **mortgage** to any particular investor. Into commingled accounts, the debtor deposited all invested funds as well as any proceeds from invested funds. Thus, a constructive trust would distribute assets not to any identifiable source, but to individuals who managed to attach an identification to assets that derived collectively from many investors. Third, in comparison to the bankruptcy process, a constructive trust provides a less assuredly equitable methodology for the administration of assets. Because a constructive trust is an imposed remedy, there is no documentary direction for distribution of any trust corpus. Thus, the court would face many potential issues involving the equity of any ultimate distribution. For example, should the constructive trust apply to the gross recovery from particular **mortgage** loans or to recoveries net of other expenses? If the distribution is net of expenses, should those expenses include a *pro rata* share of all **[**19]** costs of administration in this bankruptcy proceeding? Because constructive trusts are equitable remedies, equity commands a fair and equitable result. When assets are distributed outside bankruptcy, parties must address the uncertainties of a constructive trust as they discern an appropriate standard of distribution. Within bankruptcy, however, the statutory scheme of distribution presumptively fulfills this objective.

Even if this court were to enforce a constructive trust for the benefit of all investors, that remedy would sacrifice the crafted protections that the bankruptcy process provides not just for investors, but for the benefit of all creditors. Under the difficult circumstances of this case, the better course of equity will treat the disputed notes and **mortgages** as assets of the bankruptcy estate. Ultimately, therefore, the trustee should distribute those assets in accord with the requirements of 11 U.S.C. § 726.

I agree with the reasoning of the Bankruptcy Appellate Panel for the Ninth Circuit in *In re Golden Triangle Capital, Inc.*, 171 B.R. 79, 82 (1994):

> Thus, [HN10] if property is excludable from the estate because of state **[**20]** constructive trust law, in order to assert control over the property, the debtor must demonstrate that bankruptcy's policy of ratable distribution outweighs the constructive trust beneficiary's right to the res. . . . In the event that circumstances warrant the remedy of a constructive trust, however, this equitable remedy must be weighed against bankruptcy's equitable policy of ratable distribution, to which **[*612]** end the point in time when the remedy is imposed may become critical.

In the present instance where the disputed notes and **mortgages** were funded from accounts that are not exclusively traceable to any particular investor, this court will decline to recognize a constructive trust for the benefit of specific creditors. Any allocation of recovery to a particular investor will inevitably deny the same recovery to other similarly entitled creditors. Further, a constructive trust may jeopardize the claims of general creditors, none of whom chose the investment risks that were knowingly made by the beneficiaries of any constructive trust. Weighing these results against the inherent fairness of bankruptcy administration, this court finds that a distribution under the Bankruptcy **[**21]** Code will achieve the most equitable result. Accordingly, the court will grant judgment declaring the disputed notes and **mortgages** to be assets of the bankruptcy estate.

[HN11] The imposition of a constructive trust for the benefit of a particular creditor is not necessarily inconsistent with bankruptcy administration. Unique and egregious circumstances may justify a constructive trust for the benefit of an injured party with respect to assets in which other creditors should rightly share no interest. In the present context, however, no extraordinary considerations compel the equitable relief sought by Rubino and Weisenfeld. Here, a constructive trust for their benefit would accord special rights at the expense of others who are equally entitled to share the limited assets of the bankruptcy estate. Consequently, such a trust would violate what Judge Duberstein identified as one of the strongest policies of the Bankruptcy Code, namely "that similarly situated investors receive equal distributions from the debtor's estate." *In re Corporate Financing, Inc.*, 221 B.R., at 682.

This court recognizes the severe hardship that fraud has inflicted upon Ilga Rubino and Sylvia

Weisenfeld. **[**22]** Unfortunately, however, all of the investors have suffered similarly unjustified loss. Under these difficult circumstances, equity commands that every investor share both pain and an equal prospect for recovery. Bankruptcy Court serves inherently as a court of equity. The Court of Appeals has recently acknowledged that the exercise of equitable authority allows a court "to treat all the fraud victims alike (in proportion to their investments) and order a *pro rata* distribution. Courts have favored *pro rata* distribution of assets where, as here, the funds of the defrauded victims were commingled and where victims were similarly situated with respect to their relationship to the defrauders." *S.E.C. v. Credit Bancorp, Ltd.*, 290 F.3d 80, 88-89 (2nd Cir. 2002).

For the reasons stated herein, this court will grant the trustee's motion for summary judgment and will deny the defendants' cross motions.

So ordered.

Dated:

Buffalo, New York

December 1, 2004

CARL L. BUCKI

U.S.B.J.

---- End of Request ----
Email Request: Current Document: 8
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