

# Fraud Law Update

## Third Party Liability for Knowing Assistance

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### 1. Introduction

Complex commercial frauds often involve an intricate web of connecting individuals and entities. Third parties, such as bankers, brokers, or lawyers, may facilitate the primary fraudster's activities. In recognition of this reality, Canadian law has developed various means by which those third parties may be held accountable for their involvement with the fraud. One such means is the tort of "knowing assistance". It provides that where a fraud has been committed by an individual or institution acting as a trustee or fiduciary to the victim of fraud, a third party to the trust or fiduciary relationship may be personally liable if that third party dishonestly assisted in the fraud.

Familiarity with the tort of "knowing assistance" is important for those tasked with recovering the proceeds of fraud. It has the ability to potentially widen the net of potential targets when seeking to recoup losses due to fraud. Accordingly, where a breach of trust or fiduciary duty is alleged by a victim of fraud, consideration should be given to whether others, particularly those offering professional services, can be said to have been involved in facilitating the breach. Where they were, liability may be distributed more broadly and recovery more effectively realized.

### 2. The Tort of "Knowing Assistance"

*Roots in English Common Law*

The Canadian tort of "knowing assistance" is rooted in *Barnes v Addy* ("*Barnes*")<sup>1</sup>, an 1874 decision of the English Court of Appeal. The case concerned the improper transfer of trust funds by a trustee and asked the Court to determine whether the lawyers who facilitated that transfer should face liability.

Although the Court of Appeal ultimately found that the lawyers did not knowingly assist in the fraudulent or dishonest scheme of the trustee, it nonetheless laid the foundation for the modern tort of knowing assistance. The Court established the proposition that third parties to a breach of trust or fiduciary relationship could be held liable if they participated in and had some knowledge of the breach. It established the now-seminal principle that third parties who act as agents of the trustee or fiduciary can be held liable if they "assist with knowledge in a dishonest and fraudulent design on the part of the trustees."<sup>2</sup>

### *The Canadian Treatment*

While Canadian courts have adopted the basic principles at the heart of knowing assistance from *Barnes*, they have expanded and refined the tort in the Canadian context. The leading case in this regard is the Supreme Court of Canada's decision in *Air Canada v M & L Travel Ltd.*<sup>3</sup> In that case, the defendant, a corporate travel agency, acted as trustee for ticket revenues for Air Canada. Those revenues were inappropriately transferred from a segregated trust account to the company's general operating account. Subsequently, a creditor of the travel agency, a bank, seized funds from the general account to satisfy debts owed by the travel agency and guaranteed by the directors of the travel agency. This resulted in a breach of trust vis-à-vis Air Canada.

In addition to suing the travel agency as a corporate entity for breach of trust, Air Canada pursued a claim of "knowing assistance" against the two directors of the travel agency, who had caused the agency to misuse trust monies.

### *Underlying breach must first be established*

The Court in *Air Canada* confirmed that there is a two-step process to succeeding on a claim for knowing assistance. First, the plaintiff must first demonstrate that the funds in question were subject to a trust or fiduciary relationship in favour of the plaintiff and that a fraudulent and dishonest breach of that trust occurred. In this regard the Court held:

Having found that the relationship between M & L [the corporate travel agency] and the respondent airline was a trust relationship, there is no question that M & L's actions were in breach of trust. M & L failed to account to the respondent for the monies collected through sales of Air Canada tickets. What remains to be decided is whether the directors of M & L should be held personally liable for the breach of trust on the basis that they were constructive trustees. [...] <sup>4</sup>

At this stage, the question is whether the underlying breach of trust or fiduciary duty was fraudulent or dishonest, not whether the third party defendant's actions should be so characterized.<sup>5</sup> Subsequent decisions have confirmed that a successful action in knowing assistance requires, first, the existence of a fiduciary duty which the fiduciary has breached fraudulently and dishonestly.<sup>6</sup> Once the plaintiff

has established those elements, the analysis shifts to considering the liability of the third party defendant.

### **Binding the third party's conscience: The knowledge component**

Having established the underlying breach of trust or fiduciary duty, the plaintiff must next demonstrate that the third party defendant acted so as to facilitate that breach. As noted in *Air Canada*, generally speaking, this stage of the analysis amounts to “the basic question of whether the stranger’s conscience is sufficiently affected to justify the imposition of personal liability.”<sup>7</sup> Determining the answer to this question requires the plaintiff to demonstrate that the third party defendant had *actual* knowledge of the trustee or fiduciary’s breach of trust or fiduciary duty. The actual knowledge standard will be satisfied if willful blindness or recklessness is proven on a balance of probabilities.<sup>8</sup> Constructive knowledge will not suffice.

The differences between the various degrees of knowledge are narrow but significant. Aside from actual knowledge, the doctrine of recklessness is perhaps most straightforward. Canadian courts have held that recklessness requires actual knowledge or risk and persistence in a course of conduct which creates a risk that the prohibited result will occur.<sup>9</sup> In a slight variation, the doctrine of willful blindness is satisfied where the defendant’s “suspicion is aroused to the point where he or she sees the need for further inquiries, but deliberately chooses not to make those inquiries.”<sup>10</sup> Accordingly, a finding of willful blindness requires an affirmative answer to the question: Did the defendant shut his eyes because he knew or strongly suspected that looking would fix him or her with knowledge?

The doctrine of constructive knowledge sets a lower standard, requiring only that the “defendant had knowledge of facts sufficient to put a reasonable person on notice or inquiry.”<sup>11</sup> Thus, whereas willful blindness requires that the defendant had a subjective suspicion and deliberately chose to ignore it, constructive knowledge requires only that a reasonable person would have inquired. In *Air Canada*, the Court confirmed that “while cases involving recklessness or willful blindness indicate a want of probity which justifies imposing a constructive trust [...] the carelessness involved in constructive knowledge cases will not normally amount to a want of probity, and will therefore be insufficient to bind the stranger’s conscience.”<sup>12</sup>

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Accordingly, if, on a balance of probabilities, the plaintiff has demonstrated that the underlying breach of trust was fraudulent and dishonest, and that the third party had actual knowledge of that breach, then a claim for “knowing assistance” can be established.

On the facts of *Air Canada*, the Court concluded that the directors of the corporate travel agency had knowingly assisted in the breach of trust. It found that “the breach of trust was directly caused by the third party defendant directors”<sup>13</sup> and that the third party directors had actual knowledge of the breach of trust. The directors were thus fixed with personal liability for the breach.

## 4. Implications for practitioners

The implications of the tort of “knowing assistance” for those tasked with recovering the proceeds of fraudulent conduct are three-fold.

First, the availability of the tort broadens the scope of potential defendants when seeking to recover proceeds of a fraud. Plaintiffs are not restricted to pursuing the main perpetrator of the fraud; a wider net can be cast, which may yield recovery of funds otherwise unavailable.

Second, when defrauded clients allege a breach of trust or breach of fiduciary duty, practitioners representing them should closely examine the particulars of the fraud with an eye to linking third parties to the main perpetrator. With the tort of “knowing assistance”, those third parties can be held to account if the plaintiff can meet the test described in *Air Canada*. In establishing a nexus between third parties and the breach of trust, the expertise of forensic accountants and investigators in tracing funds and property is particularly salient.

Finally, the tort is not easy to establish. In requiring proof—on a balance of probabilities—of an underlying dishonest and fraudulent breach of trust *in addition* to the stranger’s knowledge of that breach, the courts have placed a double onus on plaintiffs. But this should not deter plaintiffs who can prepare their cases with the assistance of accountants and forensic investigators whose expertise can be invaluable in establishing the necessary links between the breach of trust and third party involvement.

<sup>1</sup> (1874), 9 Ch App 244 (Eng CA).

<sup>2</sup> *Supra* note 2, at 251.

<sup>3</sup> [1993] SCJ No 118.

<sup>4</sup> *Supra* note 4, ¶ 31.

<sup>5</sup> *Supra* note 4, ¶ 58.

<sup>6</sup> For instance: *Harris v. Leikin Group Inc.*, [2011] OJ No 5714 (CA), ¶ 8.

<sup>7</sup> *Supra* note 4, ¶ 58.

<sup>8</sup> *Citadel General Assurance Co v Lloyds Bank Canada*, [1997] SCJ no 92 (SCC).

<sup>9</sup> See: *Ibid.*

<sup>10</sup> See: *York Region Condominium Corp No. 890 v. RPS Resource Property Services Ltd.*, 2011 ONSC 732, aff’d 2012 ONCA 670.

<sup>11</sup> *Pardhan v. Bank of Montreal*, [2012] OJ No 1629 (SCJ) at para. 142, aff’d at [2013] OJ No 329 (SCJ Div Ct).

<sup>12</sup> *Supra* note 4, ¶ 40.

<sup>13</sup> *Supra* note 4, ¶ 62.



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