Ontario Court Declines to Impose a Duty on a Bank to Protect Third-Party Victims of a Fraud based on Constructive Knowledge

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I. Overview

In *1169822 Ontario Limited v. The Toronto-Dominion Bank*[1] ("*TD*"), the Ontario Superior Court of Justice recently revisited the circumstances in which a bank may owe a duty to protect third-party victims of a fraud perpetrated by one of its own customers.

The court confirmed the long-standing principle that "only proof of actual knowledge of the fraud (or proof of its moral equivalence in wilful blindness or recklessness) will suffice to require a bank to take steps to protect third parties from a fraud being perpetrated by its customer using accounts at the bank."[2] The bank will not be liable for the economic losses of third-party victims where only constructive knowledge of the fraud can be established.[3]

II. Factual Background

On June 1, 2006, Seaquest Corporation ("Seaquest") opened bank accounts at TD. The account opening forms were processed by a TD small business advisor.

David Holden ("Holden"), an existing client of TD, became the President of Seaquest in November 2007. Holden had a criminal record. In 1995, he was convicted of several breaches of the *Securities Act*. In 2000, he pled guilty to his role in a mortgage fraud scheme and was sentenced to six years in prison.

Over a period of approximately five years, between August 2006 and October 2011, the plaintiffs collectively invested over $30 million with Seaquest and other related companies. Holden persuaded each of the plaintiffs to make the investments and offered a high rate of return. The investments, which were usually guaranteed by Seaquest, were often relatively short term in nature. The plaintiffs were convinced to "roll over" their investments into new and attractive opportunities, sometimes when Seaquest failed to repay an investment when it became due. Seaquest was, in fact, operating a sophisticated Ponzi scheme with "investments" described by the court as "mere Potemkin villages devoid of substance."[4]

On June 30, 2011, the scheme began to unravel as one group of investors served a Notice of Motion seeking a *Mareva* injunction. The Notice was sent to TD's corporate security office. The motion was scheduled to proceed on the next business day but was ultimately withdrawn and settled. On October 24, 2011, Seaquest filed a Notice of Intention to make a bankruptcy proposal. Seaquest was later put into liquidation where the extent of the company's fraud was finally revealed.

The plaintiffs commenced an action against TD in which they alleged that the bank ought to have discovered and stopped Seaquest's scheme. The plaintiffs claimed that TD was negligent in not closing

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[1] *1169822 Ontario Limited v. The Toronto-Dominion Bank*, 2018 ONSC 1631 [*TD*].

[2] *Ibid* at para. 2.

[3] *Ibid* at para. 15.

[4] *Ibid* at para. 5.

Seaquest's accounts at the point where TD was alleged to have actual or constructive knowledge of the fraud. The plaintiffs also claimed that the bank knowingly assisted Seaquest in breach of trust.

III. Law and Analysis

(a) Knowing Assistance in Breach of an Express Trust Requires Actual Knowledge

In *Air Canada v. M & L Travel Ltd.*[5] ("*Air Canada*"), the Supreme Court of Canada stated that a person who knowingly assists another to breach a trust is liable for the breach of trust as a constructive trustee.[6] The claim requires the plaintiff to prove that the defendant had actual knowledge of the existence of a trust obligation and of the dishonest performance of the trust by the trustee. Recklessness or wilful blindness constitutes actual knowledge in this regard.[7]

Justice Dunphy determined that TD had not knowingly assisted Seaquest in the breach of an express trust. The plaintiffs' oral evidence on this subject was only adduced after leading questions and there was nothing in the documentary record to indicate the existence of an express trust. Seaquest never had a trust account or escrow account with TD and it never suggested to its investors that it did.

(b) Actual Knowledge Necessary in Knowing Assistance in Breach of a Constructive Trust and to Establish a Duty of Care Owing by Banks to Third Parties

The court's rejection of the plaintiffs' claim arising out of an *express* trust did not preclude the possibility of such a claim being established on breach of a *constructive* trust. TD admitted that Seaquest was a Ponzi scheme and, in effect, also admitted that Seaquest was a constructive trustee of the plaintiffs' funds. As the court stated, further to the principles described in *Air Canada*, anyone who knowingly assisted Seaquest in breach of the constructive trust could be found to have been a constructive trustee.[8] However, the court underscored that "[o]nly actual knowledge of the existence and breach of the trust – or its moral equivalents wilful blindness or recklessness – will bind the stranger's conscience in favour of the victim of the breach of trust and give rise to a remedy where the required action was not taken. The bank's liability does not arise where only constructive knowledge of the breach can be shown."[9]

Actual knowledge of the fraud and the use of TD's services to facilitate it were also found to be necessary to establishing a duty of care in negligence. In *Dynasty Furniture Manufacturing Ltd. v. Toronto-Dominion Bank*[10] ("*Dynasty*"), the Court of Appeal for Ontario affirmed that a "bank has a duty to a non-customer only where it has actual knowledge (including wilful blindness or recklessness) of its customer's fraudulent conduct."[11]

Actual knowledge, along with wilful blindness and recklessness, are high standards. They require proof of culpable conduct that is more than mere negligence or laziness underlying a failure to make inquiries. Justice Dunphy referred to the Supreme Court of Canada's decision in *R. v. Sansregret*,[12] which provides

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[5] *Air Canada v. M & L Travel Ltd.*, [1993] 3 SCR 787, 15 OR (3d) 804, 1993 CarswellOnt 568.

[6] *Ibid* at para. 38.

[7] *Ibid* at para. 39.

[8] *TD*, *supra* note 1 at para. 127.

[9] *Ibid* at para. 128.

[10] *Dynasty Furniture Manufacturing Ltd. v. Toronto Dominion Bank*, 2010 ONSC 436, 74 CCLT (3d) 286, 2010 CarswellOnt 1241, aff'd 2010 ONCA 514, 321 DLR (4th) 334, 2010 CarswellOnt 5263 [*Dynasty*].

[11] *Ibid* at para. 2.

[12] *R. v. Sansregret*, [1985] 1 SCR 570, 58 NR 123, 1985 CarswellMan 176.

that "wilful blindness arises where a person who has become aware of the need for some inquiry declines to make the inquiry because he does not wish to know the truth."[13] Recklessness involves acting in such a manner to create obvious or serious risk and doing so without thought to the risk or recognizing the risk but persisting in the course of conduct.[14]

The plaintiffs' assertion that the bank had actual knowledge of the Ponzi scheme focused heavily on the small business advisor who had processed the account opening forms for Seaquest at the outset. Justice Dunphy ultimately concluded that the advisor did not have the level of information necessary to satisfy the standard of actual knowledge, wilful blindness, or recklessness.[15] The court also determined that delivery of the Notice of Motion seeking a *Mareva* injunction did not impart sufficient information to meet the requirement of actual knowledge, wilful blindness, or recklessness. The Notice of Motion was sent to TD's corporate security department and was never forwarded to the local branch where the advisor worked. There was no reference to a fraud or a Ponzi scheme in the Notice of Motion. Indeed, the Notice of Motion conveyed little actual information that TD could have used to investigate Seaquest's activities, particularly in light of the fact that the motion was settled shortly thereafter.

(c) Constructive Notice of a Fraud Not Sufficient to Establish a Duty of Care

The plaintiffs also argued that constructive knowledge of the fraud by TD was enough to create a duty of care in negligence even if that lower level of awareness would not sustain the claim for knowing assistance. This particular question was left unanswered by the Court of Appeal for Ontario in *Dynasty*.[16]

Accordingly, Justice Dunphy was required to engage in an *Anns/Cooper* analysis, as refined by the Supreme Court of Canada in *Deloitte & Touche v. Livent Inc. (Receiver of)*[17] ("*Livent*"), as follows:

> […] my first task is to inquire whether the proposed duty of care is one that has either already been recognized or is analogous to one that has already been recognized. This is done after considering the identity of the parties and examining the true nature of their relationship. […]
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> If the conclusion is that the proposed category has not yet been sufficiently recognized and applied as part of the common law, the second step is to undertake a more complete proximity analysis. This must assess whether the harm was reasonably foreseeable and whether the relationship between the parties is sufficiently close and direct to warrant the imposition of such a duty. At this point, consideration of expectations, representations, reliance, property or other interests involved as well as the impact of any statutory obligations would enter the mix.
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> If the potential duty of care is found to be *prima facie* valid after the proximity analysis is undertaken, the third step is to undertake an analysis of applicable public policy considerations. At this last stage of the analysis, the question of whether the proposed duty of care can creates [*sic*] unlimited liability to an unlimited class of persons or violates

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[13] *Ibid* at para. 22; and *TD*, *supra* note 1 at para. 136.

[14] *TD*, *supra* note 1 at para. 138.

[15] *Ibid* at paras. 160 and 188.

[16] *Dynasty*, *supra* note 10 at para. 9.

[17] *Deloitte & Touche v. Livent Inc. (Receiver of)*, 2017 SCC 63, [2017] 2 SCR 795, 2017 CarswellOnt 20138.

> other public policy concerns is examined to determine whether these concerns negative the *prima facie* findings of foreseeability and proximity.[18]

The court had no difficulty in concluding that the common law does not impose a duty of care on a bank to prevent harm to an unknown third party by a fraudulent customer of the bank where the bank might only have constructive knowledge of the fraud.

The court then turned to a fulsome proximity analysis. According to Justice Dunphy, "[t]he connection made by *Livent* between proximity and foreseeable reliance of the plaintiff is a crucial one. There must be a logical and foreseeable connection between the information possessed by [the bank] and the services undertaken by it that put [the bank] in proximity to the plaintiff and to the loss of the plaintiff."[19]

In this case, TD provided conventional banking services to Seaquest. There was nothing about Seaquest's line of business that required increased due diligence by the bank. The court was not persuaded by the "red flags" raised by the plaintiffs as being evidence of any constructive knowledge of the fraud or any obligation to conduct an investigation. Justice Dunphy held that "[a] logical objection to each of these 'red flags' is that none of them has a direct relationship to the plaintiffs' loss in the sense that they do not lead logically to a suspicion of an active, on-going fraud in general, still less to a suspicion of any particular fraud involving a class of victims that includes the plaintiffs."[20]

The undertaking by TD in agreeing to provide bank account services to Seaquest could not be extended to an ongoing monitoring of account activity for the purpose of discovering a potential fraud against third parties. Therefore, the plaintiffs could not have had a reasonable expectation that TD was conducting such a review and would thereby protect them from a fraud carried out by its dishonest customer.[21]

The court recognized that banks themselves are often victims of fraud and that they already devote a significant amount of time and resources trying to protect themselves. Justice Dunphy stated that "[a]dding a duty to conduct more regular or detailed account supervision would add a potentially enormous compliance burden without any measureable likelihood of corresponding utility."[22] There was no policy or procedure that TD could have conducted that would have discovered Seaquest's fraud. In this regard, "[i]f a duty of care is to be imposed, it must be one that is capable of being discharged with reasonable diligence."[23]

In the result, the court concluded that the bank did not owe a duty of care to the plaintiffs that extended to constructive knowledge of fraud or breach of trust. The plaintiffs' action was dismissed.

IV. Comment

Financial institutions should be aware of the decision in *TD*, which confirms that actual knowledge of the fraud (or its moral equivalents in wilful blindness or recklessness) is required before a bank is obliged to take steps to protect third parties from a fraud being committed by a customer using accounts at the bank.

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[18] *TD*, *supra* note 1 at paras. 207-209.

[19] *Ibid* at para. 225.

[20] *Ibid* at para. 230.

[21] *Ibid* at para. 256.

[22] *Ibid* at para. 261.

[23] *Ibid*.

In this regard, Justice Dunphy may be seen to have answered the question left “to another day” by the Court of Appeal for Ontario in *Dynasty*. Constructive knowledge of the fraudulent activities being carried out through an account of a bank’s customer is not sufficient to establish a duty of care by a bank to third parties.