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Shell Game Liability: Recovering Damages in Complex Fraud Cases

How can an innocent victim recover their losses when a fraudster uses multiple corporations as part of a complex “shell game” to hide and co-mingle misappropriated funds? In *DBDC Spadina v Walton*, the Ontario Court of Appeal considered a complex multi-real estate transaction investment fraud, perpetrated over an extended period of time with the involvement of numerous corporate actors – all under the control of the fraudster.

In a majority decision, the Court held that the fraudster-controlled corporations knowingly assisted in her fraudulent scheme, and were therefore jointly and severally liable for the net amount of funds diverted from the applicants’ investments. This is a significant decision for parties who have fallen victim to complex frauds perpetuated through a series of shell corporations.

The Test for Knowing Assistance

In arriving at this result, the Court first considered the distinction between claims for knowing receipt and knowing assistance. While both are equitable remedies, knowing receipt is restitution-based and rooted in the concept of unjust enrichment. By contrast, knowing assistance, or “accessory liability”, is fault-based and concerned with correcting matters related to the furtherance of fraud.

There are four criteria that must be met for a plaintiff to establish knowing assistance:

- there must be a fiduciary duty;
- the fiduciary must have breached that duty fraudulently and dishonestly;
- the stranger to the fiduciary relationship must have had actual knowledge of both the fiduciary relationship and the fiduciary’s fraudulent and dishonest conduct; and
- the stranger must have participated in or assisted the fiduciary’s fraudulent and dishonest conduct.

In this case, there was no question that the fraudster had a fiduciary duty to the applicants, and had breached that duty by misappropriating, misusing and misdirecting investment funds advanced by the applicants to companies which were co-

owned by the fraudster and the applicant.

The “strangers” to the fiduciary relationship between the fraudster and the applicant were a number of other corporations owned by the fraudster and, in some cases, third party investors. Despite the fact that she was not always the sole owner, these companies (referred to as the “Schedule C Companies”) were under the complete control of the fraudster.

Corporations as “Alter Ego”

In arriving at the conclusion that the fraudster was the “directing mind” of the Schedule C Companies, the Court of Appeal held that the factual reality of the situation is more important than the formal governing structure established by corporate documentation. In other words, if the fraudster had full decision-making power for the relevant corporate activity and flow of funds, then the corporation may be seen as the fraudster’s “alter-ego”.

In such circumstances, the directing mind’s knowledge and conduct can be attributed to the corporation. Since the fraudster knows of her fiduciary duty and her fraudulent and dishonest conduct, so too does the corporation, the “stranger” here, have active knowledge for the purpose of establishing knowing assistance. As Justice Blair put it, “In short, her perpetration of the scheme was their participation in the scheme.”

Flexible Rules for Civil Liability

The Court held that when establishing corporate civil liability, as opposed to corporate criminal liability, the requirements that the directing mind’s conduct not be totally in fraud of the corporation and must be at least partly for the benefit of the corporation must be applied with more flexibility. It is not necessary for the innocent victim to show precise evidence of each company’s individual benefit from the scheme.

In this case, the tracing analysis showed that the Schedule C Companies were individually engaged as actors in the overall fraudulent scheme and were, as a group, net beneficiaries of the applicants’ funds. While more precision might be required for other types of claims, liability for knowing assistance must be sufficiently flexible in order to properly do justice in cases where the fraudulent co-mingling of funds renders it impossible to track down every dollar.

Complicit Corporations are not “Innocent” Parties

Unlike in a claim for constructive trust, the interests of other investors or interested parties are not relevant when considering whether the corporation knowingly assisted or

participated in a fraud. While individual Schedule C Company investors may be innocent victims, the companies themselves are not – they are participants in the fraud. As the Court concluded, “[i]t is the overall fraudulent scheme, and the Schedule C Companies’ knowing assistance in the perpetration of that “shell game” that provides the prism through which liability for this claim must be determined.”

Implications

The Court’s decision in this case offers hope for victims of large, complex, multi-party frauds. In many cases, misappropriated funds are co-mingled and scattered to the winds, unable to be traced by even the most sophisticated forensic accounting. Corporations that assist in frauds by knowingly acting as conduits and hiding places may now be on the hook for the losses suffered by innocent victims, regardless of whether or not they personally benefitted from the scheme.