

focus

on

Insolvency Law

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The logo for Fraser Milner Casgrain LLP, consisting of the letters 'FMC' in white on a dark blue square background.

FRASER MILNER CASGRAIN LLP

BANKER BEWARE - JOINT OPERATING AGREEMENTS AND TRUST FUNDS

Bankers to the oil and gas industry should be wary of applying customer's funds held in accounts with the bank against obligations owed to the bank where the customer is known to be an "Operator" under a Joint Operating Agreement and where the possibility exists that those funds are impressed with a trust in favour of non-operators.

FUNDS HELD BY AN OPERATOR ARE TRUST FUNDS

In *Bank of Nova Scotia v. Societe General (Canada)* (1988) 87 A.R. 133, the Court of Appeal of Alberta considered the nature of the relationship between an operator of certain oil and gas properties and the non-operators who each had a specifically defined interest in those properties. The non-operators alleged that the operator stood in a fiduciary relationship to them and that it held funds on deposit in its general account in trust for the benefit of the non-operators. The relationship between the two parties was governed by a 1981 CAPL agreement. The Court of Appeal concluded that under the terms of the 1981 CAPL agreement, the operator was given wide powers to act for the non-operators in the management and control of the exploration, development of the joint lands for the joint account and as such "was in a fiduciary position with respect to the management, administration and marketing of the product and ultimately the distribution of the revenues therefrom." Based on this conclusion, the Court of Appeal found that the funds held by the operator were held in trust for the non-operators.

CONSTRUCTIVE KNOWLEDGE OF A BANKER

While, pursuant to Bank of Nova Scotia, the funds held by an operator on behalf of a non-operator are trust funds, the decision of the Supreme Court of Canada in *Citadel General*

Assurance Co. v. Lloyds Bank Canada [1997] S.C.J. No. 92 (S.C.C.), determined that a bank will only be precluded from applying those funds to obligations owed by the customer to it where it has constructive knowledge that its customer's funds are trust funds.

In *Citadel*, the Supreme Court recognized that, in general, a bank is not under a duty to regularly monitor the activities of its clients simply because the funds deposited by those clients are impressed with a trust. However, the Supreme Court also recognized that, in certain circumstances, a bank's knowledge of its customer's affairs will require the bank to make inquiries as to a possible breach of trust. The Supreme Court found that where a bank is enriched by the receipt of trust property and had knowledge of facts that would put a reasonable person on inquiry regarding the existence of a trust, the bank will be under a duty to make inquiries of its customer regarding a possible breach of trust. If the bank fails to make the appropriate inquiries, it will have constructive knowledge of the breach of trust. In these circumstances, the bank will be unjustly enriched and, therefore, required to disgorge the benefit it received at the plaintiff's expense.

In *National Bank of Canada v. Argyll Energy Corp.* [1991] A.J. No. 1258, the Court found that the bank had constructive knowledge because, amongst other factors, it was aware that its customer was depositing joint venture funds in its accounts with the bank. The Court found that, the question of whether the bank must return the trust funds it has taken for its own benefit, will turn on the level of knowledge the bank had of facts which would put a reasonable person on inquiry as to whether the funds on deposit with it were trust funds.

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