

# 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

### TRUST CLAIMS UNDER A JOA

Vanquish Oil & Gas ("Vanquish"), now in receivership, was a trustee under a joint operating agreement for an oil well. It was required to remit 45% of the well's net production proceeds to a proportional owner - either Karl Oil and Gas Ltd. or Choice Resources Corporation (who disputed the entitlement at the time).

The joint operating agreement ("JOA") provided that as production revenues were paid to Vanquish, the 45% remittance moneys were deemed to be held in trust for the proportional owner. Under the JOA Vanquish was permitted to intermingle the trust monies. As a result, all revenues were paid into Vanquish's general account.

On March 14, 2007 the general account balance was approximately \$40,000. On March 16, 2007 an additional \$40,000 was deposited, which moneys were impressed with the trust obligation. On subsequent dates, further proceeds were deposited from other sources that were not expressly subject to the trust obligation. The balance at the time of receivership was approximately \$417,000. At this time, Vanquish was in arrears of its trust remittances in the approximate amount of \$320,000.

The receiver sold all of the assets of Vanquish on behalf of the secured creditor of Vanquish. The question before the Court was whether the rights of Karl or Choice as trust beneficiary extended to the additional deposits in the general account, or to the proceeds of the sale of the assets of Vanquish, in priority to a secured creditor.

A trust relationship extends proprietary rights to the beneficiaries. Where third parties deal with trust property and are not aware of these proprietary rights, the beneficiaries' proprietary rights are extinguished so as to protect the innocent third party. The risk of a breach of trust by a trustee therefore falls on the beneficiaries. In cases of constructive trusts, often used as an equitable remedy to grant proprietary rights, the court will refrain from granting a constructive trust where to do so would impeach the rights of a bona fide third party.

At the time of payment to Vanquish, the trust moneys would have been held for the beneficiary (Karl or Choice) and would have been protected from secured creditors. In cases where trust moneys are intermingled, such as this, a trustee is presumed honest and any disbursements to innocent third parties made from the intermingled funds are deemed to be paid firstly from non-trust funds. At the time Vanquish's account balance was at its lowest on March 14, 2007, those moneys had been paid into the account under the operating agreement and were considered wholly trust moneys. The following \$40,000 (deposited March 16, 2007) was also deposited under the operating agreement and was considered trust moneys.

The deposits made after March 16, 2007 were not made under the operating agreement. It was argued that, as at this time the trust moneys had already fallen into arrears, that these deposits were made in "replenishment" of the improperly disbursed trust monies. The Court rejected the idea that the trustee had only "borrowed" the improperly disbursed trust monies. Rather, the Court decided the loss must be shouldered by the beneficiaries who cannot claim a proprietary interest in the subsequent replenishment of the account.

In result, the Alberta Court of Appeal overturned the finding of the Court below. The Appellate Court found that, upon the insolvency and receivership of the trustee, trust moneys were insulated from the creditors of the trustee as they did not form a part of the general account balance. However, subsequent deposits and sale proceeds were available for the benefit of the trustee's secured creditor as the trust agreement did not extend either an express or constructive trust to these moneys. This could only be avoided if there was clear intent of the trustee to replenish the missing trust funds, which was not the case for Vanquish.

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