

BETTER LATE THAN EARLY - WHAT IS "JUST, CONVENIENT AND EQUITABLE" AMONG INNOCENT INVESTORS IN FRAUDULENT INVESTMENT SCHEMES

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Overview

Defrauded investors in an investment scheme rarely recover all of the funds that they have invested, and the question of the amount to which each investor is entitled is complicated when the investments are comingled. In Ontario, the courts have determined that the fairest way to distribute the remaining funds of innocent investors caught in a fraudulent investment scheme is by using the lowest intermediate balance rule ("LIBR"). The lowest intermediate balance can be difficult to calculate, and thus the LIBR method is only used when it is practically possible to apply. The LIBR method protects later investors in a fund by preventing them from sharing the burden of losses incurred prior to such investor's investment and allocates subsequent losses amongst all investors. When it is impossible or extremely difficult to calculate the lowest intermediate balance, the *pro-rata* method is appropriate.

Legal Background and *Greyhawk*

Until recently, the law in Ontario respecting the entitlement of defrauded investors to comingled funds in the event of a shortfall appeared unsettled. This was the result of two ostensibly divergent cases: *Ontario (Securities Commission) v. Greymac Credit Corp* 1986 CarswellOnt 158 (Ont. C.A.) ("*Greymac*") and *Law Society of Upper Canada v. Toronto Dominion Bank* [1999] 3 S.C.R. xiii (S.C.C.) ("*Law Society*"). A 2013 Ontario Court of Appeal decision affirming the decision of Justice Morawetz in *Boughner v. Greyhawk Equity Partners Limited Partnership (Millennium)*, 2012 CarswellOnt 10466 (Ont. S.C.J.) [Commercial List] (affirmed 2013 CarswellOnt 510 (Ont. C.A.)) ("*Greyhawk*") clarified the law and explained that the foregoing cases may be read together and are not contradictory.

Greyhawk arose in the context of a fraudulently operated investment vehicle that misled investors with false financial statements. When the fraud was discovered the remaining funds, which had been comingled in the *Greyhawk* Fund's bank accounts, were vastly less than the invested total. The court was charged with determining the correct method of distributing the remaining funds.

The Methods of Distribution of Remaining Funds

Pro Rata

Under the *pro rata* method, each investor is entitled to an amount equal to the total amount that they invested in the fund, divided by the total amount invested by all investors in the fund. Thus, if an investor invested 20% of the total funds, they would receive 20% of the remaining funds.

LIFO

Last in, first out ("**LIFO**") is the simplest method to calculate. This method provides that the last investor recovers all of such investor's

investment, followed by the next to last and so on, until there are no funds remaining.

LIBR

The LIBR method, which is also known as the "fund unit allocation method" or, confusingly, the "*pro rata* on the basis of tracing method", provides for investors to receive a payout based on the performance of the fund during the time period in which each investor's money was invested. This method limits the amount that a claimant can recover to a maximum of the lowest balance in a fund that is subsequent and attributable to such claimant's investment, though investors frequently receive less than this amount. In order to apply the LIBR method, the lowest balance of each investor at the time the funds are comingled with a subsequent investor are added together and each investor receives their *pro rata* share of the remaining balance based on the total at the time of the comingling.

The Difference Between the Methods

In *Greyhawk*, Justice Morawetz provided a fact pattern to illustrate the differences between the three methods:

Investor A invests \$100 in a fund, following which the value of the fund decreases to \$50. Investor B then invests \$100 and the fund subsequently decreases to \$120.

Under the *pro rata* method, Investor A would be entitled to \$60 (50% of the remaining funds) while Investor B would also be entitled to \$60 (50% of the remaining funds). As each invested half of the total money invested in the fund, each is entitled to half of the remaining funds.

Under the LIFO method, Investor A would receive \$20 (16.66% of the remaining funds) after Investor B was fully repaid its investment of \$100 (83.33% of the remaining funds).

Under the LIBR method, the percentage amounts are calculated from the point at which the funds were comingled: at that time a total of \$150. Investor A would be entitled to a maximum of \$50, but would only receive \$40 ($50/150 \times 120$, being 33.33% of the remaining funds) while Investor B would be entitled to a maximum of \$100, but would only receive \$80 ($100/150 \times 120$, being 66.66% of the remaining funds).

To expand on this example, if Investor C subsequently invested \$80, bringing the total of the fund to \$200, and the fund then dropped to \$50, Investor A would be entitled to a maximum of \$40 (the amount to which Investor A was entitled in the previous calculation), but would only receive \$10 ($40/200 \times 50$, being 20% of the remaining funds), Investor B would be entitled to a maximum of \$80 but would only receive \$20 ($80/200 \times 50$, being 40% of the remaining funds) and Investor C would be entitled to a maximum of \$80, but would only receive \$20 ($80/200 \times 50$, being 40% of the remaining funds). As noted above, the percentage amounts are calculated based on the value of the fund at the time at which the funds were comingled.

The Ruling in Greyhawk

In *Greyhawk* the court confirmed that funds are to be distributed in a manner that is “just, convenient and equitable”. The court quickly dispensed with using the LIFO method in this situation, as simply being the second person to invest should not entitle an investor to all of the remaining funds.

After recognizing *Greymac* as the controlling authority, Justice Morawetz found that *Law Society* was consistent with *Greymac* as, though *Greymac* used the LIBR method and *Law Society* used the *pro rata* method, both courts accepted that where the LIBR method is not practically possible to calculate, the *pro rata* method should be used. In *Law Society* the court considered *Greymac*, but found that the LIBR method was too complex and impractical to apply as the situation in *Law Society* involved “over 100 claimants with misappropriations of roughly \$900,000 in bits and pieces”. The court in *Law Society* noted that the LIBR method is “manifestly fairer” but that it is also “manifestly more complicated and more difficult to apply than other solutions”.

Thus, where funds have been commingled the general rule is to use the LIBR method. The only exception is where it is practically impossible to apply the LIBR method, in which case the *pro rata* method is appropriate.

In *Greymac*, as the receiver had already taken all necessary steps to assess entitlements under both the *pro rata* and LIBR methods, the court applied the LIBR method. On appeal, the Court of Appeal confirmed that the *pro rata* method should only be used when the LIBR method cannot practically be calculated, and clarified that the calculations to be done using LIBR are not predicated on the ability to trace each investor’s funds, but rather on the ability to determine the overall value of the fund at each point of commingling.

Conclusion

Though when it is practically impossible to use the LIBR method is unclear, the courts have finally, and correctly, set a clear rule on the ordering of the methods that balances the interests of all investors. Notwithstanding the innocence of such persons, the fairest way to distribute any remaining funds is the LIBR method. Therefore, in respect of investments in what turns out to be a fraudulent investment scheme, it is better to be late than early.

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