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Commercial Litigation Insights: From Banks to Blockchain: Could Exchanges in Receipt of Stolen Digital Assets be Liable as Constructive Trustees?

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The lines between banks and cryptocurrency exchanges are blurring as an increasing number of digital transactions intersect between traditional and decentralized finance. Major payment processors are incorporating blockchain technology into their networks and traditional financial institutions are offering cryptocurrency exchange-traded funds. The regulatory landscapes have also converged with Canadian virtual currency exchanges being required to register with FINTRAC as money services businesses and being subject to the same reporting requirements as banks for suspicious transactions under the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*.

With these intersections between traditional banking and decentralized finance comes new vulnerabilities as external and internal factors pose risks of data breaches, fraud, and regulatory non-compliance. One such vulnerability that is new to decentralized finance, is the risk of being held liable as a constructive trustee for receipt of fraudulently procured digital assets. Canadian courts have yet to consider whether a cryptocurrency exchange should be held liable as a constructive trustee and particularly for the knowing receipt of digital assets that a customer wrongfully took or received from a third-party. While the risk of such liability is well-established for banks and is a vulnerability that traditional financial institutions have guarded against for decades, the growing connections between traditional and decentralized finance leave real risk that digital asset exchanges could be liable under the same constructive trust doctrines and left holding the bag for bad actors that misuse their platforms. Digital asset platforms should be looking to adopt (or ensure compliance with) policies and processes that mitigate this risk and help protect their customers and other digital asset investors.

Canadian courts have long recognized three circumstances in which a financial institution (or other similarly situated parties) can be held liable as a constructive trustee for its involvement with misappropriated funds:

- (i) a bank (or other person) can be liable as a trustee *de son tort*, where they are not appointed as a trustee, but “take on themselves to act as such and to possess and administer trust property”. In assuming the office or functions of a trustee and administering trust funds, a financial institution or individual can become a constructive trustee;
- (ii) a bank (or other person) who is a stranger to a trust, can be liable for *knowingly assisting* in a fraudulent or dishonest plan committed by a trustee or fiduciary. Liability here can arise where a bank or other person *assists* a fiduciary in their breach of duty and has actual knowledge, or is reckless or wilfully blind to the dishonesty or fraudulent breach of trustee duties; and
- a bank (or other person) who is a stranger to a trust can be liable where they are in *knowing receipt* of trust property, and the financial institution uses those funds for their own benefit with actual or constructive knowledge that the funds have been misapplied.[1]

The constructive knowledge standard for *knowing receipt* poses a particular risk for banks and other entities receiving funds from

customers because the liability stems from the *receipt of misappropriated funds*, rather than from fault or assistance in the scheme. The lesser degree of knowledge only requires the recipient of trust funds to know enough that a reasonable person would have made inquiries about the funds before proceeding.[2] For example, in the oft-cited *Citadel General Assurance Co. v. Lloyds Bank Canada*, a bank was found liable for knowing receipt where it benefited from a warranty company paying down its parent company's large overdraft with funds that the bank should have viewed as suspicious and possibly derived from a breach of trust. The bank had knowledge that the funds the warrant company collected were insurance premiums that were payable to the plaintiff insurer, and the bank should have made inquiries when the insurance premiums were suddenly being redirected to the account of the parent entity of the warranty company, which had a substantial overdraft. It is not hard to imagine similar circumstances where a digital asset exchange could be in receipt and benefitting from digital assets that were misappropriated by a customer.

While Canadian courts have not reported any decisions finding a cryptocurrency exchange liable as a constructive trustee or for the tort of knowing receipt, such arguments have been raised in a number of cases in the United Kingdom. As a result, digital asset platforms should be reassessing the risk of potential liability posed by bad actors misusing their platforms.

In *Piroozzadeh v. Persons Unknown and Others*,[3] a claimant obtained an injunction against a cryptocurrency exchange at a without notice hearing requiring the cryptocurrency exchange to preserve the claimant's cryptocurrency procured by other defendants' wrongdoing. The England and Wales High Court of Justice (the "**EWHC**") granted the injunction on the basis that there was an *arguable case* that the cryptocurrency exchange was a constructive trustee because the exchange was in control of cryptocurrency assets. However, at the return date of the injunction on notice to the defendants, the court discharged the injunction because the claimant had failed to fairly present the significance of the cryptocurrency exchange's potential *bona fide* purchaser for value defence as it related to the exchange's pooling of the claimant's funds. While the EWHC was clear that there is no general proposition that digital asset exchanges are constructive trustees, such an argument was left open to be considered in future cases with a caution to claimants to ensure they make full and frank presentations of material facts underlying potential defences.

Similarly, in *D'Aloia v. Person Unknown and Others*,[4] the EWHC considered whether a digital asset platform should be held liable as a constructive trustee or for knowing receipt in relation to a cryptocurrency investment scam where, after dozens of intermediary transfers, the digital assets were allegedly exchanged for Thai baht through a pooled hot wallet belonging to the platform. The EWHC found that the first recipient of the claimant's investments (i.e. the first defendant before a series of further transfers of the digital assets) was a constructive trustee due to the fraudulent nature of the contract under which the digital assets were invested. The EWHC also found that the digital asset platform (i.e. the sixth defendant alleged to be at the end of the series of transfers) could not avail itself of the *bona fide* purchaser for value defence since the withdrawal of Thai baht from the exchange had not been done in line with the platform's own anti-money laundering policies.

However, despite both of these findings, the EWHC declined to hold the platform liable as a constructive trustee on the basis that the claimant had not established that his cryptocurrency was in fact received by the exchange. Specifically, the claimant's expert had not used a satisfactory methodology to trace the cryptocurrency to the platform's hot wallet. Further, the EWCH declined to consider the constructive trust and knowing receipt claims as the claimant had not pleaded such claims against the exchange platform and rather raised these causes of action for the first time at trial. Despite its dismissal, the *D'Aloia* decision leaves open the possibility of a successful constructive trust claim with the right expert evidence and pleadings.

With the continued proliferation of blockchain technology and interconnectedness of traditional and decentralized finance, it will only be a matter of time until the question of digital asset platforms as constructive trustees is put before a Canadian court. The defeated constructive trust claims in *Piroozzadeh* and *D'Aloia* point to some of the factors that Canadian courts are likely to consider, particularly:

- whether the digital assets have been transferred to or through any pooled, unsegregated wallets of a digital asset platform;
- whether there is clear expert evidence tracing digital assets to the digital asset platform using a reliable methodology (like first

in, first out); and

- whether the digital asset platform complied with its policies and procedures when the digital assets were received by, transmitted through, or withdrawn from the exchange.

Litigants should be ready to advance the constructive trust argument, and cryptocurrency exchanges should be ensuring compliance with (and updating where necessary) existing internal controls and policies to help avoid fraudulent losses, to both protect their users and to mitigate the risk of future claims.

The information and comments herein are for the general information of the reader and are not intended as advice or opinion to be relied upon in relation to any particular circumstances. For particular application of the law to specific situations, the reader should seek professional advice.

[1] *Citadel General Assurance Co. v. Lloyds Bank Canada*, 1997 CanLII 334 at paras. 19-24; see also Quantum Dealer Financial Corporation v. Toronto Fine Cars and Leasing Inc., 2023 ONCA 256.

[2] *Citadel General Assurance Co. v. Lloyds Bank Canada* 1997 CanLII 334 at paras. 46-48; Quantum Dealer Financial Corporation v. Toronto Fine Cars and Leasing Inc., 2023 ONCA 256 at para. 52.

[3] *Piroozzadeh v. Persons Unknown and Others*, [2023] EWHC 1024 (Ch).

[4] *D'Aloia v Person Unknown and Others*, [2024] EWHC 2342.

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