

CANADA / JUDGMENT

Schwarzkopf v. McLaughlin

2008 BCSC 730

COURT

Supreme Court of British Columbia

DECIDED

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2008 BCSC 730amended Schwarzkopf v. McLaughlin

IN THE SUPREME COURT OF BRITISH COLUMBIA

Citation:

Schwarzkopf v. McLaughlin,

2008 BCSC 730

Date: 20080606

Docket: S026759

Registry: Vancouver

Between:

John Michael Schwarzkopf, J&T Schwarzkopf Holdings Inc.

and John Schwarzkopf Investments Inc.

Plaintiffs

And

Kevin M.D. McLaughlin, Bonnie McLaughlin, Dancerwood Estates Inc.

and Kevin McLaughlin Insurance Services Ltd.

Defendants

John van Driesum and David Roper

Third Parties

Before: The Honourable Madam Justice Gerow

Reasons for Judgment

Counsel for Plaintiffs:

J.C. MacInnis

Date and Place of Hearing:

April 7, 2008

Vancouver, B.C.

- [1] In 1990, John Schwarzkopf inherited approximately \$10 million. With the assistance of an accountant he invested most of those funds in securities and the value of his portfolio increased substantially between 1990 and 1996. In 1997, Mr Schwarzkopf met the defendant Kevin McLaughlin and retained him to be his financial advisor in February 1997. Between February 1997 and 2002, Mr. McLaughlin had total control over Mr. Schwarzkopf's portfolio, which in 1997 consisted of blue chip marketable securities. As of December 31, 1996, these assets were worth close to \$17 million (the "Schwarzkopf securities"). Mr. McLaughlin liquidated the Schwarzkopf securities and converted them, in large part, to a speculative venture in raw land known as Lake McGregor Resort Corporation ("LMRC").
- [2] In 2002, Mr. Schwarzkopf learned that Mr. McLaughlin had liquidated all of the Schwarzkopf securities. He terminated Mr. McLaughlin's retainer and commenced this action against Mr. McLaughlin and his companies, Dancerwood Estates Ltd. ("Dancerwood") and Kevin McLaughlin Insurance Services ("KMIS"), (collectively, the "McLaughlin defendants") claiming damages for breach of contract, negligence, gross negligence, breach of fiduciary duty, defalcation and equitable fraud. The plaintiffs submit that they suffered losses in the amount of \$6.4 million as a result of the negligence and breaches. On March 13, 2008, judgment was granted against the McLaughlin defendants, with damages to be assessed and the action against the defendant, Bonnie McLaughlin was adjourned generally. The third party action has been dismissed. On this application, the plaintiffs seek to have damages assessed and vesting orders against the McLaughlin defendants so that they can take control of the real estate assets and mitigate their losses.

BACKGROUND

- [3] From February 1997 until June 30, 2002, Mr. Schwarzkopf was the sole shareholder of the two corporate plaintiffs, John Schwarzkopf Investments Inc. ("Schwarzkopf Investments") and J&T Schwarzkopf Holdings Inc. ("J&T Holdings"). Mr. Schwarzkopf used Schwarzkopf Investments for the purposes of holding most of his marketable securities.
- [4] When Mr. McLaughlin's retainer was terminated, the Schwarzkopf securities were worth approximately \$12.5 million. The plaintiffs take the position that if Mr. McLaughlin had not liquidated the Schwarzkopf assets they would have been worth approximately \$19 million as at June 2002.

- [5] During the time that Mr. McLaughlin was Mr. Schwarzkopf's financial manager he took, for himself and his company, Dancerwood, shares in companies which controlled the assets paid for with the Schwarzkopf securities. Since 2002, Mr. McLaughlin has used this shareholding to prevent real estate assets from being sold.
- [6] Karen Henderson, an investment specialist, provided an expert opinion valuing the Schwarzkopf securities as at December 31, 1996 as \$16,739,155 (the "Initial Value"). These were the assets given to Mr. McLaughlin to manage.
- [7] In June 2002, when Mr. Schwarzkopf terminated Mr. McLaughlin's retainer, he learned that J&T Holdings and Schwarzkopf Investments had \$2.5 million remaining in accessible funds. These came from three sources:
- Most of these funds (approximately \$1.8 million) had been received by J&T Holdings in the spring of 2002 as a payout on mortgage security which had been realized following a foreclosure on a real estate development in Victoria called Island View Beach Estates, to which Mr. McLaughlin had advanced substantial funds on behalf of J&T Holdings;
 - Approximately \$250,000 of these funds came from the sale of a vessel owned by a company called Irishmist Charters Ltd., which had been bought with funds loaned to it by Schwarzkopf Investments. These funds represented a partial repayment of this loan;
 - Approximately \$500,000 represented the remainder of funds resulting from the liquidation of Schwarzkopf Securities.
- [8] It appears from a review of the financial statements of Schwarzkopf Investments and J&T Holdings, that Mr. McLaughlin began liquidating the Schwarzkopf securities almost immediately upon his retainer. According to Ms. Henderson, Mr. McLaughlin would have been in violation of the Securities Act, R.S.B.C. 1996, c. 418 when he liquidated the securities as he was not registered to advise or act in respect to the sale of anything other than mutual funds and insurance related investments.
- [9] The financial statements of Schwarzkopf Investments disclose that, as at December 31, 2002, it held only \$230,585 in marketable securities and had \$12,415,835 in "Loans Receivable", of which \$11,680,786 was owed by J&T Holdings.
- [10] J&T Holdings' financial statements in the same period show a dramatic increase in "Due to Related Party," representing the debt to Schwarzkopf Investments. In addition, the statements show a substantial "Note Receivable," acknowledging that the funds passed through J&T Holdings to various real estate ventures (Jo-Ke, Irish Mist Charter Ltd. etc.), but primarily to LMRC.
- [11] LMRC is a company which owned raw, undeveloped land in Alberta which has since been developed into an RV and cottage strata development (the "Development"). Although he put no funds into the purchase of the land or the Development, Mr. McLaughlin caused Dancerwood, a company owned by himself and his wife, to take 49% of the shares of LMRC.

The entire venture has been financed through the liquidation of the Schwarzkopf securities. In turn, the plaintiffs say they have been left with worthless shares, and an unsecured shareholders' debt which is worth less than the value of the Development.

[12] As at June 2002, the following assets had been purchased by Mr. McLaughlin with the monies from the liquidation of the Schwarzkopf securities:

- J&T Holdings held 51% of the shares of LMRC. LMRC's only asset is the land in Alberta. However, by reason of the land's value, and the size of J&T Holdings' shareholders' loan, these shares had no value;
- J&T Holdings owned an unsecured shareholder's loan from LMRC of \$9,541,330. However, as at March 7, 2003, the Development had an appraised value of \$5,620,000. The value of the loan is limited to the value of the corporation's only asset;
- Mr. Schwarzkopf held 50% of the shares of Jo-Ke Holdings Ltd. ("Jo-Ke") with Mr. McLaughlin holding the other 50%. There was a \$300,000 unsecured shareholder's loan owed by Jo-Ke to Mr. Schwarzkopf. Jo-Ke's only asset was the strata unit which KMIS used as its offices. Jo-Ke also has \$21,191 in the bank. The strata unit has been appraised at June 20, 2002 at \$148,000;
- J&T Holdings owned a property on Goldstream Avenue, Victoria, known as Langford Lake, appraised at June 20, 2002 at \$1.3 million;
- J&T Holdings owned five bare property lots owned in East Sooke, appraised as at June 20, 2002 at \$616,000;
- J&T Holdings owned a property located on Hamsterley Road, Victoria, appraised at June 20, 2002 at \$269,000;
- Mr. Schwarzkopf owned four annuities purchased for \$920,000 which provided Mr. Schwarzkopf with a monthly income of \$10,000 for ten years until May 2007. Mr. Schwarzkopf used these funds for his day to day living expenses;
- J&T Holdings and Schwarzkopf Investments collectively had \$2.5 million in cash;
- Mr. Schwarzkopf, through intermediary trusts set up by Mr. McLaughlin, held an offshore account with Chambers Global Investments, which had been capitalized by Mr. McLaughlin. In 2003, \$161,097 was recovered from this account;
- Mr. Schwarzkopf owned a property at #15 Strachan Point which he sold in December 2003 for a net gain of \$458,049. He used these funds to complete the Development.

(the "Resulting Assets")

- [13] The foregoing figures indicate an asset value as at June 2002 of \$12,293,337. The plaintiffs submit that this figure, as a reflection of the value of the Resulting Assets, is overstated because it does not take into account any transaction costs, or tax consequences upon sale of the real estate holdings. It also gives the defendants full credit for the value of annuities (\$10,000 multiplied by 12 months and 10 years), without taking into account the time value of money.

ANALYSIS

Applicable case law

- [14] The plaintiffs' claim is framed in a number of causes of action, but includes a claim for breach of fiduciary duty, and a demand for accounting. Default judgment was awarded against the McLaughlin defendants. The defaulted defendants are deemed to have admitted the allegations contained in the statement of claim: Rule 19(19) of the Rules of Court, B.C. Reg. 221/90; *Mintie v. Iverson* (1963), 45 W.W.R. 403 at 405 (B.C.S.C.); *Sandes v. Brown* (1979), 16 B.C.L.R. 341 (Co. Ct.). As a result of the deemed admissions, the McLaughlin defendants have admitted that they were in breach of their fiduciary duty to the plaintiffs.
- [15] Where money is given by a beneficiary to a person in a fiduciary position, the monies are held by the fiduciary as trust funds. The fiduciary owes an equitable duty to account to the beneficiary for the funds. The test for determining whether or not the funds are held in trust by the fiduciary is whether the money was paid over by or for the account of the principal: *Nelson v. Rye*, [1996] 2 All E.R. 186 at 199 (Ch. D.).
- [16] A fiduciary holding property for the benefit of another must account for that property. The equitable duty to account is well established in law. The fiduciary duty to account extends beyond trust claims to such matters as agents who hold property for their principals. The basis for duty to account is the fiduciary relationship: *Attorney General v. Cocke*, [1988] 1 Ch. 414 at 420.
- [17] In *Canson Enterprises Ltd. v. Boughton & Co.*, [1991] 3 S.C.R. 534 at ¶72, the Supreme Court of Canada stated that the measure of damages for breach of trust involving a failure to account for trust property is that the trustee must make the trust whole. To the extent that monies have been paid over to the trustee or fiduciary which cannot be accounted for, the trustee or fiduciary must make up the difference.
- [18] The burden of establishing that the Schwarzkopf securities were properly applied and dealt with falls to Mr. McLaughlin. A trustee has the burden of establishing that he has both accounted for and discharged his duty prudently: *Wall v. Patterson* (1996), 15 E.T.R. (2d) 29 at 34 (Ont. G.D.), citing *Chisholm v. Barnard* (1864), 10 Gr. 479 (Ch. Div.).

- [19] In *Hodgkinson v. Simms*, [1994] 3 S.C.R. 377 at 440, the Supreme Court of Canada stated that it is well established that the proper approach to damages for breach of fiduciary duty is restitutionary. The plaintiffs are entitled to be put in as good a position as they would have been in had the breach not occurred.
- [20] On the facts in this case, that means the plaintiffs are entitled to be restored to the position they were in before the transactions. This includes a substantial expectation loss, flowing from the fact that the Schwarzkopf securities would have increased in value through to June 2002. The plaintiffs have taken steps to mitigate the losses thereby reducing the monetary claim being advanced.
- [21] The fact that the damages are difficult to assess or measure accurately does not mean that a damage award will not be made. The court must do the best it can and make a reasonable estimate of the loss: *G.H.L. Fridman, The Law of Contract*, 5th ed. (Toronto: Thomson Carswell, 2006) at p. 757; *Kohler v. Thorold Natural Gas Co.* (1916), 52 S.C.R. 514 at 530.

Evidence regarding plaintiffs' losses

- [22] The plaintiffs have provided a number of expert's reports dealing with the issue of damages. Ms. Henderson has provided a report setting out her analysis of what the Schwarzkopf securities would have been worth, but for Mr. McLaughlin's breach of fiduciary duty. Ms. Henderson's opinion is that if the Schwarzkopf securities had been untouched between 1997 and June 2002, they would have been worth \$20,372,896 as of June 30, 2002. In the report, four alternative scenarios were set out ranging from \$20,791,410 to \$21,549,844, depending on the type of securities which were purchased. The average of the four alternatives is \$20,860,862.
- [23] Saunder N. Sheinin is a Chartered Accountant who restricts his practice to taxation and related financial matters. He has provided an expert report dealing with tax erosion arising from Ms. Henderson's alternate return scenarios. In his analysis, Mr. Sheinin has used assumptions favourable to the McLaughlin defendants, i.e., the highest marginal tax rates, and the highest tax rates that would apply irrespective of the form of security. Applying those assumptions to the average portfolio figure above, the net value is \$18,920,802.
- [24] Based on the Resulting Assets having a value of \$12,293,337, the decline in value of the plaintiffs' assets which were placed in the hands of Mr. McLaughlin is reasonably assessed at \$6,627,465 as of June 2002.

Plaintiffs' efforts to mitigate

- [25] Mr. McLaughlin owns 50% of the shares of Jo-Ke. In 2006, Mr. McLaughlin consented to the sale of the strata unit owned by Jo-Ke, and the funds were paid to Mr. Schwarzkopf, thereby reducing the loan receivable to \$65,333.

- [26] Since 2002, the McLaughlins have refused to consent on behalf of Dancerwood to the sale of the Development owned by LMRC. Mr. Schwarzkopf requires a special resolution of the shareholders to sell the Development. The project has ongoing expenses which cannot be covered from the strata fees paid by the lot owners. As a result, it has been necessary for J&T Holdings to invest a further \$1.9 million in the project in order to complete Phase 1 and market the lots. Mr. Schwarzkopf has financed this, in part, by the sale of other properties owned by him.
- [27] Starting in 2004, LMRC was able to sell a number of lots which has resulted in revenue and a pay-down of J&T Holdings' shareholder's loan. Most of these funds, \$3.956 million, were paid in the fiscal year ending July 31, 2007.
- [28] Of the assets held by the plaintiffs in June 2002, the value of the Jo-Ke assets, and the LMRC assets (both in the form of a loan receivable and the valueless shares) was \$5,789,191.. As a percentage of what the Schwarzkopf securities would have been worth in June 2002 but for their liquidation, assuming the average of the various scenarios discussed earlier, the Jo-Ke/LMRC assets represent a lost opportunity on the part of the plaintiffs to take advantage of what would have been the 30.5% growth in the Schwarzkopf securities.
- [29] Ms. Henderson has valued the Schwarzkopf securities as to what they would be worth at December 31, 2007, assuming they had been untouched. She has used the same four scenarios, based on investment in different types of securities. In Mr. Sheinen's report, he has taken the values from Ms. Henderson's report, and provided an opinion as to what the tax implications would be. In his opinion, taxes would have eroded growth and reduced the value of the securities. The average figure for the value of the Schwarzkopf securities at December 31, 2007, after tax erosion, is \$26,744,600, which represents an increase from June 2002 of \$7,823,789.
- [30] From this figure, the McLaughlin defendants should be given credit for the growth in the value of the LMRC assets from completion of the Development by Mr. Schwarzkopf (through investment of further funds) and lot sales. This is represented by the reduction in J&T Holdings' shareholders' loan, less the decline in the value of the property itself arising from decline in the inventory of lots for sale. Between June 2002 and the present day, J&T Holdings' shareholders' loan has been reduced by \$3,885,344. However, the Development has declined in value by \$1,360,000 according to a recent appraisal report prepared by Max Findlay, a real estate appraiser with Outlook Realty. The net advantage to the plaintiffs is therefore \$2,525,344.
- [31] As the LMRC/Jo-Ke assets represent 30.5% of the value of the Schwarzkopf securities in June 2002, the measure of the loss attributable to these two assets since June 2002 is \$2,386,255. The difference between this figure and the figure in paragraph 29 is \$139,089.

[32] The McLaughlin defendants should also be given credit for the difference between the June 2002 value of the strata unit and the actual sale price in 2006, which is \$90,331. Therefore, the full credit against damages, representing mitigation to the trial date, is \$229,420.

[33] When deducted from the loss to June 2002, the resulting loss after mitigation is \$6,398,045.

Alternate Assessment

[34] The fairness of the foregoing assessment of damages can be tested by an alternate assessment of damages at the trial date, which gives the defendants the benefit of the increase in value since June 2002 of all of the assets Mr. McLaughlin purchased between 1997 and June 2002, and the sale of lots by LMRC since June 2002.

[35] The Resulting Assets now have the following values:

- (a) J&T Holdings owns 51% of the shares of LMRC. J&T Holdings also has a loan owing by LMRC in the amount of \$5,655,986, the value of which is dependent on the value of LMRC's land. The land value has been appraised by Mr. Findlay, as at March 21, 2008, as \$4,260,000. Accordingly, the plaintiffs' collective assets in the Development have no greater value than \$4,260,000;
 - (b) Mr. Schwarzkopf owns 50% of the shares of Jo-Ke, which has \$21,191 in a bank account. His remaining loan receivable of \$65,633 has no prospect of full repayment;
 - (c) J&T Holdings owns the property located on Goldstream Avenue, known as Langford Lake, which has an appraised value of \$1.8 million;
 - (d) J&T Holdings owns five lots located at 6100 Block, Llanilar Road, East Sooke, with a combined assessed value as at March 12, 2008 of \$1,515,600;
 - (e) J&T Holdings owns the property located at 5481 Hamsterley Road, Victoria, with an assessed value as at March 2008 of \$465,500;
 - (f) Mr. Schwarzkopf has two brokerage accounts with TD Waterhouse with a combined balance of \$2,810,895, which represents the \$2.5 million left in cash in June 2002 and some modest growth. Some of these funds had to be used to pay LMRC's ongoing operating expenses, although all but \$300,000 has been returned to the account;
 - (g) J&T Holdings has \$4,580,036 in money market funds and GICs, representing funds repaid by LMRC to J&T Holdings on its shareholders loan.
- [36] On the basis of the foregoing, the Resulting Assets have a current value of approximately \$16,653,222, which does not take into account any transaction costs or tax consequences flowing from liquidation. It also gives the McLaughlin defendants full credit (at \$1.2 million) for the four annuities which were paid out by May 2007.

- [37] Deducting this amount from the average after-tax value of the Schwarzkopf securities at December 31, 2007 would result in a loss to the plaintiffs of \$10,091,378.

Constructive Trust and Vesting Order

- [38] The plaintiffs seek a constructive trust over the shares held by Mr. McLaughlin in Jo-Ke and by Dancerwood in LMRC, and an order vesting ownership of these assets in Mr. Schwarzkopf and J&T Holdings.
- [39] The McLaughlin defendants paid nothing for these shares. They were taken by Mr. McLaughlin and Dancerwood at a time when Mr. McLaughlin was acting in a fiduciary capacity to the plaintiffs. He has used his shareholding to prevent the sale of underlying assets required in order that the plaintiffs can mitigate their losses. The shares of Jo-Ke are required to access \$21,191 in a bank account which otherwise cannot be accessed without Mr. McLaughlin's consent.
- [40] In my view, there is a good reason for a proprietary remedy in this case. Mr. Schwarzkopf has deposed that the first phase of the Development has been completed, and there are only a few strata units left to sell. Once the remaining lots are sold, LMRC will have no means of raising revenue except for modest strata fees paid by the owners of the lots. The fees do not cover the overhead of LMRC, which includes taxes and maintenance of a clubhouse and pool. Mr. Schwarzkopf has no experience in real estate development and would prefer to sell the property rather than to develop a second phase of the Development to mitigate his losses. In my opinion, that is a reasonable approach to mitigation.
- [41] As stated earlier, the plaintiffs have obtained a default judgment against the McLaughlin defendants. As a result, the McLaughlin defendants are deemed to have admitted the allegations contained in the statement of claim. The statement of claim contains the following allegations against the McLaughlin defendants:

Jo-Ke Holdings Inc.

29. Kevin McLaughlin breached his fiduciary obligations to Schwarzkopf and Schwarzkopf Investments by incorporating Jo-Ke and recommending and implementing the loan to Jo-Ke, particulars of which are as follows:
- (a) the transaction was a wholly improvident and unconscionable bargain in that Kevin McLaughlin received 50% of the equity in Jo-Ke at no cost to him and without assuming any risk, Schwarzkopf and Schwarzkopf Investments received no return on the loan to Jo-Ke, and McLaughlin Insurance paid less than market rent for use of the Strata Unit;
 - (b) Kevin McLaughlin failed to ensure Schwarzkopf obtained independent legal advice before incorporating a company in which Kevin McLaughlin held a 50% interest and would thereby share in any increase in the capital value of the Strata Unit;

- (c) Kevin McLaughlin failed to ensure Schwarzkopf obtained independent legal advice before advising and facilitating a loan to Jo-Ke which would personally benefit Kevin McLaughlin and Bonnie McLaughlin by reason of Kevin McLaughlin's interest in Jo-Ke and the McLaughlins' interest in McLaughlin Insurance;
 - (d) Kevin McLaughlin allowed his interest to conflict with his duty to Schwarzkopf by causing Jo-Ke to enter into a commercial lease with a company owned by himself and Bonnie McLaughlin, McLaughlin Insurance, for less than market rent;
 - (e) when Schwarzkopf requested on March 19, 2003 that Kevin McLaughlin consent to the sale of the Strata Unit. Kevin McLaughlin failed to consent, contrary to Schwarzkopf's best interests.
30. The conduct particularized in paragraph 29 constituted defalcation by a person while acting in a fiduciary capacity.
31. By reason of the facts pleaded in paragraphs 23 through 30, Kevin McLaughlin holds his shares in Jo-Ke for the benefit of the plaintiffs pursuant to a constructive trust.

Lake McGregor Resort Corp.

76. Kevin McLaughlin advised Schwarzkopf that it was prudent that the land be developed as a joint venture between J&T Holdings and the McLaughlins' company, Dancerwood, in conjunction with a third party, John Koren. To this end, Kevin McLaughlin caused Lake McGregor Resort Corp. ("LMRC") to be incorporated. Kevin McLaughlin caused the shareholding in LMRC to be divided 34% to J&T Holdings, 33% to Dancerwood, and 33% to a company controlled by Mr. Koren's wife, 565469 B.C. Ltd..
77. On or about April 30, 1998, and on Kevin McLaughlin's advice, Schwarzkopf signed a shareholders' agreement (the "Shareholders' Agreement") on behalf of J&T Holdings, which purported to delineate the rights and responsibilities of LMRC's shareholders.
78. The Shareholders' Agreement constituted an unconscionable bargain in that it was an agreement through which the McLaughlins intended to and did take unfair advantage of Schwarzkopf and J&T Holdings. Particulars of this unfair advantage include:
- (a) the McLaughlins provided no consideration for Dancerwood's equity interest in the joint venture;
 - (b) the Shareholders' Agreement was drafted to insulate the McLaughlins, John Koren, and their respective companies, from any requirement to make a financial contribution to LMRC;
 - (c) the Shareholders' Agreement gave the McLaughlins and John Koren complete control over LMRC to the exclusion of Schwarzkopf and J&T Holdings;
 - (d) Kevin McLaughlin failed to ensure Schwarzkopf obtained independent legal advice before signing the Shareholders' Agreement.

88. On or about May 1, 2001, Kevin McLaughlin caused LMRC to purchase 565469 B.C. Ltd.'s shares in LMRC for \$112,374. In order to facilitate this purchase, Kevin McLaughlin used funds advanced to LMRC by J&T Holdings and Schwarzkopf Investments. Kevin McLaughlin failed to transfer the shares to J&T Holdings. Instead, Kevin McLaughlin caused the shares to be redeemed by LMRC and cancelled. By this action, Kevin McLaughlin increased Dancerwood's equity interest in LMRC from 33% to 49%.
89. By reason of the facts pleaded in paragraphs 75 through 88, Dancerwood holds its shares in LMRC pursuant to a constructive trust for the benefit of the plaintiffs. Further, at all material times, the McLaughlins owed to the plaintiffs a continuing fiduciary obligation to ensure that Dancerwood votes its shares in LMRC in the best interests of the plaintiffs.
95. Kevin McLaughlin breached the fiduciary duty he owed to Schwarzkopf, J&T Holdings, and Schwarzkopf Investments, particulars of which include:
- (a) restructuring Schwarzkopf's portfolio from one holding significant income producing marketable securities to one holding primarily unsecured debt in a highly speculative venture, which was in the best interests of the McLaughlins and Dancerwood but was not in the best interests of the plaintiffs;
 - (b) providing a substantial equity interest to Dancerwood and 565469 B.C. Ltd., companies in the control of the McLaughlins and John Koren, in circumstances where the plaintiffs provided all of the funds and the McLaughlins and John Koren or their companies were being paid for the services they provided to the project in addition to their equity interest;
 - (c) structuring the Shareholders' Agreement and the joint venture generally, in the best interests of the McLaughlins and Dancerwood, and contrary to the best interests of Schwarzkopf and J&T Holdings;
 - (d) failing to ensure Schwarzkopf obtained independent legal advice before signing the Shareholders' Agreement and the September 1998 Letter, and agreeing to the terms of the joint venture generally;
 - (e) billing LMRC for time he spent working on the project at a significant hourly rate, contrary to the representation he made to Schwarzkopf in the September 1998 Letter that Kevin McLaughlin would be paid for his time out of profits;
 - (f) billing the plaintiffs for time spent by himself and his assistant on the project as part of the ongoing services he provided to Schwarzkopf pursuant to the Retainer Agreements;
 - (g) failing to obtain Schwarzkopf's informed consent to liquidate marketable securities owned by Schwarzkopf Investments for the purposes of advancing those funds to LMRC;
 - (h) failing to warn or, in the alternative, to adequately warn Schwarzkopf of the significant financial risks associated with the venture, including his failure to warn Schwarzkopf of changes in those risks as they developed between April 1998 and June 2002;

- (i) allowing his personal interest in LMRC to conflict with the duty he owed to the plaintiffs to protect their financial interests;
- (j) knowingly taking a wrongful risk in advancing funds from Schwarzkopf Investments and J&T Holdings to LMRC at a time when this was an imprudent financial strategy which no reasonable financial advisor would recommend;
- (k) redeeming and cancelling 565469 B.C. Ltd.'s LMRC shares rather than transferring those shares to J&T Holdings, in effect increasing the McLaughlins' and Dancerwood's interest in LMRC from 33% to 49% and thereby advancing the interests of the McLaughlins and Dancerwood to the detriment of Schwarzkopf and J&T Holdings;
- (l) acting generally for Schwarzkopf in managing his financial affairs while there existed a conflict between Kevin McLaughlin's interest and duty;
- (n) continuing to remove funds from LMRC's bank accounts following the termination of the Retainer Agreements.

96. Kevin McLaughlin's conduct, particularized in paragraphs 95, constituted equitable fraud.

97. Kevin McLaughlin's conduct, particularized in paragraph 95, constituted defalcation by a person while acting in a fiduciary capacity.

[42] A constructive trust is imposed in circumstances where "good conscience" requires it, and to hold fiduciaries and people in positions of trust to the high standards of trust and honesty. Constructive trusts may also be imposed to do justice between the parties, and to maintain the integrity of institutions dependent on trust-like relationships. There are two categories in which a constructive trust may be imposed. The first is where property has been obtained by the wrongful act of the defendant, such as breach of fiduciary duty or a duty of loyalty, and secondly, where although the defendant has not acted wrongfully in obtaining the property, he would be unjustly enriched to the plaintiff's detriment if he was allowed to keep the property: *Soulos v. Korkontzilas*, [1997] 2 S.C.R. 217 at ¶33, 34 and 36.

[43] The four conditions which generally should be satisfied before a constructive trust is imposed in respect of the first category are set out at ¶45:

(1)

The defendant must have been under an equitable obligation, that is, an obligation of the type that courts of equity have enforced, in relation to the activities giving rise to the assets in his hands;

(2)

The assets in the hands of the defendant must be shown to have resulted from deemed or actual agency activities of the defendant in breach of his equitable obligation to the plaintiff;

(3)

The plaintiff must show a legitimate reason for seeking a proprietary remedy, either personal or related to the need to ensure that others like the defendant remain faithful to their duties and;

(4)

There must be no factors which would render imposition of a constructive trust unjust in all the circumstances of the case; e.g., the interests of intervening creditors must be protected.

[44] In my view, Mr. McLaughlin's breach of his fiduciary duty and duty of loyalty are sufficient to engage the conscience of the court and support a finding of constructive trust. Mr. McLaughlin was under a fiduciary duty in relation to the property at issue. He failed to pass on information to the plaintiffs, and allowed his own interest and that of the other McLaughlin defendants to conflict with those of his client. He acquired property for himself and for the other McLaughlin defendants as a direct result of his breach of his duties to the plaintiffs. The McLaughlin defendants were enriched by the wrongful acquisition of the property.

[45] As well, it is clear from the case law that a constructive trust is required in a case such as this to ensure that financial advisors and others in positions of trust remain faithful to their fiduciary duties and duty of loyalty: *Soulos* at ¶50.

[46] In my view, there are no factors which would make the imposition of a constructive trust unjust in this case. There is no evidence of any third parties who would suffer as a result of an order requiring the McLaughlin defendants to convey the property in issue to the plaintiffs. Nor would this be unfair to McLaughlin defendants. As indicated earlier, the calculation of the losses suffered by the plaintiffs is based on assumptions that are most favourable to the defendants.

[47] In all of the circumstances, I have concluded that all four conditions set out in *Soulos* have been satisfied and it is appropriate to impose a constructive trust over the assets held by the McLaughlin defendants.

[48] Accordingly, I am making the following orders:

- judgment in the amount of \$6,398,045;
- a declaration that Dancerwood holds its shares in LMRC in trust for J&T Holdings;
- an order requiring Dancerwood to deliver up its shares in LMRC to J&T Holdings;
- an order that in the event that Dancerwood fails to deliver up those shares to LMRC within 14 days, a declaration and order that ownership of those shares shall immediately vest in J&T Holdings without any further order of the Court;
- a declaration that Mr. McLaughlin holds his shares in Jo-Ke in trust for Mr. Schwarzkopf;
- an order requiring Mr. McLaughlin to deliver his shares in Jo-Ke to Mr. Schwarzkopf;

· an order that in the event that Mr. McLaughlin fails to deliver up his shares in Jo-Ke to Mr. Schwarzkopf within 14 days, a declaration and order that ownership of those shares shall immediately vest in Mr. Schwarzkopf without any further order of the Court.

[49] The plaintiffs are entitled to costs of the action at scale B.

"Gerow J."

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