**CITATION:** *Pallotta v. Cengarle*, 2024 ONSC 3911
**COURT FILE NO.:** CV-22-00689642-00CL
**DATE:** 20240710



**SUPERIOR COURT OF JUSTICE - ONTARIO**
**(COMMERCIAL LIST)**

**RE:** PETER PALLOTTA and DOROTEA PALLOTTA
also known as DORA PALLOTTA

Applicants

**AND:**

LICIO EDWARD CENGARLE

Respondent

**BEFORE:** Penny J.

**COUNSEL:** *Michael De Lellis* and *Andrew Rintoul* for the Applicants

*Anthony J. O'Brien* for the Respondent

**HEARD:** May 23, 2024

## REASONS FOR DECISION

### Overview

[1] In 2020 following a trial before Justice Faieta, the Pallottas were granted judgment in the amount of $254,056.89 (plus interest) against Mr. Cengarle, their former solicitor. There was no appeal from this Judgment. Four months after the Judgment was issued, Mr. Cengarle filed a proposal under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3. At the direction of the Trustee, the Pallottas filed a proof of claim in the bankruptcy. In December 2020, all of the creditors *other than* the Pallottas voted in favour of the proposal. In January, the court approved the proposal under s. 60(5) of the BIA. The Trustee's certificate of performance was issued in March 2021. The Pallottas received a distribution representing a little more than 10% of their claim.

[2] In this application, the Pallottas seek a declaration under s.178(1)(d) of the BIA that Cengarle's discharge from bankruptcy did not release him from the unpaid balance of his debt under the Judgment because that debt arose out of "misappropriation or defalcation" while acting in a fiduciary capacity.

**Issue**

[3] There are three issues:

(a) is the Judgment a debt that falls within the meaning of misappropriation or defalcation under s. 178(1)(d) of the BIA?

(b) are the conditions for the exemption in s. 62(2.1) of the BIA met such that s. 178(1) of the BIA is not engaged? and

(c) should the statutory stay of proceedings under s. 69.1 of the BIA be lifted?

[4] For reasons I will explain below, the Judgment is a debt resulting from misappropriation or defalcation within the meaning of s. 178(1)(d), the exemption under s. 62(2.1) does not apply, and the stay should be lifted to permit the Pallottas to enforce their Judgment.

**Background.**

[5] On a s. 178(1) application in respect of a debt resulting from a court order or judgment, "the judge's task is to determine the nature and substance of the debt by examining the pleadings, any reasons that might have been given, and the proceedings that were before the court that granted the judgment." The nature of the court's judgment determines the applicability of s. 178(1): *Zumbo, Re*, 18 CBR (4th) 148, 2000 CanLII 22481 (ONSC). In this case, therefore, the facts relevant to the question of whether the Judgment survives the bankruptcy are contained in the Judgment, the Reasons and the other proceedings and pleadings that were before Justice Faieta.

[6] Justice Faieta, in the course of his Reasons, made the following factual findings.

[7] Cengarle's law practice was primarily real estate solicitor's work. He also arranged mortgages between various clients who had money to lend or needed to borrow. He employed a real estate assistant, Ms. De Filippis. De Filippis had a lot of autonomy to deal with the clients and would brief Cengarle on each file. De Filippis was given a secondary key to Cengarle's Teranet account, which allowed her to prepare documents, such as transfers and charges, but not to register them. De Filippis also prepared cheques from Cengarle's trust account for the real estate transactions but only Cengarle could sign them.

[8] In 2004, Cengarle's licence to practise was suspended for a period of time because he was found to have engaged in professional misconduct in relation to an unsecured loan he arranged for De Filippis out of an estate while he was acting as executor.

[9] The Pallotta's were longstanding clients of Cengarle for wills, powers of attorney and at least 15 real estate transactions. Between 2003 and 2012, the Pallottas made several private mortgage investments facilitated by De Filippis through Cengarle's office which were represented to them as being safe and secure investments.

[10] In 2012, De Filippis told the Pallottas about a company called Blue Spruce Investments Limited and a related good, short-term $200,000 mortgage investment in a development in Caledon, Ontario (the "Blue Spruce Mortgage"). This investment was a fiction. De Filippis used the Pallottas' money for her own personal investment in a project in Panama managed by an acquaintance of hers. De Filippis falsified mortgage documents by accessing the Teranet website and altering a $200,000 mortgage given by Blue Spruce Investments Limited on a separate mortgage to make it appear that it was for the Pallottas. She was able to do this, in part, because Cengarle had, improperly, given De Filippis his Teranet licence and password information.

[11] The Pallottas made the $200,000 investment from two sources: (1) $100,000 from an installment on a previous mortgage that was placed in Cengarle's trust account; and (2) a cheque for $100,000 from Mr. Pallotta, delivered April 4, 2012 and payable to "Licio Cengarle in trust" wich had been deposited into Cengarle's trust account. The $200,000 cheque withdrawing the Pallottas' funds from his trust account was signed by Cengarle. He admitted he did not investigate or independently verify the nature and purpose of this cheque when presented to him by De Filippis for signature.

[12] Cengarle also signed several cheques payable to the Pallottas as 'interest payments' on the fake Blue Spruce Mortgage, without seeking to verify their purpose or nature. This occurred on numerous occasions from 2012 to January 2016, when the last interest payment was made. Several months later, with the interest payments in arrears, the Pallottas demanded their money back. When they did not hear back, they contacted De Filippis. She told them she was in hospital, having suffered a nervous breakdown. She also told them that Cengarle had their money and to speak to him. When they called Cengarle, he told them he did not know anything about the Blue Spruce Mortgage and told them to get lawyer.

[13] The plaintiffs commenced their action in 2016. At the trial in 2019, the Pallottas sued for fraud, breach of trust/fiduciary duty and negligence. They also sought a finding of vicarious liability against Cengarle for the fraudulent actions of De Filippis. Cengarle also became a defendant in 15 other actions related to De Filippis.

[14] In November 2017, the Law Society Tribunal granted the Law Society's motion for an interlocutory suspension of Cengarle's licence to practise law given concerns about the fraudulent investment scheme run by De Filippis through his office. The Tribunal noted that Cengarle:

(a) either knowingly or recklessly facilitated De Filippis' scheme by failing to supervise or question her as she directed funds into and out of his trust account;

(b) admitted that he learned by August 2015 that De Filippis had possibly engaged in improper self-dealing, but did not terminate her employment nor report the allegations to the LSO until after the LSO started its investigation in August 2016;

(c) admitted that De Filippis had improperly been given access to his Teranet key and knew his password; and

(d) had been disciplined before for loaning client funds to De Filippis in preference to an estate and its beneficiaries on the basis that he had acted out of personal loyalty to De Filippis, contrary to the best interests of his client.

[15] Following the trial, Justice Faieta dismissed the claim for fraud, granted the claim for breach of trust and dismissed the claim for negligence. He also found Cengarle vicariously liable for the fraudulent conduct of De Filippis.

[16] In his Reasons, Justice Faieta found that Cengarle breached his fiduciary duties owed to the Pallottas, describing the solicitor-client relationship as one of trust and confidence from which flow obligations of loyalty and transparency. Justice Faieta found that the Pallottas were "relatively unsophisticated businesspersons and were vulnerable, trusting clients" who accepted the recommendations of De Filippis, Cengarle's employee. The significant autonomy Cengarle gave De Filippis, and Cengarle's relationship as a fiduciary to the Pallottas, made him responsible for her actions. Justice Faieta said:

> It is no answer for Mr. Cengarle to say that he had no knowledge that Ms. De Filippis [had] taken money from the plaintiffs on false pretenses, that she had used his trust account to steal funds from the plaintiffs and that he had unknowingly signed a cheque removing the plaintiffs' funds from his trust account which gave effect to that theft. The integrity and good faith required of Mr. Cengarle, as a fiduciary in dealing with the plaintiffs, extends to him also being responsible for the actions of his real estate clerk who largely ran his real estate practice. If it were otherwise, then the trust and confidence reposed by a client in dealing with their solicitor would be undermined.

[17] Justice Faieta also found Cengarle liable in breach of trust for his wrongful disbursement of the Pallottas' funds from his trust account to a fake mortgage investment without their knowledge. Justice Faieta found that Cengarle:

> …committed a breach of trust by allowing trust funds received from longstanding clients that had been placed into his trust account, by Ms. De Filippis to whom he had given a great deal of autonomy over his practice and trust account, to be misappropriated by her when *he* signed a cheque permitting the plaintiffs' funds to be paid out of his trust account to the benefit of Ms. De Filippis.

[18] In concluding that Cengarle was vicariously liable for the dishonest conduct of Di Filippis, Justice Faieta found that Cengarle authorized the delegation of the management of his real estate practice to his employee. She was not only responsible for preparing the "paperwork" but also met with clients and had a licence provided by Mr. Cengarle that allowed her to access land registration records on Teranet.

[19] He went on to find that there was a significant connection between the risk created by having De Filippis manage all aspects of his real estate practice and the fraud that she perpetrated on the Pallottas. The trust and autonomy given to DeFilippis, along with her ability to have

Cengarle sign a cheque removing the funds from his trust account to realize her fraudulent aim, provided her with the opportunity to perpetrate the fraud of the Blue Spruce Mortgage on the Pallottas.

[20] It was on behalf of Cengarle that De Filippis arranged for the preparation and registration of mortgage investments (aside from the Blue Spruce Mortgage) for the Pallottas, for which Cengarle collected legal fees. Cengarle made De Filippis the face of his firm for the Pallottas. Those other mortgages investments were legitimate mortgage loans and were repaid. The connection between the risk created by Cengarle and the Blue Spruce Mortgage fraud was fortified by the fact that the Pallottas were relatively unsophisticated mortgage investors who relied on the guidance provided by De Filippis.

[21] Cengarle argued that he did not profit from the fraudulent conduct of De Filippis and that he was not authorizing the placement of private mortgage loans at the time the Blue Spruce Mortgage fraud was perpetrated. Justice Faieta found that vicarious liability is not conditioned on the employer profiting from the employee's dishonest conduct. He also found that the Blue Spruce Mortgage was a pure fiction in any event; it represented a theft of the Pallottas money, not an otherwise legitimate private mortgage that he may or may not have authorized.

## Analysis

### *Legal Framework*

[22] Section 178(1)(d) of the BIA provides:

> An order of discharge does not release the bankrupt from…
>
> (d) any debt or liability arising out of fraud, embezzlement, misappropriation or defalcation while acting in a fiduciary capacity or, in the Province of Quebec, as a trustee or administrator of the property of others…

[23] It is misappropriation and defalcation which are at issue in this case. It is not in dispute that Cengarle was acting in a fiduciary capacity.

[24] One of the leading cases is *Simone v Daley*, 43 O.R. (3d) 511, 1999 CanLII 3208 (ONCA). In that case, Blair J. (ad hoc) speaking for the court examined the concepts of "misappropriation" and "defalcation" in s. 178(1)(d). The court reviewed various authorities on these points both in Canada and the United States and found two different approaches:

> On one hand, the approach reflected in *Ironwood Investments Joint Venture v. Leggett* and in *Jerrard v. Peacock* views the words in the context of those with which they are associated in the paragraph and attributes to them some element of dishonesty, wrongdoing, or misconduct. On the other hand, decisions such as that of the British Columbia Court of Appeal in *Smith v. Henderson* suggest a broader interpretation which eschews the need for dishonesty, wrongdoing or misconduct, and is prepared to extend the

> exception to all cases in which a fiduciary is in breach of any fiduciary obligation: at p. 525.

[25] Blair J rejected the latter approach. At p. 529 he wrote:

> Consequently, I am not persuaded that the exception to a release of liability upon a bankruptcy discharge which is provided for in s. 178(1)(d) of the BIA should be extended to conduct which does not display at least some element of wrongdoing or improper conduct on the part of the fiduciary in question in the sense of a failure to account properly for moneys or property entrusted to the fiduciary in that capacity or inappropriate dealing with such trust property.

[26] At p. 526, Blair J. gave the following caution:

> [C]ourts should avoid attempting to sweep into concepts such as "misappropriation" or "defalcation" — which in their ordinary meanings connote some element of wrong doing, improper conduct, or improper accounting — any and all failures by the fiduciary to comply with the obligations attending upon that capacity. When it comes to the application of insolvency legislation, the results of not resisting that temptation can be far reaching and inconsistent with the purposes of such legislation.

[27] When the cases distinguish between misappropriation and defalcation, misappropriation focuses on the use of the funds and defalcation focuses on breach of trust. For example, misappropriation has been defined as "turning [funds] to a wrong purpose": *Re Ieluzzi* (#2), 2012 ONSC 1474 at para 36. Defalcation generally focuses on breach of trust, for example, "a monetary deficiency through breach of trust by one who has management or charge of funds" or a "failure to properly account for such funds": *Garofalo v. All Type Financial Services Ltd.*, [2008] O.J. No. 2698 (ONSC) at para. 20 (aff'd *Garofalo v. Papadopoulos*, 2009 ONCA 120).

[28] The courts have adopted a three-part test to determine whether a debt qualifies as a s. 178(1)(d) debt: *Re Ieluzzi (#2)* at paras 31-32 and 37; *Convoy Supply v. Elite Construction*, 2022 ONSC 5353 at para. 45 (aff'd 2023 ONCA 373). The three-part test is:

(a) the money taken by the debtor to create the debt must have belonged to someone other than the debtor;

(b) the taking must involve a wrongful use of the money; and

(c) the debtor must have received the money as a fiduciary.

[29] In respect of the second, "wrongful use", requirement, Ontario courts have looked for "some element of wrongdoing or improper conduct that would be unacceptable to society because of its moral turpitude or dishonesty": *Convoy Supply* (ONCA), at para 15.

[30] Misappropriation or defalcation while acting in a fiduciary capacity, therefore, requires wrongdoing that rises above inadvertence, negligence or incompetence. The debtor's conduct must go beyond acts that are "no more than reasonable, but ultimately unwise acts". However, it is not necessary to establish that the bankrupt derived direct personal benefit from the breach of trust to qualify as a debt falling within s. 178(1)(d): *Fong v. Cheung*, 2010 ONSC 4198 at paras. 38 and 42.

[31] In *Commdoor Aluminum v. Solar Sunrooms Inc.*, 2004 CanLII 465 (C.A.), at para. 2, the Court of Appeal for Ontario found that when a trial judge finds as a fact that a corporate director has failed to adequately discharge their onus as a trustee to account for the relevant trust funds, that finding, supported by the evidence, is sufficient to trigger s. 178(1)(d) of the BIA.

[32] The decision in *Garofalo* is instructive in this context. In *Garofalo*, the debtor applied the creditor's funds to the wrong mortgages, contrary to the creditor's instructions, and provided limited particulars of the loan to the creditor. The debtor argued that his conduct did not rise to the level of "moral turpitude" required to show defalcation. The Court of Appeal found that, given the fiduciary relationship, there had been "serious misconduct" by the debtor, namely "not investing all of the respondent's money, investing it in something different from what the parties had agreed, not trying to recover the money, and not accounting for the money including indicating who actually received it": *Garofalo*, para. 3.

[33] I also find *Yanic Dufresne Excavation Inc. v. Saint Joseph Developments Ltd. et al.*, 2021 ONSC 6633 at paras 137-163 (aff'd 2022 ONCA 556) apposite in the present context. In *Yanic* the debtor, an experienced real estate broker, delegated his fiduciary duties as the operator of a trust account under Ontario's *Real Estate and Business Brokers Act* without proper oversight. Kershman J. found that the debtor's attempt to pass his fiduciary duties off to someone else, when he had signing authority on the trust account and could have taken steps to ensure he was properly carrying out his duties, amounted to willful blindness and constituted the requisite element of misconduct.

***Application to This Case***

[34] It is clear from Justice Faieta's Reasons that the money taken from Cengarle's trust account belonged to the Pallottas, not to Cengarle. It is also clear that Cengarle was in a fiduciary relationship with the Pallottas; indeed, he was a trustee of their funds. The first and third parts of the three-part test are, therefore, clearly established. The only issue in dispute in this case is whether, because Cengarle did not personally intend to take the Pallottas' money (it was intentionally taken by De Filippa), he does not fall within the "wrongful use" threshold required in the second part of the test.

[35] Counsel for Cengarle submits that in most of the cases cited by the plaintiffs, the debtor knew he was misusing the funds (see for example *Re Zumbo* and *Garofalo*). By contrast, in this case, Cengarle was unaware of any breach of trust. He did not benefit from the fraudulent scheme and was actively misled by De Filippis who, among other things, made false entries in the firm's trust ledger. Cengarle was not found by Justice Faieta to have made any false

representations to the Pallottas or even to have interacted with them at the relevant time. He did not obtain the funds under false pretenses or make any promises or representations to the Pallottas to induce the receipt of the funds. The Judgment granted against him was in relation to an unsecured debt which he failed to repay and vicarious liability for the actions of an employee. However, an employer who is found vicariously liable for a debt caused by an employee's dishonesty is not, by that fact alone, considered to have committed the dishonest act themselves in the sense of the moral repercussions of the act. The employer's exposure is the obligation to repay or to compensate. An unsecured debt is anticipated by the BIA as the proper subject matter of a release in either a bankruptcy or proposal proceeding.

[36] I am unable to accept these arguments.

[37] Justice Faieta's Reasons contain clear, binding findings that Cengarle:

- failed to properly account for the trust funds over which he had control as a fiduciary, and which were deposited into and disbursed from his trust account by cheques that he signed;
- committed a breach of trust flowing from a misuse of trust funds;
- failed in his fiduciary duties by granting significant autonomy to a real estate clerk "who largely ran his real estate practice", including by improperly giving her access to his Teranet account and allowing her to meet with and make representations to clients in respect of significant investments, which turned out to be false; and
- provided De Filippis with the opportunity to perpetrate the fraud which could have been prevented if he exercised proper oversight and control over his clerk's activities and the activities in his trust account.

[38] Justice Faieta's Reasons also make clear that Cengarle engaged in wrongdoing or improper conduct that rises above inadvertence, negligence or incompetence: "it is no answer for Mr. Cengarle to say that he had no knowledge that Ms. De Filippis [had] taken money from the plaintiffs on false pretenses, that she had used his trust account to steal funds from the plaintiffs and that he had unknowingly signed a cheque removing the plaintiffs' funds from his trust account which gave effect to that theft."

[39] Justice Faieta also cited the Law Society Tribunal's decision in 2017, which found that Cengarle created a significant risk of harm to the public by misappropriation of trust monies. Cengarle learned at least by August 2015 that De Filippis had possibly engaged in improper self-dealing but did not terminate her employment or report these misappropriations to the LSO until after the LSO began its own investigation in August 2016 as a result client complaints like those of the Pallottas. Cengarle, at the very least, recklessly facilitated DeFilippis' fraudulent scheme by failing to supervise or question her as she directed funds into and out of his trust account, even after she admitted her wrongdoing to him.

[40] When I balance the purposes of s. 178(1)(d), read in light of the applicable case law, against the rehabilitative purposes of the BIA in general, I am left in no doubt that the appropriate balance in this case is that Cengarle, not the Pallottas, should bear the consequences of his reckless breach of trust. The facts of this case as found by Justice Faieta fall well within the terms "misappropriation or defalcation" as interpreted by judicial precedent from Ontario and other parts of Canada. This conclusion is not an unwarranted or unprecedented expansion of the meaning or scope of these concepts.

***The Section 62(2.1) Exception***

[41] Section 62(2.1) of the BIA states that s. 178(1) debts may be discharged if two conditions are met: (i) the proposal explicitly provides for the compromise of that s. 178(1) debt, and (ii) the creditor in relation to that debt or liability voted for the acceptance of the proposal. Section 62(2.1) reads:

> A proposal accepted by the creditors and approved by the court does not release the insolvent person from any particular debt or liability referred to in subsection 178(1) unless the proposal explicitly provides for the compromise of that debt or liability and the creditor in relation to that debt or liability voted for the acceptance of the proposal.

[42] The conjunctive "and" in s. 62(2.1) means that both requirements must be met in order for the exception to apply. Here, the Judgment formed the basis of a claim made by the Pallottas (at the Trustee's suggestion)> The claim was compromised by the proposal in the sense that the Pallottas received a small distribution in respect of their claim. The proposal did not purport to release Cengarle from the effect of s. 178(1)(d), however, and the Pallottas were on record as specifically reserving their rights in that regard before the creditors voted on Cengarle's proposal.

[43] More importantly, it is absolutely clear on the evidence that the Pallottas did *not* vote in favour of the proposal. Thus, the second requirement for the application of the s. 62(2.1) exception was manifestly not met in any event.

[44] In his written material, counsel for Cengarle made much of the fact that the Pallottas made a claim in the bankruptcy and received a distribution, as if this somehow constituted a form of estoppel or an abuse of process. This argument was not pursued in oral argument, with good reason in my view.

[45] It is normal course behaviour for a creditor to participate in a proposal process, and even receive a distribution under a proposal, and then subsequently pursue recovery of the balance of a debt falling within s. 178(1). Even a claim that constitutes a s. 178(1) liability is a claim provable in bankruptcy. That creditor, like any other creditor, may file a proof of claim with the trustee. This entitles the creditor to share in the distribution, vote at creditors' meetings (if they choose to do so) and the like. Filing a proof of claim and receiving a partial distribution out of the bankrupts' estate does not estop a creditor from pursuing the balance of his s. 178(1) claim after discharge from bankruptcy. This is so because the discharge does not release the bankrupt

of liability for a s. 178(1)(d) claim: *Algoma Steelworkers Credit Union Ltd. v. Kennedy* (1973), 1973 CanLII 533 (ON SC), 18 C.B.R. (N.S.) 51 (Ont. Dist. Ct.). It is only if, as s. 62(2.1) says, the creditor votes in favour of the proposal that the exception applies.

***Lifting the Stay***

[46] The Pallottas also ask this Court to lift the statutory stay of proceedings under s. 69.1 of the BIA to allow them to take steps to enforce the Judgment. The BIA empowers the bankruptcy court to lift the statutory stay under s. 69.4 where not doing so would result in material prejudice to the creditor or on other equitable grounds. The stay may be lifted where a debt falls within s. 178 of the BIA, as a refusal to do so creates a "material prejudice" to the claimant: *Gagnon (Re)*, 2021 ABQB 583 at paras 51, 59-60.

[47] Lifting the stay is also consistent with the aims and scheme of the BIA, as it protects vulnerable persons and gives effect to Parliament's intention that debtors should not use the BIA to be released from debts of a certain character. The Pallottas would be materially prejudiced by a refusal to lift the stay of proceedings, as it would prevent them from recovering nearly all the funds they invested in the fake Blue Spruce Mortgage, in respect of which they have already received Judgment of their entitlement, and on which they rely for their living expenses. Further, there is no prejudice to other creditors; they all voted in favour of the proposal and received the amounts they agreed to accept in respect of their debts.

**Conclusion**

[48] For the foregoing reasons, the request for a declaration that the Judgment is a debt under s. 178(1)(d) which survives bankruptcy is granted. The conditions required for the application of the exception in s. 62(2.1) have not been met. It is appropriate to lift the statutory stay to permit the Pallottas to pursue their remedies.

[49] I wish to thank both counsel for their helpful written submissions and their focus at the oral hearing on the central issue in this case.

**Costs**

[50] The parties agreed that there should be no order as to costs.

Penny J.

**Date:** July 10, 2024