

RECENT DEVELOPMENTS IN THE LAW OF TRUSTS

Glaholt & Associates
Barristers & Solicitors
141 Adelaide Street West
Suite 800
Toronto, Ontario
M5H 3L5

Duncan W. Glaholt
Markus Rotterdam

© Duncan W. Glaholt &
Markus Rotterdam
February, 2001

1. Introduction

The trusts established by the *Construction Lien Act* are now one of the most frequently litigated areas of construction law. A body of case law is developing in Ontario that provides some of the clearest guidelines to the construction industry to date. Yet, even as late as November 2000, in the face of an abundance of case law telling those working in construction how to handle trust funds, Madam Justice Molloy once again heard the infamous “but everybody is doing it” defence from yet another contractor who had disregarded the developing case law. In *RSG Mechanical Inc. v. ABCO Construction Inc.*,¹ the contractor, apparently secure in its knowledge that “everybody does it”, placed funds received from various owners for various projects into one single blended bank account, spent funds received for project A to pay trades of project B, and paid for its overhead expenses in project C with funds received in trust for the trades of project D. The defendant was likely surprised when Justice Molloy found it liable for breach of trust, but few others would have been. This paper will offer an outline of the trust provisions

¹ [2000] O.J. No. 4287 (Ont. S.C.J.). See also *S.E. Rozell & Sons v. Groff* (2000), 2 C.L.R. (3d) 58 (Ont. S.C.J.).

of the Act and then look at how recent decisions have interpreted or applied these provisions.

Seven provisions of the *Construction Lien Act*² comprise the statutory code of construction trusts. Three of these sections, sections 7, 8 and 9, create the trust. Three of these sections, sections 10, 11 and 12, provide specific *limited* defences to trustees, and section 13 provides a truly remarkable, far ranging and comprehensive code for personal and accessory liability for breach of trust.

2. Trusts

Section 7 creates the “owner’s trust”:

Owner's trust, amounts received for financing a trust

7.--(1) All amounts received by an owner, other than the Crown or a municipality, that are to be used in the financing of the improvement, including any amount that is to be used in the payment of the purchase price of the land and the payment of prior encumbrances, constitute, subject to the payment of the purchase price of the land and prior encumbrances, a trust fund for the benefit of the contractor.

Amounts certified as payable

(2) Where amounts become payable under a contract to a contractor by the owner on a certificate of a payment certifier, an amount that is equal to an

² R.S.O. 1990, c. C.30.

amount so certified that is in the owner's hands or received by the owner at any time thereafter constitutes a trust fund for the benefit of the contractor.

Where substantial performance certified

(3) Where the substantial performance of a contract has been certified, or has been declared by the court, an amount that is equal to the unpaid price of the substantially performed portion of the contract that is in the owner's hands or is received by the owner at any time thereafter constitutes a trust fund for the benefit of the contractor.

Obligations as trustee

(4) The owner is the trustee of the trust fund created by subsection (1), (2) or (3), and the owner shall not appropriate or convert any part of a fund to the owner's own use or to any use inconsistent with the trust until the contractor is paid all amounts related to the improvement owed to the contractor by the owner.

Section 8 creates the “contractor’s and subcontractor’s trust”:

*Contractor's and subcontractor's trust,
amounts received a trust*

8.--(1) All amounts,

- (a) owing to a contractor or subcontractor, whether or not due or payable; or
- (b) received by a contractor or subcontractor,

on account of the contract or subcontract price of an improvement constitute a trust fund for the benefit of the subcontractors and other persons who have supplied services or materials to the improvement who are owed amounts by the contractor or subcontractor.

Obligations as trustee

(2) The contractor or subcontractor is the trustee of the trust fund created by subsection (1) and the contractor or subcontractor shall not appropriate or convert any part of the fund to the contractor's or subcontractor's own use or to any use inconsistent with the trust until all subcontractors and other persons who supply services or materials to the improvement are paid all amounts related to the improvement owed to them by the contractor or subcontractor.

Section 9 creates a “vendor’s trust”:

Vendor's trust, amounts received a trust

9.--(1) Where the owner's interest in a premises is sold by the owner, an amount equal to,

- (a) the value of the consideration received by the owner as a result of the sale,

less,

- (b) the reasonable expenses arising from the sale and the amount, if any, paid by the vendor to discharge any existing mortgage indebtedness on the premises,

constitutes a trust fund for the benefit of the contractor.

Obligations as trustee

(2) The former owner is the trustee of the trust created by subsection (1), and shall not appropriate or convert any part of the trust property to the former owner's own use or to any use inconsistent with the trust until the contractor is paid all amounts owed to the contractor that relate to the improvement.

One of the first key issues to develop in this area was the built in conflict between these three trusts and the common and efficient business practice of running a single operating bank account. The recent decision of Justice Quinn in *S.E. Rozell & Sons Inc. v. Groff*³ revisited the issue of whether the commingling of trust funds with other funds in itself amounts to a breach of trust. Justice Quinn held that:

³ (2000), 2 C.L.R. (3d) 58 (Ont. S.C.J.).

While it is true that s. 8 does not prohibit the commingling of trust funds with other funds, the weight of the case law seems to be to the effect that commingling places the trust funds at risk, and merely exposing them to that unnecessary risk is an act which is inconsistent with the high standards expected of a trustee. The fact that, in the end, the risk is not realized is immaterial - good luck should not be a defence to a breach of trust.

Even though Twin City used job numbers to designate its projects and identified each deposit and withdrawal by means of a job number, I find that the commingling, by itself, was imprudent, ran contrary to the proper conduct expected of a trustee and amounted to a breach of the trust obligation created by s. 8 of the CLA. It may reasonably be said that the trust funds here were exposed to unnecessary risk. For example, the entire general operating account was an exigible asset of Twin City at a time when the business of that company was in decline. The account, therefore, was at the mercy of a nervous banker or available to any judgment creditor of Twin City. A trustee should never put the corpus of a trust in such a position. I should say, however, that I am not in agreement with those who hold that commingling trust funds with other funds is always, by itself, a breach of trust. It is only where the commingling places the trust funds at risk - and there may be limited instances where the nature of the commingling does not do so. The risk of which I speak could range from, on the one hand, seizure of the trust funds by a non-beneficiary to, on the other hand, inaccurate record-keeping.

S.E. Rozell therefore teaches us that running blended operating accounts places trust funds at risk and that this could be a *prima facie* breach of either the s. 7 owner's trust or the s. 8 contractor's trust. While we are on the topic, it is now relatively easy to list a couple of other established principles:

1. Overheads may not be paid out of trust funds. See *Rudco Insulation Ltd. v. Toronto Sanitary Inc.*,⁴ *Dietrich Steel Ltd. v. Shar-Dee Towers (1987) Ltd.*⁵ and *Tam-Kal Ltd. v. Stock Mechanical Inc.*⁶
2. Set-offs must be retained and money set off cannot be spent. See *Arborform Countertops Inc. v. Stellato*.⁷
3. Tragically, legal fees are not always payable out of trust funds. See *RSG Mechanical*.

⁴ (1998), 41 C.L.R. (2d) 1 (Ont. C.A.).

⁵ (1999), 170 D.L.R. (4th) 475 (Ont. C.A.).

⁶ (1999), 50 C.L.R. (2d) 224 (Ont. C.A.).

⁷ (1996), 29 O.R. (3d) 129 (Ont. Gen. Div.)

The thread running through all of these cases that found its clearest articulation in the reasons of Austin J.A. in the recent decision in *Structural Contractors Ltd. v. Westcola Holdings Inc.*⁸ is that Part II means what it says. The Legislature was in deadly earnest when it enacted this code that requires all money that enters the “construction pyramid” to stay in the “construction pyramid”. The Court of Appeal, in *Structural*, dismissed an appeal from an order of Justice Pitt, who had granted summary judgment against a corporate commercial landlord and its sole owner for breach of trust under s. 7(2) and s. 13 of the *Construction Lien Act*⁹ respectively. What was the landlord’s breach? The landlord had applied rents to debt service, taxes and other routine operating expenses instead of paying certified progress payments to the contractor that was repairing the building’s parking garage.

The facts of *Structural* are straightforward. Westcola owned a four storey office building in Toronto, incorporating an underground parking structure. The largest tenant of the building was the Government of Canada which occupied 75% of the building. Westcola contracted with the Respondent, Structural Contracting Ltd. (“Structural”), to

⁸ (2000), 48 O.R. (3d) 417 (Ont. C.A.).

⁹ R.S.O. 1990, c. C.30.

rehabilitate this underground parking structure. Their initial contract price was \$122,515.00. Shortly after the Plaintiff commenced work Westcola was advised by its Consultants that additional work was necessary and Structural quoted \$92,000.00 over and above the original contract price for this work. Westcola had no choice but to continue with the work since the parking structure was unusable by its tenants. Westcola paid Structural \$143,441.67. During the period of garage reconstruction in 1997, Westcola received rents on a monthly basis from its tenants, in the ordinary course of its business. These rents were deposited to Westcola's bank account and paid out for first mortgage debt service, utilities, maintenance, property taxes and GST, again in the ordinary course of business. The contract between Structural and Westcola provided that work was to be certified by Trow Consulting Engineers Ltd. ("Trow"). Trow certified substantial completion. Trow's certificates triggered trust liability under s. 7(2) and s. 7(3) of the Ontario *Construction Lien Act*. Structural does *not* apply where there are no such certificates.

Structural sued Westcola for breach of trust under s. 7 of the Ontario *Construction Lien Act* in September of 1998. Structural moved for and obtained summary judgment, and the Court of Appeal for Ontario

affirmed this summary judgment, holding that rents received by Westcola were trust funds to the extent of certified funds due to Structural. The appellant attempted to distinguish between the considerations guiding the courts in cases of contractors' trusts and those governing owners' trusts. Austin J.A., for the Court, refused to follow this argument:

The appellant's factum draws a distinction between ss. 7 and 8 of the Act. As noted earlier, s. 8 imposes a trust upon certain funds received by the contractor while s. 7 imposes a trust on the owner. A line of cases has decided that the contractor is not entitled to pay overhead from those funds at the expense of subcontractors: see for example, *Rudco Insulation Ltd. v. Toronto Sanitary Inc.* (1998), 42 O.R. (3d) 292, 167 D.L.R. (4th) 121 (C.A.).

The appellants argue that the same considerations do not apply to s. 7, particularly where the funds are received on account of rent, without which the owner would be unable to provide the services required by its lease obligations. I do not see how this submission can prevail given the language of s. 7(4).

That argument must be rejected. Westcola is essentially a landlord. Rent is not an incidental matter to it. Rent is its lifeblood, its *raison d'être*. To exclude rent from the trust in the case of a landlord would be to exclude Westcola from the application of s. 7. No justification has been suggested for such a step.

3. Statutory Defences

Now let us consider the issue of defences. Once again the Act, Part II, is a complete code. There are four defences contained in sections 10, 11 and 12.

3.1 Section 10 – Right to Spend Trust Funds in “Discharge of the Trust”

According to s. 10, it is a defence to a breach of trust claim that the trustee paid for services or materials supplied to the improvement. Each such payment actually “discharges” the trust:

Payment discharging trust

10. Subject to Part IV (holdbacks), every payment by a trustee to a person the trustee is liable to pay for services or materials supplied to the improvement discharges the trust of the trustee making the payment and the trustee's obligations and liability as trustee to all beneficiaries of the trust to the extent of the payment made by the trustee.

Payments that do not fall under s. 10, i.e. payments to someone who did not supply services or materials to the improvement, do not discharge the trust. This is now conclusively and absolutely established subject only to a possible re-hearing of *Structural v. Westcola* by the Supreme Court of Canada. The most common situation in which defendants have attempted to rely on this section, almost uniformly without success, is found in the so-called “overhead” cases. The Court of Appeal trilogy of *Rudco Insulation Ltd. v. Toronto Sanitary Inc.*,¹⁰ *Dietrich Steel Ltd. v. Shar-Dee Towers (1987) Ltd.*¹¹ and *Tam-Kal Ltd. v. Stock Mechanical Inc.*¹² have now made it absolutely clear that overhead payments do not reduce trust obligations under s. 10 of the Act.

The recent motion court decision of *Desourdy 1949 Paving Inc. (Trustee of), Re*¹³ applies this law on interesting facts. The defendant was a trustee in bankruptcy of Teperman and Sons Inc., the contractor hired to demolish a building and dispose of the rubbish. The plaintiff was also a trustee in bankruptcy, of the subcontractor Desourdy, hired by Teperman to

¹⁰ (1998), 41 C.L.R. (2d) 1 (Ont. C.A.).

¹¹ (1999), 170 D.L.R. (4th) 475 (Ont. C.A.).

¹² (1999), 50 C.L.R. (2d) 224 (Ont. C.A.).

dispose of the rubbish. Desourdy had to remove iron bars from the concrete material on site before disposing of it. At some point, several liens had been registered, the owner had paid money into court and Desourdy ended up being the only remaining lien claimant outstanding. A secured creditor claimed priority over the funds paid into court, relying on sections 10 and 11 of the Act. The first issue before the court was whether Desourdy's services were in respect of an improvement. The Court had no trouble finding that this was so. The services were directly related to the demolition activity performed by Teperman. Desourdy provided a direct and essential contribution to the construction of an improvement on the site, i.e. the disposal of demolition rubbish.

The defendant's argument was old enough that it could wear a beard. Teperman's trustee argued that as Teperman could prove that it had paid out much more than the total sum of \$499,200.00 it received from the owner under the contract, and therefore it must be that it was discharged from its trust obligations because it lost money. A logical argument, but

¹³ (2000), 3 C.L.R. (3d) 93 (Ont. S.C.J.).

one that has found uniform disfavour in the Court of Appeal.¹⁴ If the court funds were not trust funds, so the argument went, the secured creditor would have priority. The defendant also relied on s. 11 of the Act, discussed in more detail below, which provides that:

Where trust funds may be reduced

11.--(1) Subject to Part IV, a trustee who pays in whole or in part for the supply of services or materials to an improvement out of money that is not subject to a trust under this Part may retain from trust funds an amount equal to that paid by the trustee without being in breach of the trust.

Application of trust funds to discharge loan

(2) Subject to Part IV, where a trustee pays in whole or in part for the supply of services or materials to an improvement out of money that is loaned to the trustee, trust funds may be applied to discharge the loan to the extent that the lender's money was so used by the trustee, and the application of trust money does not constitute a breach of the trust.

The Court's discussion on this point is worth reproducing in full:

¹⁴ See *Ontario Electrical Construction Co. v. S.I. Guttman Ltd.* [1997] O.J. 4094, (Ont. C.A.).

As to the issue of sections 10 and 11 of the Act and whether Repet as a secured creditor is able to claim the court funds, I find as follows. The court funds are trust funds in favour of Desourdy by operation of section 8(1) of the Act. The trust claim in respect of Desourdy's services has not been paid in full. Based on these findings and by operation of section 67(1)(a) of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended, the court funds do not vest in the Estate of Teperman and Sons Inc., a Bankrupt, so that Repet has no claim to them as a secured creditor.

Although I have not been referred to cases or other authorities on this particular issue, I also find that Repet cannot claim it is entitled to those funds, relying on sections 10 and 11 of the Act. By their express terms, those sections provide a defence to the trustee in bankruptcy for Teperman, not to other creditors of the bankrupt's estate. To allow Repet, as a secured creditor, to claim the court funds and to rely on the protection of those sections would defeat the trust protection and the resulting financial preference accorded to trust claimants by section 8(1) of the Act and section 67(1)(a) of the *Bankruptcy and Insolvency Act*. From a plain meaning interpretation of sections 10 and 11, it would appear that the trustee is able to "recoup" its non trust fund payments made in good faith in respect of an improvement by retaining an equal amount from trust funds, without being in breach of trust. If this were extended to allow Repet to make a claim against the court funds, the purpose of the trust protection in the legislation would not only be defeated, but sections 10 and 11 would be being used to assert a secured creditor's claim over that of a trust claimant, as opposed to defending a good faith

payment by a trustee. I cannot understand that this is a result intended by the Act.

The trustee in *RSG Mechanical Inc. v. ABCO Construction Inc.*, *supra*, attempted to make the same argument as made by Teperman's trustee in *Desourdy*: "We spent more than we got, so we cannot possibly be in breach of trust." Molloy J. disagreed:

ABCO argues that since it paid out more than it took in, it should not be liable for breach of trust. This argument has no merit. ABCO's responsibilities in contract, and its responsibilities under the Act, are completely independent of its profit situation. The total amount paid out by ABCO included payments to persons who were not trust beneficiaries. It is only payments to eligible trust beneficiaries that have any potential to reduce a liability for breach of trust.

RSG Mechanical also raised the issue of whether law firms can be eligible recipients of trust funds under ss. 8 or 10 of the Act. The Court answered this question in the negative, even for those expenditures directed towards the recovery of funds owing to the trustee:

In my opinion, law firms are not eligible recipients of trust funds under s. 8 or 10 of the Act. The Act contemplates that the payment out of trust funds should only be to beneficiaries of the trust. It cannot be said that the services of the law firms were performed upon or in respect of the improvement itself. On the contrary, such services are more in the nature of the kinds of services that have been held to be overhead and not eligible for payment out of trust funds. I consider the exclusion of law firms from the class of trust beneficiaries to be a logical extension of the principles of interpretation applied by the Court of Appeal in *Rudco*.

[...]

The defendants argue that expenditures directed towards the recovery of monies owing from the Numbered Company owner are consistent with the purposes of the trust in that any funds obtained will constitute trust funds and will increase the size of the pot available for distribution to trust beneficiaries. Therefore, it is said, payment for those services is not "a use inconsistent with the trust" and not a breach of the trustee's obligations under s. 8(2) of the Act. However, the defendants overlook the fact that s. 8(2) specifically prohibits the contractor from converting any part of the trust fund to its own use. The trust beneficiaries all have direct claims against ABCO in contract for the full amount of their accounts. ABCO is legally liable to its subcontractors and workers for the full amount of their claims regardless of what amounts ABCO is able to collect from those above it. Therefore, the collection of money owing to ABCO is entirely for

ABCO's benefit as it provides ABCO with a source of funds from which to discharge its legal responsibilities to those with whom it has contracted. As a practical matter, it is useful for the subcontractors to have as much money as possible fall into the trust fund. However, this does not alter ABCO's liability for the full amount of its contractual obligations and only arises in the event that ABCO fails to honour its legal responsibilities under its contracts. The payment of legal fees by ABCO in order to secure funds from which it can meet its legal obligations is an overhead expense of ABCO. Payment of those fees out of trust funds, therefore, constitutes a conversion of those funds to the use of ABCO contrary to s. 8(2) of the Act.

3.2 Section 11 – “Right to Reduce Trust Funds”

Section 11 allows the trustee to “reduce” the trust fund, but not, it is noted, in “discharge” of the trustee’s obligation, to repay any non-trust monies the trustee has used or borrowed to pay otherwise valid beneficiaries on the improvement in question. This is a double barrelled defence, with one provision, s. 11(1), dealing with trustee’s cash used for trust purposes and another, s. 11(2), dealing with repayment of borrowed funds.

Where trust funds may be reduced

11.--(1) Subject to Part IV, a trustee who pays in whole or in part for the supply of services or materials to an improvement out of money that is not subject to a trust under this Part may retain from trust funds an amount equal to that paid by the trustee without being in breach of the trust.

Application of trust funds to discharge loan

(2) Subject to Part IV, where a trustee pays in whole or in part for the supply of services or materials to an improvement out of money that is loaned to the trustee, trust funds may be applied to discharge the loan to the extent that the lender's money was so used by the trustee, and the application of trust money does not constitute a breach of the trust.

There is an important distinction in the subsections. Under subsection 11(1), if the trustee has used its own funds to pay beneficiaries, it may only “retain” a like amount. If the trustee has borrowed such money, however, the money can actually be repaid, not merely retained. If handled with care, most such payments can be successfully structured as loan repayments. It is not easy to understand the reasoning behind this distinction and it may be a simple anomaly. The Attorney General’s

Advisory Committee on the Draft *Construction Lien Act*, in its 1983 report, states only that the purpose of subsection 11(1) is to allow a trustee who used non-trust funds to pay a beneficiary to retain an equal amount of money out of the trust fund. In this sense, therefore, s. 11 is not much of a defence. It depends in any event on a strict and accurate accounting.

In *RSG Mechanical Inc. v. ABCO Construction Inc.*, the contractor attempted to rely on section 11, arguing that it had spent funds received on other projects pay trades in the project in question. The Court made clear that “money that is not subject to a trust” for the purposes of s. 11 means money not subject to a trust on *any* project:

In my opinion, the requirements of s. 11 are clear. Since ABCO cannot prove the \$34,280.51 it paid to Oakville beneficiaries was nor, in fact, impressed with a s. 8 trust in favour of workers on other projects, it is not entitled to the protection of the s. 11 defence.

Subsection 11(2) was raised as a defence and considered in detail as a central issue in *Ontario Electrical Construction Co. v. S.I. Guttman Ltd.*¹⁵ This was a tragic case on its facts. A mechanical subcontractor had experienced financial difficulties following the unexpected death of its founder. The assets of the operating company were sold to a new employee-owned company which completed various contracts underway at the time on behalf of and under contract to the operating company. During this period of transition, the deceased's beneficiaries injected \$4.7 million into the original operating company to keep the projects going and to keep the bonding company satisfied. Advances were made as needed in large amounts without differentiating between the several projects that were being completed at the same time. The last receivables from the last job were then taken and applied in partial repayment to the family. The argument in favour of this conduct was that as this last job was unprofitable, more money had been paid to trades than had been received from the contractor, and an amount equal to that shortfall, logically, would have had to have been made up by borrowings from the estate beneficiaries. The motions court Judge, citing the Ontario cases of *Canadian Advanced Air Ltd. v. Peel Board of*

¹⁵ (1996), 29 C.L.R. (2d) 146 (Ont. Gen. Div.), affirmed (1997), 104 O.A.C. 232 (Ont. C.A.).

Education,¹⁶ *Andrea Schmidt Construction Ltd. v. Glatt*¹⁷ and the Manitoba authority of *ASL Paving Ltd. v. Magnus Construction Ltd.*,¹⁸ cited four prerequisites for the justification of such a repayment and clarified the onus upon the parties in using this section as follows:

1. The trustee must be the one who exercises the discretion to pay the lender;
2. The funds must have been used to complete in whole or in part any work done;
3. The amount which can be justified by way of repayment shall be limited to the extent that the lender's money was so used by the trustee;
4. The onus to establish that a payment comes within the exception permitted by the Act and is not an appropriation not authorized but the trust rests with the party who claims to be entitled to take advantage of it.

The trustee's appropriation in *Ontario Electrical* was disallowed as not falling within the strict confines of s. 11(2). This result was upheld on appeal.¹⁹ The Court of Appeal held as follows:

To come within s. 11 the appellants would have to show that the loans to S.I. Guttman Limited were used to pay for work or materials on that project . . . To give effect to the appellants' submission would shift S.I. Guttman's loss on the

¹⁶ (1980), 31 O.R. (2d) 225, 118 D.L.R. (3d) 699 (Co. Ct.).

¹⁷ (1979), 25 O.R. (2d) 567, 104 D.L.R. (3d) 130 (H.C.), affirmed (1980), 28 O.R. (2d) 672, 112 D.L.R. (3d) 371 (C.A.).

¹⁸ (1994), 13 C.L.R. (2d) 253 (C.A.).

¹⁹ *Ontario Electrical Construction Co. v. S.I. Guttman Ltd.* [1997] O.J. 4094, (Ont. C.A.).

library project to the trades even though the appellants concede that the money is owing to the trades under their subcontracts.

3.3 Section 12 – “Right to Retain Trust Funds”

The final statutory defence permits a trustee to *retain* trusts funds with respect to setoffs against a trust beneficiary:

Set-off by trustee

12. Subject to Part IV, a trustee may, without being in breach of trust, retain from trust funds an amount that, as between the trustee and the person the trustee is liable to pay under a contract or subcontract related to the improvement, is equal to the balance in the trustee's favour of all outstanding debts, claims or damages, whether or not related to the improvement.

The purpose and scope of the so-called set-off “defence” was discussed in the 1996 trial decision in *Arborform Countertops Inc. v. Stellato*.²⁰ The plaintiff in this case supplied countertops to the personal defendants’

²⁰ (1996), 28 C.L.R. (2d) 25 (Ont. Gen. Div.). See also *Datasphere Sales Ltd. v. Universal Light & Power Corp.* (1991), 48 C.L.R. 25 (Ont. Gen. Div.).

company for installation on various projects. The defendants subsequently ceased operations, only to immediately commence business again under a slightly different name, substituting the “Ltd.” for “Inc.” The plaintiff remained unpaid and sued for breach of trust. The defendants attempted to plead set-off, arguing that the countertops were defective and that alterations had to be made at a cost to the defendants. LaForme J. held that while the Act specifically permits the pleading of set-off as a defence, the defence will only succeed in very specific circumstances. He held that:

The authority section 12 grants to a trustee was given judicial meaning by Coe J. in *Datasphere*. In reasons which I adopt, the learned Justice had this to say:

There is no right in [the trustee] to put some or all of the funds to general use because in its view, in light of claims it has or proposes to assert against the beneficiary-contractor, the ultimate arithmetical calculations demonstrate that the trust moneys owing net out a balance less than the gross totals of the funds retained. The word used in s. 12 is “retain” not “spend”. I recognize that the same word is used in s. 11, but in my view the words must have the meaning I attribute to them to give shape and substance to the trust scheme set out in Part II of the Act, while at the same time providing for the right to make those

payments specifically permitted in the statutory scheme, avoiding the trust concept paralyzing payments to the trades sought to be protected by it.

In other words, the intention of section 12 of the Act, especially when read together with the prohibiting provisions of section 8, is to allow the trustee to retain moneys alleged to be for set-off, but not to expend them.

In *Datasphere Sales Ltd. v. Universal Light & Power Corp.*,²¹ the plaintiff contractor had sought a declaration that certain funds received by the defendant under section 8(1)(b) were held in trust. The defendant argued that it had claims against the contractor which exceeded the money to be held in trust and therefore, it could treat the trust fund as any other part of their cash flow. Coe J. rejected this argument for the reasons attributed to him in the quotation from the *Arborform* case immediately above.

Thus a trustee has no right to put trust funds to general use simply because the trustee believes that it has or will assert a set-off. Furthermore, it is not sufficient to merely allege set-off, it must be

²¹ (1991), 48 C.L.R. 25 (Ont. Gen. Div.).

proven on all of the evidence.²² To repeat, until the set-off is established in Court or on consent, the trust monies in respect of which the set-off is claimed must be *retained*, not applied to general use.

In the 1997 decision in *West York Construction (1984) Ltd. v. Walton Place (Scarborough) Inc.*,²³ the Court held that a claim for delay in performance of the contract could be set off under section 12. In this case, the contractor was entitled to payment of the holdback, but the owner had retained a portion of the funds based on the delay claim. The funds were at all times retained in a separate trust account. Referring to *Datasphere*, Kiteley J. held that while the funds remained trust funds, they were no longer technically holdback funds, as liens had not been registered. The trustee was held to have rightfully refused payment.

It is important not to confuse the *Construction Lien Act* set-off with the common law set-off. Generally, under common law, debts may not be set-off unless they are mutual. In *Victoria Steel Products Ltd. v. Matassa*

²² *E. Bondy Excavating and Trucking Ltd. v. Amberstburg (Town)* [1987] O.J. No. 918 (Ont. H.C.).

²³ (1997), 35 C.L.R. (2d) 58 (Ont. Gen. Div.).

Contractors Ltd.,²⁴ Sutherland J. explained the common law principle as follows:

[T]he general rule is that set-off is available in respect of mutual debts between parties acting in the same capacities with regard to each. The element of capacities or mutuality means that there can be no set-off between debts where, for example, A in his personal capacity has a debt claim against B and A in his capacity as a trustee is indebted to B. It is also essential under the general rule that the claims sought to be set off are *debt* claims, and it therefore follows that under the general rule set-off is not available where one of the claims is an unliquidated claim. [emphasis in original]

The statutory right of set-off as provided for in section 12 of the *Construction Lien Act* contains no express mutuality requirement. Also, section 12 is not restricted to debts. Section 12 as drafted is a much broader *right* of set-off than that available at common law.²⁵ On the other hand, at common law, as long as the debts are mutual, there is no general rule that the funds cannot be spent. Under section 12, as seen, funds have to be retained. Therefore, while the statutory right to set-off

²⁴ (1987), 25 C.L.R. 238 (Ont. H.C.).

may broaden the *right* to set-off, it severely constrains the *remedy* of set-off.

4. Personal Liability Under the Act

This is truly the “13th”, unlucky provision for many in the construction industry. It is a section of such scope and breadth that even the recent array of decisions has not yet fully developed its potential impact on the industry. Section 13 of the Act reads as follows:

13.--(1) In addition to the persons who are otherwise liable in an action for breach of trust under this Part,

- (a) every director or officer of a corporation; and
- (b) any person, including an employee or agent of the corporation, who has effective control of a corporation or its relevant activities,

²⁵ See also *C & A Steel (1983) Ltd. v. Tesc Contracting Co.* (1998), 39 O.R. (3d) 155 (Ont. Gen. Div.), which compares the equitable law of set-off to the set-off provided in s. 17(3) of the *Construction Lien Act*.

who assents to, or acquiesces in, conduct that he or she knows or reasonably ought to know amounts to breach of trust by the corporation is liable for the breach of trust.

The standard approach to s. 13 is found in what is called the “single shareholder” line of cases, of which *Structural* is the latest example. Austin J.A. held that:

Colatosti was the only person involved. He was the sole officer, director, controlling mind and signing officer of the corporation and the person who signed all of the cheques in question. Whether or not he knew he was committing a breach of trust, it is beyond argument that he reasonably ought to have known as he had effective control of the activities of the corporation. Accordingly, the defence based upon s. 13 of the Act must fail.

The decision in *RSG Mechanical* is one of the relatively rare examples in which directors and officers successfully defended a claim against them personally. The Court held that:

The situation is less clear as against the defendants Theresa Sara and Irene Jensen. Both were officers and directors of ABCO. Neither was actively involved in the actual running of the company. The fact that Theresa Sara signed

a few cheques from time to time as a matter of convenience to assist her brother and at his direction does not raise her to the level of an active participant in the business. Neither Ms. Sara nor Ms. Jensen asked any questions about how the finances of the company were being managed and neither took any steps to ensure that the trust provisions in the Act were being honoured. Each knew that her name was being used in a fictitious way to shelter her brother or husband from liability. Each was foolish, perhaps even somewhat dishonest, to participate in such a scheme. However, the Act requires that before liability can be imposed, an officer or director must have assented to, or acquiesced in, conduct that she ought reasonably to know amounted to a breach of trust. Mere knowledge or suspicion that the business was running into financial difficulty, or that full payment was not being received on a particular project, is not the same as knowing facts from which one ought reasonably to conclude that the trust provisions of the Act are being breached. The plaintiffs argue that the officers and directors of a corporation are not entitled to stick their heads in the sand and abdicate all responsibility for the corporation. There is a positive obligation, they argue, to make reasonable inquiries from time to time to ensure that the corporation is not in breach of its duties to others under the Act. I have considerable sympathy for that point of view. However, Ms. Sara and Ms. Jensen were mere dupes in this case. They were never the beneficial owners of the company and they were never its real directors and officers except in name only. While I do not condone their actions, neither can I find them to fall within the provisions of s. 13 of the Act. The Act does not create strict liability for officers and directors. I can see no basis for distinguishing this case from the

situation of the defendant Juliana Paron in *Commonwealth Brick Ltd. v. Paron*, [1998] O.J. No. 1196 (C.A.). The Court held in that case that although her husband was liable for breach of trust, Mrs. Paron was not. She was merely an officer or director and there was no evidence that she participated in the day to day operations of the company or that she assented to or acquiesced in conduct that she knew or ought to have known amounted to breach of trust. Accordingly, the action as against Irene Sara and Irene Jensen is dismissed

Recent Ontario decisions have also dealt with the effect of a bankruptcy on personal liability for a breach of trust under s. 13(1). In *Toro Aluminum Ltd. v. Revah*,²⁶ Madam Justice Molloy held that personal liability may fall within the exception set out in s. 178(1)(d) of the *Bankruptcy and Insolvency Act*²⁷ and consequently may be extinguished upon discharge.²⁸ The two relevant statutory provisions are as follows:

Bankruptcy and Insolvency Act, section 178(1)(d):

178. (1) An order of discharge does not release the bankrupt from

(...)

(d) any debt or liability arising out of fraud, embezzlement, misappropriation

²⁶ (1999), 3 C.L.R. (3d) 1 (Ont. S.C.J.). The following discussion of the *Toro Aluminum* case was published 3 C.L.R. (3d) 16.

²⁷ R.S.C. 1985, c. B-3.

²⁸ The reasoning in *Toro* was adopted in *Re Zumbo* (2000), 2 C.L.R. (3d) 297 (Ont. S.C.J.).

or defalcation while acting in a fiduciary capacity;

In its recent decision in *Simone v. Daley* (1999), 43 O.R. (3d) 511, which concerned a failed real estate transaction, the Ontario Court of Appeal held that not every breach of an obligation by a trustee falls within section 178(1)(d) of the *Bankruptcy and Insolvency Act*. Blair J. (ad hoc) held that:

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. Had Parliament intended that any innocent breach of an obligation on the part of a fiduciary would give rise to a debt that would not be released by a discharge from the bankruptcy it could very easily have done so, by providing that an order for discharge does not release the bankrupt from any debt or liability arising from a breach of fiduciary obligation. It did not do so... I can only conclude that Parliament intended the words 'misappropriation' and 'defalcation' to bear their plain and ordinary meaning, as the context in which they are used suggests.

In *Simone*, the plaintiffs had agreed orally to purchase a home from the defendants with immediate possession, but a later closing. The plaintiffs moved in and began making payments to the defendant which, according to the agreement, were to be applied against the purchase price. Before the closing date, the defendant experienced serious financial difficulties, resulting in his voluntary assignment into bankruptcy and the sale of the property by mortgagees under power of sale. The issue before the Court was whether the payments to the defendant were a liability of the defendant which survived his bankruptcy. The Court of Appeal held that while the defendant had breached his fiduciary duty, the breach did not amount to misappropriation or defalcation under the *Bankruptcy and Insolvency Act*, with the result that the liability did not survive the bankruptcy. In *Toro Aluminum*, Justice Molloy considered the *Simone* reasoning in the context of a section 13 *Construction Lien Act* case:

Based on the reasons of the Court of Appeal in *Simone and Daley*, it cannot be said that any finding of liability under the trust provisions of the *Construction Lien Act* will constitute a liability falling within section 178(1)(d) of the *Bankruptcy and Insolvency Act*. One can imagine situations in which there could be breach of the trust provisions in the CLA without any deliberate wrongdoing on the part of the trustee. For example, funds might be paid out to third parties due to inadvertence

or an accounting error. Such conduct might not fall within the Court of Appeal test as articulated in *Simone and Daley*. However, there will certainly be some breaches of trust under the *Construction Lien Act* which will fall clearly within section 178(1)(d) of the *Bankruptcy and Insolvency Act*. An obvious example is where a trustee deliberately misappropriates trust money for his own use so as to defeat the claim of (sic) beneficiary. In between these two extremes, there is a spectrum of conduct which breaches the CLA, but which may or may not fall within section 178(1)(d) of the *Bankruptcy and Insolvency Act*, depending on the extent to which there was any wrongdoing or improper conduct by his (sic) bankrupt in his fiduciary capacity.

Molloy J. observed that as not every breach of trust automatically falls within the meaning of section 178(1)(d) of the *Bankruptcy and Insolvency Act*. The determination of a breach of section 13(1) does not necessarily involve a determination of wrongdoing or improper conduct and, consequently, such a breach does not automatically bring a bankrupt within the meaning of the section 178(1)(d) *Bankruptcy and Insolvency Act* exception.

In the authors' view, while moral turpitude is, arguably, a necessary element of "fraud, embezzlement, misappropriation or defalcation", as listed in section 178(1)(d) BIA, it is not enough to stop there. For a

discharge from bankruptcy to release a bankrupt from a debt incurred by a breach of the statutory *Construction Lien Act* trust, it should also be required that there be no form of personal benefit, direct or indirect. In Her Honour's simple example of breach by payment to third parties through inadvertence or accounting error, both tests would be met. In the example, there was inadvertence, not moral turpitude, and no personal benefit is suggested. But, if one of these third parties held the bankrupt's personal guarantee, and discharged that guarantee upon receipt of payment in breach of trust, then, on the writers' analysis, the bankrupt's discharge should not release the breach of trust, whether or not the bankrupt knew of the guarantee or its release. On this extended example, personal benefit should be sufficient, alone, to trigger the section 178(1)(d) exception. Section 13 of the *Construction Lien Act* was explicitly drafted to prevent clever but unscrupulous people from manipulating contract and corporate status so as to avoid personal liability. No test adopted under the *Bankruptcy and Insolvency Act* should open the door to such chicanery.

This is an important issue for another reason. Recent decisions of the Ontario Court of Appeal have made it abundantly clear that breaches of trust under the CLA do not necessarily require knowing misconduct.

The result has been to significantly expand personal liability under section 13 and, inevitably, the issue of discharge from personal bankruptcy can be expected to arise more often.

As a result of *Toro Aluminum*, we may expect to hear more of the “but it was only a little breach” defense found in section 35 of Ontario’s *Trustee Act*, R.S.O. 1990, c. T.23. It is interesting to compare the treatment that section 35 of the *Trustee Act* has received in the Court of Appeal in cases dealing with section 13 *Construction Lien Act* liability. Section 35 of the *Trustee Act* is an otherwise solid and necessary piece of legislation but it has proven a uniform failure as a section 13 defence. Section 35 of the *Trustee Act* is as follows:

35. (1) If in any proceeding affecting a trustee or trust property it appears to the court that a trustee, or that any person who may be held to be fiduciarily responsible as a trustee, is or may be personally liable for any breach of trust whenever the transaction alleged or found to be a breach of trust occurred, but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust, and for omitting to obtain the directions of the court in the matter in which the trustee committed the breach, the court may relieve the trustee either wholly or partly from personal liability for the same.

(2) Subsection (1) does not apply to liability for a loss to the trust arising from the investment of trust property.

This section became a perennial favorite of defense counsel acting on behalf of personal defendants charged with “objective” or technical breaches of trust, where no element of personal benefit was alleged or proven. It was popular because it re-introduced a “subjective” or conduct based test for personal liability whereas the Court had stripped away such a requirement in the case of the substantive corporate breach. The section has proved to be cold comfort. In *Ontario Electrical Construction Co. v. S.I. Guttman Ltd.* (1996), 29 C.L.R. (2d) 146 (Ont. Gen. Div.), the Motions Court Judge, Hoilett J., held as follows:

I am of the opinion that s. 35 of the *Trustee Act* may not be invoked by the respondents in defence of their impugned conduct. To arrive at any other conclusion would be, in my view, to ignore the very *raison d'être* of legislation of the genre of the *Construction Lien Act*. Legislation of that kind is usually designed to deal with a specific subject area; usually very specialized, often technical. The legislation in such cases usually establishes a complete code of procedure aimed at dealing with all the issues arising in that domain. It would be an improper reading of section 35 of the *Trustee Act*, in my view, to construe it in such a manner as to

diminish the rights of those clearly sought to be protected by the trust provisions of the *Construction Lien Act*.

In a short endorsement, the Court of Appeal agreed (1997), 104 O.A.C. 232 (Ont. C.A.). The same view was taken by the Court of Appeal in *Dietrich Steel Ltd. v. Shar-Dee Towers (1987) Ltd.* (1999), 42 O.R. (3d) 749 (Ont. C.A.). McKinlay J.A., for the Court, held that:

Assuming, without deciding the question, that s. 35 could apply to a breach of a specific statutory trust, I have difficulty in seeing how the provisions of s. 35 could apply to give relief to a contractor who becomes a trustee by virtue of the provisions of s. 8 of the *Construction Lien Act*. The whole purpose of the Act is to protect persons supplying services and materials to an “improvement” to real property, and s. 8(2) sets out specific duties of a trustee. The trustee must not appropriate funds to its own use or to a use inconsistent with the trust until all amounts owed money (sic) by the trustee for services or materials supplied to the improvement are paid. If we assume that a trustee passes the test of honesty required by s. 35, I do not see how the trustee could pass the test of reasonableness if it has acted contrary to the specific provisions of s. 8(2). To say that the trustee’s actions could be reasonable in such a situation would be to subvert the whole *raison d’être* of the Act.

The issue arose again before the Court of Appeal in *Structural Contractors Ltd. v. Westcola Holdings Inc.*²⁹ It is now clear that the so-called section 35 defence is no defence at all in the context of section 13 of the *Construction Lien Act* in the case of a sole shareholder corporation. So, then, how do we come to distinguish between innocent and culpable breaches of the statutory trust under the *Bankruptcy and Insolvency Act* when we do not do so under the *Trustee Act*? Our Court of Appeal seems to be saying that there can be no “reasonable”, i.e. innocent, conduct which otherwise amounts to a breach of a statutory trust. The ideas are contradictory. Why, then, should “innocent” breach of a statutory trust permit discharge from bankruptcy when it does not permit a defense under the *Trustee Act*? If the direction of the Ontario Court of Appeal in the section 35 *Trustee Act* cases is to be followed, there may be no such thing as an honest, reasonable or fair excuse for breach of the statutory *Construction Lien Act* trust.

5. Conclusion

Courts are increasingly critical of parties who choose to ignore the clear trust provisions of Part II of the *Construction Lien Act* and the guidelines

²⁹ (2000), 48 O.R. (3d) 417 (Ont. C.A.).

the Courts have provided on the interpretation of those provisions. The only true defences to breach of trust claims are those provided for in the Act, each of which actually support the remedial purpose of the statutory trust. Any defence to the effect that a party should not be held liable for a breach of trust because such breaches are common in the construction industry will inflame rather than impress the courts. As Madam Justice Molloy put it in *RSG Mechanical Inc. v. ABCO Construction Inc.*:

In short, it juggled its funds, hoping to keep all of the balls in the air until such time as it was in a position to see everybody paid on all of the projects, with money left over for itself. ABCO breached the trust provisions of the Act, gambling that it would be able to continue to pay obligations on previous projects from money on subsequent projects. The gamble did not work. This is a clear breach of trust and flies in the face of the intention of the Act. It is not a mere "technical" problem.

The defendants insisted that the plaintiffs' interpretation of the trust provision runs counter to the consistent practice of construction companies throughout the industry and therefore should not be accepted. I am not sure that I can simply accept the evidence of the defendants that "everybody" in the industry deals with trust funds in this manner. However, this is certainly not the first case in which submissions of this nature have been made to me. It has also been urged upon me that a literal interpretation of the trust provisions is totally unworkable and

would grind the construction industry to a halt. Even if I accepted the accuracy of those submissions (and I have a great reluctance in doing so), that does not change the clear direction given in the legislation. The trust provisions were intended to protect those who did actual work on the improvement by ensuring that payments made from the top trickled down to them. The clear intention of the legislation is to apply all monies received in respect of the work done on any given project first to the workers and suppliers. The practice of playing fast and loose with trust monies, intermingling them with funds of all sorts of description (including other trust funds) and then paying out to all and sundry without any regard to the source of the funds or whether the recipient is a beneficiary, is a practice which is wholly inconsistent with the Act. It is no defence that "everybody is doing it". Indeed, if that is the case, this is all the more reason to scrupulously uphold the provisions of the Act lest they be rendered completely meaningless in practice and undermine the protections which the Act was designed to provide.