

**HOW WILL *STRUCTURAL V. WESTCOLA* AFFECT THE PRACTICE
OF REAL ESTATE LAW?**

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

Duncan W. Glaholt
Markus Rotterdam

© Duncan W. Glaholt & Markus Rotterdam
November 2000

1. Introduction

On June 12, 2000, the Ontario Court of Appeal released its reasons in *Structural Contractors Ltd. v. Westcola Holdings Inc.*,¹ dismissing 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*² 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. How could this be? Easy. As the Court observed, there is nothing equivocal about s. 7(2); it means what it says:

s. 7(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 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.

The *Structural* case has broad implications for the real estate bar. In essence, it creates a kind of inchoate liability that may affect the administration of

¹ (2000), 48 O.R. (3d) 417 (Ont. C.A.).

² R.S.O. 1990, c. C.30.

mortgages and their enforcement. On the conveyancing side, the case may add uncertainty to the otherwise settled vendor's trust provisions. For example, of what value is an attornment of rents in the face of certified payments due to a mortgagor's contractor? What new obligations rest on a mortgagee in possession in the face of unpaid progress certificates? What must be included in reporting letters on mortgage financing to properly advise a mortgage lender? What needs to be done or can be done when acting for a purchaser of lands in such circumstances, or the purchaser of a mortgage? Will the law change, and if so, when and how? Even more troubling: will *Structural v. Westcola* cause unpaid trades to revisit power of sale and foreclosure proceedings, to reopen them to properly account for the result in *Structural*? There is, after all, no limitation on a trust claim.

To begin to answer these questions, the *Structural* case must be placed in context. It must be remembered firstly that the law was always there, in the form of s. 7(2). Nothing has changed in that regard. The issues in practice come from being reminded by the Court of Appeal that s. 7(2) means exactly what it says. Secondly, it must be remembered that *Structural* follows an unbroken series of relatively recent Ontario Court of Appeal cases affirming, correctly in the authors' view, the remedial purpose of the trust remedy and giving a restrictive reading to the few statutory exceptions that exist. The Court

of Appeal is doing nothing more than applying this remarkable legislation just as it is written.

In *Rudco Insulation Ltd. v. Toronto Sanitary Inc.*³ and *Dietrich Steel Ltd. v. Shar-Dee Towers (1987) Ltd.*,⁴ the Ontario Court of Appeal made it absolutely clear that overhead payments cannot be deducted from trust monies. Contractors and subcontractors must operate their business from non-trust cash sources, whatever they may be, so as to ensure that all cash flows to their trades until they are paid in full. Prior to the Court of Appeal's decisions in these cases, a number of lower court decisions had considered the issue and arrived at the same conclusion.⁵ Only one decision, *BPCO Inc. v. Deelstra*,⁶ had held that payment of overhead costs out of monies received by the contractor, prior to payment of the subcontractors, did not amount to a breach of statutory trust. *BPCO* is now overruled. The judge in *BPCO* cited the following annotation by Raymond F. Barnard to the original decision in *Emco*:

The learned Judge states that the second reason for finding the defendant in breach of trust was the defendant paying its overhead expenses from trust moneys. To the

³ (1998), 42 O.R. (3d) 292 (Ont. C.A.).

⁴ (1999), 42 O.R. (3d) 749 (Ont. C.A.).

⁵ *Heritage Masonry Ltd. v. Building Team Ltd.* (1995), 28 C.L.R. (2d) 108 (Ont. Gen. Div.); *Home Depot Inc. (c.o.b. Pittsburg Paint Centre) v. Fieder Painting Inc.* [1995] O.J. No. 2263 (Ont. Gen. Div.); *Datasphere Sales Ltd. v. Universal Light & Power Corp.* (1991), 48 C.L.R. 25 (Ont. Gen. Div.); *Emco*

extent that overhead included profit, this is a correct statement. However, to the extent that overhead represented a legitimate cost to the general contractor for carrying on business and that only a proper percentage of the defendant's total overhead was charged to a particular project, there was no breach of trust. To say that a general contractor is not entitled to pay such things as staff payroll, office rents, insurance premiums, etc., from project funds, as these costs arise in the normal course of business, is not only unreasonable but not within the contemplation of the Act.

Mr. Barnard, who had been a practising engineer for many years prior to becoming a lawyer, foresaw practical difficulties in applying a strict "no overhead rule". W. A. Jenkins J. agreed:

I believe Mr. Barnard is correct. A contractor could not carry on business without the ability to pay its legitimate overhead expenses from the draws received by it during the course of construction.

BPCO, in turn, attracted its own critical commentary from another well known construction lawyer:⁷

Supply v. Gueguen (1987), 25 C.L.R. 229 (Ont. H.C.); *St. Mary's Cement Corp. v. Construc Ltd.* (1997), 32 O.R. (3d) 595 (Ont. Gen. Div.).

⁶ (1994), 19 C.L.R. (2d) 125 (Ont. Gen. Div.).

⁷ J. S. Kuchar, "Breach of Trust Actions Under the Construction Lien Act" (1995), 20 C.L.R. (2d) 18 at 37.

Although permitting a contractor to pay for such items as staff payroll, office rents, insurance premiums and other legitimate overhead expenses from project funds on a proportionate basis, as those costs arise in the normal course of business, generally seems to be a fair and sensible recognition of the realities of business, this decision may nonetheless prove to have serious repercussions to legitimate trust claimants, as it may serve to open the door to questionable 'overhead' claims, limited only by the ingenuity and creativity of contractors, their accountants and legal counsel. In any event, now that there are two directly conflicting decisions on this issue rendered by courts of equal jurisdiction, a definite decision by the Court of Appeal is urgently needed.

Sections 7, 8 and 9 of the *Construction Lien Act*⁸ provide as follows:

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 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.

⁸ R.S.O. 1990, c. C.30.

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. R.S.O. 1990, c. C.30, s. 7.

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. R.S.O. 1990, c. C.30, s. 8.

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. R.S.O. 1990, c. C.30, s. 9.

2. Rudco Insulation Ltd. v. Toronto Sanitary Inc.

The first true “overhead” case to reach the Ontario Court of Appeal was *Rudco Insulation Ltd. v. Toronto Sanitary Inc.*,⁹ released on October 15, 1998. The defendants had been sued for breach of trust, corporately and personally, after

using project funds to pay “wages, office expenses, rent, legal and accounting fees and the like” in priority to their subcontractors. At trial, Coe J. held that the group of people receiving such payments, e.g. lawyers, accountants and landlords, were not “other persons” to whom trust benefits accrued. The Ontario Court of Appeal agreed. It was common ground on the appeal that the recipients of overhead expenses did not supply materials to an improvement, in the sense of lienable supply. Therefore the only way that legitimate payments could be made would be to bring them within s. 10 of the *Act*:

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 to all beneficiaries of the trust to the extent of the payment made by the trustee.

Section 1 of the *Act* defines “supply of services” as:

[A]ny work done or service performed upon or in respect of an improvement, and includes, (a) the rental of equipment with an operator, and (b) where the making of the

⁹ (1998), 42 O.R. (3d) 292, 41 C.L.R. (2d) 1 (Ont. C.A.).

planned improvement is not commenced, the supply of a design, plan, drawing or specification that in itself enhances the value of the owner's interest in the land.

As the recipients of the overhead expenses did not perform services upon an improvement, the question became one of whether those payments were made "in respect of an improvement". The contractor argued that but for the ability to pay such overhead expenses, no work could have been done and, consequently, there would have been no improvement and the payments were therefore made "in respect of" the improvement.

O'Connor J.A. disagreed, holding that as sections 8(1) and 14(1) provide for a preference for one class of creditor, the trust beneficiary, not enjoyed by other classes of creditors of the same debtor. As such, the *Act* creates a statutory preference unknown at common law and the question of whether a creditor falls into the group benefiting from the *Act* must be strictly interpreted. The Court also observed that if the recipients of overhead payments were to be included in the benefited class, the benefits to the members of the group who supplied services and materials would be significantly reduced. Consequently, the Court held that the payment of overhead expenses did not reduce the contractor's statutory trust obligations to Rudco under s. 10. This line of

argument was followed in the November, 1998, decision of Jenkins J. in *Central Supply Co. (1972) v. Modern Tile Supply Co.*¹⁰

3. Dietrich Steel Ltd. v. Shar-Dee Towers (1987) Ltd.

The next case to reach the Ontario Court of Appeal was *Dietrich Steel Ltd. v. Shar-Dee Towers (1987) Ltd.*,¹¹ released February 3, 1999. *Dietrich* differed from *Rudco* in several respects but, most importantly, in what might be called its “equities”. The appellant was one of two personal defendants who had taken great care to observe the law as it was then understood. The defendant corporation took legal advice in 1990 and set up a segregated project-specific bank account and paid only direct, project-specific overheads out of the account. At that time only the *Emco* case had been reported. In *Emco*, Salhany J. had expressed himself in a way that could be read, legitimately, as criticizing only the payment of the overheads out of a blended account. As we have seen, even at the time *Emco* was controversial. The developer in *Dietrich Steel*, however, adopted a conservative approach, set up a segregated trust account and, as we have noted, paid only direct project specific overheads and trades

¹⁰ (1998), 43 C.L.R. (2d) 216 (Ont. Gen. Div.).

¹¹ (1999), 170 D.L.R. (4th) 475, (1999), 42 O.R. (3d) 749 (Ont. C.A.).

out of this account. No personal benefit or head office overheads of any kind were paid.

Stopping here for a moment, we see a situation very much like the one that now obtains with respect to s. 7(2). For years, everyone has read and understood the section one way, wrongly it turns out, with a view to business efficacy. Now, on a matter of pure statutory interpretation, the Court of Appeal has said that the old way of doing business is, and always was, wrong.

In *Dietrich*, the project began to show signs of failing and the directors took the further, extraordinary step of appointing a court administered trustee to sell the units in the project and distribute the proceeds of sale with judicial approval. Years later, long after the distribution of sale proceeds to lien claimants, and as the law prohibiting overhead payments began to mature *Dietrich* commenced its action against the two directors of the defendant corporation under section 13 of the *Construction Lien Act*. The claim was confined to a complaint about the payment of certain specific overheads, totaling slightly more than the plaintiff claimed to be owed, with interest and costs. Stopping again to reference s. 7(2), we can see the parallels. Nothing stops unpaid contractors from re-opening an owner's conduct, or a mortgagee's for that matter, years after the fact.

The trial in *Dietrich* proceeded on an agreed statement of fact. Adopting the then conventional analysis, the trial judge held that the payments were not payments for services or materials supplied to the improvement and therefore did not fall within the provisions of s. 10 of the *Act*. In other words, unless payments were made for services or materials that were otherwise lienable, they were made in breach of trust. The Ontario Court of Appeal agreed with the trial judge on all material legal points related to the overheads and expressly dealt with and dismissed or rejected the following arguments:

1. It was argued that if the strict interpretation theory was correct, then statutory construction lien trusts were unique in requiring the trustee to bear the costs of administration of the trust. Justice McKinlay agreed that construction lien trusts are unique in this way.
2. It was argued that if the contractor had fulfilled at least the policy of the statute by segregating the bank account for the particular project and paying only project specific direct overheads. If the policy of the statute was met then quasi-criminal personal liability should not follow. The Court held that segregation of the account did not necessarily preclude either a breach of trust or personal liability of a director, officer or person in control.

3. It was argued that the contractor had not appropriated or converted trust funds to its own use or to “any use *inconsistent with* the trust”. The previous version of the statute, the *Mechanics’ Lien Act*, had, until its repeal in 1983, prohibited payment to uses “*not authorized*” by the trust. It was argued that the amendment to “inconsistent with” broadened the list of permissible applications of trust money to include “consistent” uses, such as project specific overheads. The Court agreed that the change may have made the section more liberal, but not so liberal as to permit payment for services that were otherwise non-liable.
4. It was argued that every payment to every lien claimant includes some component of overhead and profit, therefore the overhead and profit component must be a permissible payment, or at least a payment that is “not inconsistent with” the trust. This argument was rejected.
5. Finally, it was argued that the *Act* should not be “read up”, so as to unnecessarily restrict trade. Only independently wealthy businesses could afford to pay all head office overheads out of non-project receipts, until all trade payables were satisfied. Furthermore, the effect of the decision is that

small contractors would be forced to either operate in knowing breach of trust or go out of business. This argument, too, was rejected by the Court.

In *Tam-Kal Ltd. v. Stock Mechanical Inc.*,¹² the third case in the trilogy, the Court of Appeal again affirmed that its prior decisions had done away with any argument that overhead payments could be made out of trust funds. The Court of Appeal has since applied the same principle in at least two cases, *Don Park Inc. v. S.E. Mechanical Engineering Ltd.*¹³ and *Nortown Electrical Contractors Associates v. Bradsil*.¹⁴ There is now no doubt at all that contractors in Ontario have to pay overheads from non-project cash flow until *all* trust beneficiaries are paid *in full*. As will be argued later in this paper, this could have various repercussions for real estate lawyers and, particularly, mortgagees making “net” advances.

4. Structural Steel Ltd. v. Westcola Holdings Inc.

One would think that the Court of Appeal’s “overhead trilogy” would dramatically affect the way contractors do business in this Province. It didn’t. It is the writers’ observation that the construction industry carries on as they always have done, as if the Court of Appeal trilogy did not exist, yet some

¹² (2000), 50 C.L.R. (2d) 224 (Ont. C.A.).

¹³ (1998), 43 C.L.R. (2d) 7 (Ont. C.A.).

¹⁴ [1999] O.J. No. 3612 (Ont. C.A.).

members of the industry still cry ‘foul’ when they are caught out at it, as they seem to be with some regularity. In practice, bank accounts are blended over multiple projects and even multiple enterprises, overheads are routinely paid out of trust funds from one or more projects, and owners, contractors and subcontractors routinely place themselves in what must now be considered knowing, daily breach of trust. As we examine the facts of *Structural Contractors Ltd. v. Westcola Holdings Inc.*,¹⁵ it would be well to bear this reaction of the business community in mind. For our part, as lawyers advising the construction industry, and their financiers, we can only offer a counsel of perfection: don’t do it. Our clients can choose to listen or not. As real estate lawyers, however, you may be held to an even higher standard, and therefore the case is worthy of a close reading and your full attention.

One way of approaching *Structural. v. Westcola* is to see it as extending the strict application of Part II of the *Construction Lien Act*, as developed in *Rudco*, *Dietrich* and *Tam-Kal*, to landlord and tenant relationships. In *Structural*, the appellant owner, Westcola, had argued that the considerations in *Rudco* and *Dietrich*, which concerned section 8 of the Act, did not apply to section 7 of the Act, i.e. the owner’s trust. The Court of Appeal disagreed with this argument. The same strict application of the statute was made.

¹⁵ (2000), 48 O.R. (3d) 417 (Ont. C.A.).

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 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.

5. Coming to Grips with the Owner's Trust: The Sleeping Giant Wakes

5.1 Mortgage Advance Deductions:

Where mortgage monies are advanced to fund construction progress, a wide range of fees, charges, interest and costs are commonly deducted from the first and often each subsequent advance. Standard Charge Terms constitute such fees, charges and interest charges a debt owing from the mortgagor to the mortgagee, so that, in effect, the mortgagee is exercising a set-off of mutual, liquidated debts against each advance the mortgagee does not “retain” but actually appropriates the relevant amounts. It is possible in view of *Rudco* and *Dietrich Steel*, that such deductions from gross advances are *prima facie* breaches of trust under the *Construction Lien Act*. Either the mortgagee should “retain” these charges, as one argument goes, or it should never make them in the first place because they are “overheads”.

If a mortgagor is building for re-sale, s. 9(1)(b) may offer a solution. Under subsection 9(1)(b), a vendor may deduct 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". In the case of construction for re-sale, there appears to be a contradiction between a mortgagor's strict responsibility as an "owner" under s. 7 where certificates are issued during construction and the more permissive treatment of the mortgagor as "vendor" under s. 9 once the building is complete and ready for sale.

What of the deductions themselves? Can the deductions be credited to the mortgagee's account, or must they somehow be retained? If the sense of the loan documentation is that the trustee/mortgagor is making the payments, effected by the mortgagee by way of set-off, there may be liability on the mortgagee not just as a stranger to the trust, but as a trustee *per se*.

S. 12 of the *Construction Lien Act* allows a trustee, without being in breach of trust, to retain from trust funds an amount that as between the trustee and such person the trustee is liable to pay equal to the balance in the trustee's favour of all outstanding debts, claims or damages whether or not related to the improvement, but that section appears to work only as between a trustee and a beneficiary, not as between a trustee and a stranger to the trust. *Datasphere Sales*

Ltd. v. Universal Light & Power Corp.,¹⁶ however, has interpreted s. 12 to require that the monies of the set-off be "retained" and not otherwise appropriated by the trustee.

If the mortgagee in such circumstances is not a statutory trustee *per se*, but merely an accessory or stranger to the trust, the concept of deemed receipt as established by *Minneapolis-Honeywell Regulator Co. v. Empire Brass Co.*¹⁷ and *Andrea Schmidt Construction Ltd. v. Glatt*¹⁸ may deem the gross advance in the mortgagee's hands to be trust funds in the hands of the owner. When gross advances are approved and deemed receipt occurs there would seem to be no express statutory right of set-off, and if the judicial policy underlying in *Rudco* and *Dietrich Steel* is pursued, the *Act* may be eventually read up to strictly limit or exclude such a right in any event.

When it comes time to repay a mortgage loan, s. 11(2) permits the trustee to repay the mortgage loan out of trust monies only to the extent that the advances were actually used to pay trust beneficiaries. This can be an accounting nightmare. Is it the net advance to the mortgagor (trustee), or the gross advance that is to be repaid? Perhaps a mortgagor can never repay the

¹⁶ (1991), 48 C.L.R. 25 (Ont. Gen. Div.).

¹⁷ (1955), 3 D.L.R. 561 (S.C.C.).

entire mortgage debt while unpaid trades remain without being in breach of trust.

There would also appear to be a constructive trust argument, in the case of a building mortgage, that deduction from a gross advance constitutes a "knowing receipt" on the *Citadel v. Lloyds Bank*¹⁹ theory of liability, and that an institutional mortgagee might have to disgorge such advances to unpaid trades and collect from its mortgagor and guarantor as it may. This would require proof of two elements: application by the bank of trust monies to its own use and benefit, and sufficient knowledge to put a reasonable person on notice or inquiry that the property received was subject to a trust. Such an argument may be of some assistance to trades when a mortgage initiates sale proceedings under a building mortgage, for example.

It will be an interesting challenge to the Courts to deal with such issues in the face of *Rudco*, *Dietrich* and *Tam-Kal*. It may be that the current practice with respect to institutional building mortgages in this province places mortgagees in breach of trust every time a net advance is made, or a gross advance is repaid.

¹⁸ (1979), 25 O.R. (2d) 567, 104 D.L.R. (3d) 130 (Ont. H.C.), affirmed (1980), 28 O.R. (2d) 672, 112 D.L.R. (3d) 371 (Ont. C.A.).

¹⁹ (1997) 152 D.L.R. (4th) 411 (S.C.C.)

5.2 Are Banks Exempt From Such Problems Under s. 437(3) of the *Bank Act* in any Event?

No. For more than a century there have been federal *Bank Act* provisions that would appear to relieve banks from the consequence of any technical non-compliance with trust fund provisions. The federal Bank Acts have long held that banks are not responsible for the execution of any trust to which deposits may be subject. Section 437(3) of the present *Bank Act*²⁰ reads as follows:

A bank is not bound to see to the execution of any trust, whether express or arising by operation of law, to which any deposit made under the authority of this Act is subject.

Section 206(1) of the *Act's* 1985 version²¹ and section 96(1) of the 1953-54 *Bank Act*²² provided that:

The bank is not bound to see to the execution of any trust, whether express, implied or constructive, to which any deposit made under the authority of this Act is subject.

Substantially similar sections have been in the Bank Acts since 1890.²³ From the beginning, though, it has been clear that while this section, read literally,

²⁰ S.C. 1991, c.46.

²¹ R.S.C. 1985, c.B.-1.

²² 1953-54 (Can.) c. 48.

would appear to exonerate banks from any breach of trust, it cannot protect a bank in cases where the bank knowingly participated in a breach of trust or should have known that funds were used improperly.²⁴ The law on point has been helpfully summarized as follows in a leading text:

1. The bank is not a watchdog of a trust account. Where a customer who is known by the bank to be a trustee, draws a cheque upon a trust account in favour of a third person, the bank will only rarely have its attention drawn to the object or purpose of the payment. It is certainly under no obligation to inquire about the purpose for which a cheque is drawn, and as it is not likely that the customer will voluntarily disclose that he is about to misapply trust funds, it will obviously be very seldom that the bank will have notice of the intended breach.
2. A bank may not knowingly participate in the misapplication of property that is subject to trust or fiduciary obligations [...]
3. If the bank does not know that the funds are held by its customer subject to fiduciary duties to others, it may deal with the customer and the funds in the ordinary course. If a customer requests the designation of an account as being “in trust”, it is an indication to the bank that others may be interested, but it is not conclusive on the point. The fact that some responsible officer of the bank knows that interests other than those of its customer exist in the account is not sufficient, unless the officer also knows that the customer is merely a fiduciary for those other interests. But even proof of the later does

²³ Crawford and Falconbridge, *Banking and Bills of Exchange*, vol. 1, 8th ed. (Toronto: Canada Law Book, 1986) 537.

²⁴ *Ibid.*, see also J. J. Maclaren, *Banks and Banking*, 5th ed. (Toronto: Carswell, 1928) 397; J. W. Teolis, C. D. Jetten, *Bank Act: Legislation and Commentary* (Toronto: Butterworths, 1998) 8.48.

not, without more, impose any liability upon the bank. It merely establishes the fact of its knowledge for the purposes of this rule.

4. In order to subject the bank to fiduciary duties with respect to the funds, it must be shown in addition that the bank knew that the acts of its customer were in breach of fiduciary duty or that the bank was negligent in not making inquiries in suspicious circumstances.²⁵

The question therefore is this: at what stage in its dealings with a customer does a bank's knowledge of its customer's affairs impose a duty on the bank to inquire as to the possible misapplication of trust funds?²⁶ In *Fonthill Lumber Ltd. v. Bank of Montreal*,²⁷ the bank had arranged a loan for a contractor it had been dealing with for about twenty years. The contractor ran into financial difficulties, the bank pressed for payment and the contractor finally went bankrupt. When lien claimants claimed against the bank for breach of trust, the bank attempted to rely on s. 96 of the *Bank Act*,²⁸ the 1953 antecedent of the present s. 437(3). The Ontario Court of Appeal rejected the *Bank Act* defence. Schroeder J.A. held that:

The wording of s.96(1) of the *Bank Act* is the same as the provision of s.56(1) relating to any trust to which any share of the bank's stock is subject. That provision, of course, is

²⁵ Crawford and Falconbrige, *supra*, note 4 at 538-9.

²⁶ *Arthur Andersen Inc. v. Toronto-Dominion Bank* (1994), 17 O.R. (3d) 363 (Ont. C.A.).

²⁷ [1959] O.R. 451 (Ont. C.A.).

²⁸ S.C. 1953-54, c.48.

applicable to trusts of which the bank has notice, for there is no responsibility in law for not seeing to the execution of a trust unless the existence of the trust has in some way been brought to the bank's knowledge. In my view, however, the section does not release a bank from liability if it knows not merely of the existence of the trust, but also of a commission of a breach thereof, or of circumstances which should put it on inquiry. It is clear that if a trustee draws a cheque on a trust account, the bank is not obliged to make inquiries to determine whether the proceeds of the cheque are to be applied in accordance with the trust. Once it has paid the cheque or made repayment of the deposit, it is not concerned with the manner in which the money is employed thereafter. Section 96(1) has not effected any alteration in the common law in relation to cases where the bank has participated in a breach of trust, or has facilitated the misapplication of trust funds as, for example, by knowingly permitting an unauthorized transfer to be made from a trust account to a trustee's personal account. In such a case the right of recovery is not founded upon the bank's duty to see to the execution of a trust, but is based upon equitable principles which ordain that it would be inequitable and unjust to permit a bank to retain, by way of credit against an overdraft on a personal account, moneys received by it through its participation in a breach of trust.

The bank, in *Fonthill*, through its manager, knew of the existence of a trust in favour of the suppliers and labourers and knew that the contractor committed a breach of trust. The bank then applied the account balance in reduction of Fonthill's overdraft. In so doing, the bank participated in a breach of trust. The proposition that s. 96(1) of the *Bank Act* will be of no use where the bank

actually participated in the breach of trust has been adopted in *Aetna Roofing (1965) Ltd. v. Robinson*:²⁹

[Counsel for the bank] argued that the bank in the case at bar was protected by s. 96(1) of the *Bank Act*. It is my view that, under the circumstances prevailing at the material time, the section does not relieve the bank of its liability to account... The bank knew the source of the funds in question, and must be taken to have known of the existence of the trust and its breach. The circumstances surrounding the receipt and deposit, in the light of all the factors which existed at the time, at the very least placed the bank upon inquiry. By allocating the proceeds [...] in reduction of one of the loans owing it, in spite of the financial information available to it, the bank participated in the breach of trust.

More recently, it has been held in *Glenko Enterprises Ltd. v. Ernie Keller Contractors Ltd.*,³⁰ that the same principles apply in cases of constructive trust:

If the bank is found to be a constructive trustee of the fund, it cannot escape its obligation to account to the trust beneficiaries by relying on subsection 437(3) of the *Bank Act*.

In the same year as *Glenko* was decided, the Ontario Court of Appeal, in *Arthur Andersen Inc. v. Toronto-Dominion Bank*,³¹ ruled on the scope of the relevant *Bank Act*³² provisions as follows:

²⁹ [1971] 4 W.W.R. 191 (Man. Q.B.).

No one would suggest that a bank has a duty to monitor, on a daily basis, the operation of its clients (even construction clients) merely because it knows that those clients have funds on deposit which may be impressed with a trust – statutory or otherwise. Indeed, s. 206(1) and (2) of the *Bank Act* specifically states that a bank is not bound to see to the execution of any trust, whether express, implied or constructive, to which any deposit is subject, and that, where a bank has notice of a trust, a receipt or cheque signed by the person in whose name the account stands is a sufficient discharge to all concerned. It is not contended in this action that s. 206 represents protection to banks in all circumstances. The real question is: at what stage in its dealings with a customer with trust funds on deposit does a bank’s knowledge of its customer’s affairs impose a duty on the bank to inquire as to the possible misapplication of trust funds?

5.3 From a Landlord’s Point of View, what About Rent Deposits and “Additional Rent”?

In fairness to the careful language of the Ontario Court of Appeal in *Structural*, the case did not present the Court with a factual record upon which any considerations of rent deposits and additional rent could arise and, thus, these more difficult questions are left for another day.

³⁰ (1994), 17 C.L.R. (2d) 273 (Man. Q.B.), affirmed (1996), 27 C.L.R. (2d) 151 (Man. C.A.).

³¹ (1994), 17 O.R. (3d) 363 (Ont. C.A.).

³² R.S.C. 1985, c. B-1.

Under provincial landlord and tenant law, for example, residential rent deposits must be applied to last month's rent.³³ To do otherwise is to commit an offence under the Ontario *Tenant Protection Act, 1997*.³⁴ On the basis of *Structural v. Westcola*, however, a residential landlord in Westcola's position, doing extensive remedial work pursuant to payment certificates, would be faced with two competing remedial legislative schemes, one in the real estate sector dealing with rent deposits, and one in the construction sector dealing with trust funds. In the case of commercial landlords, those in Westcola's position may be compelled to apply tenants' "additional rent" otherwise than in accordance with the intent and purpose of the underlying leases, where there is not enough income to proceed. The interpretation and application of s. 7 in the Court below puts the defendant landlord in a bit of a dilemma. Fortunately, s. 66 of the *Construction Lien Act* provides a ready made procedure to resolve the matter:

66. Where a person is in possession of an amount that may be subject to a trust under Part II, the person may apply to the court for direction and the court may give any direction or make any order that the court considers appropriate in the circumstances.

³³ *Tenant Protection Act, 1997*, S.O. 1997, c. 24, s. 118(8).

³⁴ *Tenant Protection Act, 1997*, S.O. 1997, c. 24, s. 206(2) No. 12.

Another solution is for landlords to simply avoid certification of payments to contractors, but that solution comes with its own nest of issues and exposes the landlord to significant construction losses.

5.4 Officers, Directors and Persons in Control: *And You Thought it was Safe to Retire!*

Whether you are a director of a contractor or owner, you are more likely now to find yourself on the receiving end of a suit for breach of trust. Even popular statutory defences to claims against personal defendants have proven to be no defence at all. In *Ontario Electrical Construction Co. v. S.I. Guttman Ltd.*³⁵ and *Dietrich*, the Court of Appeal doubted and in *Structural* dismissed the applicability of s. 35 of the *Trustee Act*, which would otherwise excuse *de minimus* breaches of trust. In *Dietrich*, it was only a lucky defect in the plaintiff's proof that got the retired director off the hook. In *Structural Steel v. Westcola*, the owner was less fortunate. Personal defendants are going to be faced with s. 13(2) in future cases, a remarkable reversal of the common law. Section 13(2) provides that:

³⁵ (1997), 104 O.A.C. 232 (Ont. C.A.).

(2) The question of whether a person has effective control of a corporation or its relevant activities is one of fact and in determining this the court may disregard the form of any transaction and the separate corporate existence of any participant.

It is an open issue whether standard directors' and officers' insurance policies cover accessory liability for breach of trust under Part II of the *Construction Lien Act*. Usually, plaintiffs target the last solvent person standing and rely on the defendants to enforce the joint and several liability and contribution provided for by s. 13(3) and s. 13(4):

13(3) Where more than one person is found liable or has admitted liability for a particular breach of trust under this Part, those persons are jointly and severally liable.

13(4) A person who is found liable, or who has admitted liability, for a particular breach of a trust under this Part is entitled to recover contribution from any other person also liable for the breach in such amount as will result in equal contribution by all parties liable for the breach unless the court considers such apportionment would not be fair and, in that case, the court may direct such contribution or indemnity as the court considers appropriate in the circumstances.

5.5 More Issues: Attornment of Rents and Mortgagee in Possession

A landlord defaults in its mortgage payments. The mortgagee attorns rents. The tenants discharge their obligation to the landlord by paying their rent to the mortgagee. There are unpaid progress certificates. On the face of it, s. 7(2) and *Structural* apply only to “owners” and not to mortgagees. Does this mean that a mortgagee exercising its remedies is exempt from s. 7? To fit easily within section 7(2), the mortgagee would have to be considered an “owner” as defined in s. 1(1) of the Act. While there is no doubt that a mortgagee has an interest in the land, it is usually difficult to argue that the work was done at the mortgagee’s request *and* either upon its credit, on its behalf, with its privity or for its direct benefit.

But here is the rub. Even if the mortgagee does not fit neatly within s. 7(2), s. 7(2) and *Structural* now make it difficult, if not impossible, for a mortgagee to defend against a claim as to its having “knowingly received” trust monies, i.e. common law liability as an accessory to a breach of trust. In two recent decisions, the Supreme Court of Canada clarified the situations in which an institutional lender may be liable for breach of trust while being a stranger to

the trust. In both *Gold v. Rosenberg*³⁶ and *Citadel General Assurance Co. v. Lloyds Bank of Canada*,³⁷ elaborated on the requirements for bringing strangers within the “knowing receipt” and “knowing assistance” categories. There are three ways in which a stranger to a trust can be held liable as a constructive trustee for breach of trust. The first category, the trustee *de son tort*, is of no interest here. It involves those cases where strangers are not appointed as trustees but take it on themselves to act as such and to possess and administer property.³⁸ The second and third categories are knowing assistance and knowing receipt. The Supreme Court decisions were released together in the fall of 1997. The majority of the Court in each case stressed that the two forms of liability are fundamentally different, “knowing assistance” being a fault-based accessory’s liability, and “knowing receipt” being a receipt-based liability requiring a restitutionary remedy. Unlike the accessory liability of knowing assistance, the act of knowing receipt enriches the defendant at the plaintiff’s expense and therefore attracts a higher standard of care on the recipient’s part and a lower requirement for proof on the beneficiary’s part. Constructive knowledge, i.e. the knowledge of facts which would put a reasonable person on inquiry, is therefore a sufficient basis for restitutionary liability for “knowing receipt”.

³⁶ (1997), 152 D.L.R. (4th) 385 (S.C.C).

³⁷ (1997), 152 D.L.R. (4th) 411 (S.C.C).

³⁸ See *Selangor United Rubber Estates, Ltd. v. Craddock (No. 3)* [1968] 2 All E.R. 1073 (Ch. D.).

In an assignment of rent situation, the mortgagor, i.e. the landlord, is most likely in financial difficulties. Obviously, the mortgagee is well aware of that. It will also most likely be aware of the fact that construction is going on or has been going on. It is therefore not inconceivable that a mortgagee who gives notice of an assignment of rent and receives rents from the tenants while contractors or trades remain unpaid may be found liable under the knowing receipt theory of liability.

What of the mortgagee in possession? Generally, as seen, a mortgagee, to be an owner, must have requested the work.³⁹ The Ontario Divisional Court, in *Vecero v. C. Wood Inns Marketing Inc.*,⁴⁰ made clear that because of Act's definition of "owner", in the absence of such a request, no trust liability could arise. In *3173763 Canada Inc. v. York Condominium Project No. 780*,⁴¹ a case concerning liens for common area expenses of a non-residential condominium, Molloy J. had to determine the status of a mortgagee in possession for the purposes of section 1(1) of the *Condominium Act*.⁴²

The Act states that "owner" means the "owner or owners of the freehold estate or estates in a unit and common interest, but does not include a mortgagee unless in possession": s.

³⁹ See *A. Toppazzini Construction Inc. v. National Frontier Insurance Co.* (1995), 20 C.L.R. (2d) 11 (Ont. Gen. Div.), affirmed (1997), 36 C.L.R. (2d) 89 (Ont. C.A.).

⁴⁰ (1995), 27 C.L.R. (2d) 74 (Ont. Div. Ct.).

⁴¹ (1997), 34 O.R. (3d) 188 (Ont. Gen. Div.).

1(1). Thus, a mortgagee in possession falls within the Act's definition of owner. It is clear that the applicant mortgagee became an owner within the meaning of the Act on December 1, 1996 when it attorned rents of the developer's 21 units and went into possession of them. At that point in time, the mortgagee assumed all of the responsibilities of an owner including the obligation to pay ongoing common expense charges: see *National Trust Co. v. Carleton Condominium Corp. No. 489* (1993), 33 R.P.R. (2d) 304 (Ont. Gen. Div.).⁴³

Could a mortgagee in possession in such circumstances be held to be a trustee under the *Construction Lien Act*?

6. Conclusion

Structural v. Westcola has recognized that business is somewhat more complex for owners. Owners cannot use rents to pay current operating expenses while their contractor remains certified and unpaid. We can now expect vigorous development of the unanswered questions presented above and others, as fact situations arise. The writers' prediction is that the trust remedy will be strengthened, as a remedial piece of legislation, and trust defences will continue to be regarded strictly.

⁴² R.S.O. 1990, c. C.26.

⁴³ See also *First Burton Developments Inc. v. Peel Condominium Corp. No. 403* (1997), 8 R.P.R. (3d) 127 (Ont. Gen. Div.), affirmed [1999] O.J. No. 1117 (Ont. C.A.).

