

CONSTRUCTION LAW: TOWARD 2001

TOP THREE ISSUES IN CONSTRUCTION TRUSTS

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I. Personal Liability for Breach of Trust

1. Legislative Framework

In 1983, the Ontario *Mechanics' Lien Act* was amended to provide for the personal liability of officers, directors or any other controlling mind of a corporation for a breach of trust under the provisions of the Act. Section 13 now 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;

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.

(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.

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

(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.

The Attorney General's Committee Report that recommended the adoption of this section noted that it was meant to prevent the use of shell corporations "as a device for defrauding creditors", a wide statement indeed. The Report notes that the words "assents to or acquiesces in" were included to limit the scope of the section to those that had effective power to prevent a breach of trust. This policy appears to have been apprehended and applied by the courts. In *St. Mary's Cement Corp. v. Construc Ltd.*,¹ for example, Molloy J. held that:

The intention of the legislation was to set up a trust with respect to monies received from owners in favour of unpaid trades. It would be inconsistent with that intention if individuals who by their conduct defeat the trust were not liable for breach of trust in the same manner as the corporate vehicle they control.

An apportionment of liability is contemplated by the Ontario section, not by reference to the *Negligence Act*, but by express codification in s. 13. This section, when enacted, replaced the quasi-criminal provision of the *Mechanics' Lien Act*, s. 3(7), which had provided for a fine and maximum term of imprisonment. Other provinces have retained this quasi-criminal sanction. The amended sections of the British Columbia *Builders' Lien Act*,² proclaimed in force February, 1998, for example, provide as follows:

- (11)(1) A contractor or subcontractor commits an offence if that person
- (a) appropriates or converts any part of a fund in contravention of section 10 (trust), or
 - (b) contravenes section 13(2) (garnishment).

¹ (1997), 32 O.R. (3d) 595 (Ont. Gen. Div.).

² S.B.C. 1997, c. 45, s. 11(1)(2).

(2) A person who commits an offence under subsection (1)(a) is liable to a fine of not more than \$10,000 or to imprisonment for a term of not more than 2 years, or both.

(3) If a contractor or subcontractor is a corporation, a director or officer of the corporation who knowingly assents to or acquiesces in an offence under subsection (1)(a) by the corporation commits the offence in addition to the corporation.

...

(5) An information must not be laid in respect of an alleged offence under subsection (1) or (3) more than 3 years after the alleged offence occurred.

Similarly, with a higher ceiling for fines, section 7 of the *Manitoba Builders' Lien Act*³ reads as follows:

Every person upon whom a trust is imposed by section 4, 5 or 6 who knowingly appropriates or converts any moneys constituting a trust under those sections to or for his own use or to or for any use not authorized by the trust is guilty of an offence and liable, on summary conviction, to a fine of not more than \$50,000 or to imprisonment for a term of not more than two years, or to both such fine and such imprisonment and every director or officer of a corporation who knowingly assents to or acquiesces in an offence by the corporation under this section is, in addition to the

corporation, guilty of the same offence and liable, on summary conviction, to a similar penalty.

Section 18 of Saskatchewan's *Builders' Lien Act*⁴ provides that:

- (1) Every person who is a trustee under this Part and who knowingly appropriates or converts any moneys constituting a trust under this Part to or for his own use or to or for any use inconsistent with the trust is guilty of an offence.
- (2) Every director or officer of a corporation who knowingly assents to or acquiesces in an offence by the corporation under subsection (1) is guilty of an offence.
- (3) Every person who is guilty of an offence under subsection (1) or (2) is liable to a fine of not more than \$50,000, to imprisonment for a term of not more than two years or to both such fine and imprisonment.
- (4) A director or officer of a corporation may be charged with an offence under this section whether or not the corporation has been charged or convicted of the offence.
- (5) The time limit for laying an information under this section is two years from the time when the offence occurred.

³ R.S.M. 1987, c. B91.

⁴ S.S. 1984-85-86, c. B-7.1.

Section 3(2) of the New Brunswick *Mechanics' Lien Act*⁵ is similar:

Every builder, contractor or sub-contractor who appropriates or converts any part of the contract price referred to in subsection (1) to his own use or to any use not authorized by the trust is guilty of an offence and on summary conviction is liable to a penalty of not more than five thousand dollars or to imprisonment for a term of not more than two years or both, and every director or officer of a corporation who knowingly assents to or acquiesces in any such offence by the corporation is guilty of such offence in addition to the corporation.

The Ontario approach, replacing burdensome quasi-criminal sanctions with lower onus and broader personal liability, renders the statutory trust a formidable and pervasive remedy. It has been established, for example, that an order granting a discharge under the *Bankruptcy Act*⁶ does not discharge a debt for breach of trust. Where a bankrupt has fraudulently converted trust funds, section 178 of the *Bankruptcy Act* will not provide a defence. The extension of the personal judgment remedy in Ontario to “persons

⁵ R.S.N.B. 1973, c. M-6.

⁶ R.S.C. 1985, c. B-3.

in control” greatly assists in the effectiveness of the remedy in that Province.

2. Standard of Proof

It had initially been held in Ontario in *Steeplejack Services (Sarnia) Ltd. v. Stowe Nut & Bolt Co.*⁷ that an element of *mens rea* was required on the part of an officer or director against whom personal liability was claimed under section 13 of the *Construction Lien Act*. A contrary result was reached in a case of equal authority, *Home Depot Inc. v. Fieder Painting Inc.*,⁸ some years later. In *Home Depot*, Justice Killeen held that section 13 had created its own standard by adopting the words “knew or ought to have known”, leaving no room for a requirement of *mens rea*. The *Home Depot* analysis appears to have prevailed⁹ and *mens rea* is not considered to be an element of liability under s. 13.

⁷ (1988), 31 C.L.R. 115 (Ont. Dist. Ct.)

⁸ [1995] O.J. No. 2263 (Gen. Div.).

⁹ *Heritage Masonry Ltd. v. Building Team Ltd.* (1995), 28 C.L.R. (2d) 101 (Ont. Gen. Div.).

In her 1995 decision in *St. Mary's Cement Co. v. MacDonald*,¹⁰ Justice Molloy went further and held that direct dealings by officers and directors need not be proven to establish personal liability under section 13(1) of the *Construction Lien Act*. This decision eases considerably the plaintiff's burden of proof and, sensibly, closes the door on some of the more puerile attempts to avoid personal liability:

The witnesses for the plaintiff could not establish that they communicated directly with the defendants in this action throughout their business relationship. This fact was used on cross-examination of both witnesses to minimize any dealings the two defendants may have had in respect of supply by the plaintiff of any materials to the relevant projects. However, s. 13(1) does not require that direct contact or dealings be established to prove liability in these circumstances.

In his November, 1998, decision in *Tam-Kal Ltd. v. Stock Mechanical*,¹¹ Ground J. relaxed the plaintiff's burden even further by rejecting a defence submission that the test under s. 13 was a subjective and not an objective test:

¹⁰ [1995] O.J. No. 2179 (Ont. Gen. Div.).

¹¹ (1998), 43 C.L.R. (2d) 94 (Ont. Gen. Div.).

The test in the statute is disjunctive i.e. ‘knows or reasonably ought to know’. It seems to me that the second wing of the test must necessarily depend upon an objective analysis as to what a reasonable person ought to know in the circumstances. It is particularly significant in our case that [the personal defendant] was the chief executive officer of [the corporate defendant] and presumably the person responsible for making decisions as to payments to suppliers and others.

After reviewing the earlier decisions of *Andrea Schmidt Construction Ltd. v. Glatt*¹² and *G.V.B.S. v. Hydro Guard Inc.*,¹³ Ground J. concluded that:

[...] a person in the position of [the personal defendant] with his years of experience in the construction industry and being the chief executive officer of [the corporate defendant], on any reasonable person test, ought to have known that the payments referred to above, which I have disallowed as payments to trust fund beneficiaries, were improper payments out of trust funds and that accordingly [the personal defendant] has personal liability for breach of trust pursuant to ss. 13(1) of the C.L.A. to the extent of the

¹² (1979), 25 O.R. (2d) 567 (Ont. H.C.), aff'd. (1980), 28 O.R. (2d) 672 (Ont. C.A.).

¹³ [1998] O.J. No. 3615 (Ont. Gen. Div.).

amount paid by [the corporate defendant] which were improper applications of trust funds.

Once again, in the authors' view, this is a sensible result that is fully consistent with the policy of the statute. The Ontario Court of Appeal has, however, imposed some limits by making it absolutely clear, in recent cases, that mere status as an officer, director or person in control will not in and of itself attract personal liability for corporate breach of trust. In *Dietrich Steel Ltd. v. Shar-Dee Towers (1987) Ltd.*,¹⁴ a company was found to have breached the trust provisions of the Act. The case had proceeded on an agreed statement of fact, which, on this point, merely stated that the personal defendants were officers and directors of the defendant corporation. The Court of Appeal held that:

From the Agreed Statement of Facts it is not clear that the personal defendants did have 'effective control of a corporation [Shar-Dee] or its relevant activities' within the meaning of s. 13(1)(b) of the Act. We do know that both were directors and officers. However, neither being an officer and director, nor being a person with 'effective control of a

¹⁴ (1999), 170 D.L.R. (4th) 475 (Ont. C.A.).

corporation or its relevant activities' is sufficient to satisfy the requirements of s. 13(1). To be liable under that provision, it is also necessary to show that the personal defendant is one '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'. There were no such facts included in the Agreed Statement of Facts.

While the finding of the company's liability was upheld, the judgment against the personal defendant was set aside.¹⁵

What, then, establishes assent or acquiescence? The December 1, 1998, decision of the Ontario Court of Appeal in *Don Park Inc. v. S.E. Mechanical Engineering Ltd.*,¹⁶ is helpful on this point. In *Don Park*, the plaintiff had supplied sheet metal to the defendant, S.E. The defendant S.E. had supplied the material to another company, Mersin. Mersin was run by the son of the couple who ran S.E. S.E. invoiced Mersin for the material, charging exactly what it had been charged by the plaintiff. Mersin was involved in the construction of two schools. When it completed its work and was paid, it paid S.E. S.E. deposited the money into a blended general account and paid

trades on other projects, leaving the plaintiff unpaid. Among the payments made, \$13,000 went to Mersin on an unrelated project. The trial judge held that the corporate defendants as well as the personal defendants were liable for breach of trust. The evidence showed that both personal defendants who were officers of S.E. had played a very active role in Mersin's affairs, particularly in relation to the school projects. They had actually hired the site foreman for their son's company, Mersin. The mother, who did administrative work in the S.E. office, at one point signed over a cheque from Mersin to S.E. While Mersin and its sole shareholder and officer had no direct contract with the plaintiff, the Court of Appeal held that the father's knowledge of the source of the material ought to be ascribed to the son's company. The son knew or ought to have known of his father's activities on behalf of Mersin, including his part in the breach of trust. The Court of Appeal saw no reason to interfere with the trial judgment and dismissed the appeal.

In addition to providing a good example as to the quality of involvement that will lead to a finding of assent or acquiescence,

¹⁵ For a lower court decision to the same effect, see *Pro Caissons Ltd. v. M & M Contracting Co.* [1999] O.J. No. 13 (Ont. Gen. Div.).

this case marks the first time in many years that privity of contract, as such, was not required to support a trust claim. The Court of Appeal decision is unburdened by detailed analysis and should not be taken as a wholesale endorsement of the proposition, but the door is open, once again, for an argument that privity is not required to support a trust claim.

There are many other Ontario cases in which individuals have been held personally liable for the breach of trust of a corporation. One common thread among the cases is the type of case in which there is no personal benefit, as such, but the trustee simply runs out of operating capital and “dips into” the trust fund. *Ontario Electrical Construction Co. v. S.I. Guttman*¹⁷ provides a subtle refinement of this common type of case that shows how even subjectively innocent conduct can lead to personal liability for breach of trust. The evidence in *Ontario Electrical* clearly indicated that the personal defendants had discussed the cash flow problems of their various family companies and simply decided to loan money to a common account to finish all projects and then to repay these

¹⁶ (1998), 43 C.L.R. (2d) 7 (Ont. C.A.).

¹⁷ (1997), 104 O.A.C. 232 (Ont. C.A.).

legitimate loans out of the last advance on the final project to be completed. By doing so, the Court of Appeal found, the family members had assented to or acquiesced in conduct that they knew or ought to have known amounted to a breach of trust. The motion judge's award of solicitor-and-client costs based on this finding was not disturbed by the Court of Appeal.

In *Colella Excavating Ltd. v. All Types Excavating & Grading Inc.*,¹⁸ the individual defendant, who was the directing mind of the corporate defendant, was held liable under section 13 because of the arrogant attitude that he displayed:

[The defendant betrayed] the attitude that has resulted in the breach of trust. He demonstrates that he has no regard for the rights of his subcontractors under the *Construction Lien Act* and he totally ignores any *Construction Lien Act* obligations to them. He proclaimed arrogantly that his subs knew that when he gets paid, they get paid. That is not the basis of the Act.

¹⁸ (1997), 34 C.L.R. (2d) 132 (Ont. Gen. Div.).

The conclusion may therefore be drawn that while the test for assent or acquiescence is objective, subjective considerations may be brought into play as well against a defendant.

Whereas the personal defendant's arrogant conduct in *Colella* attracted liability, passivity appears to have excused a defendant in *J. (Jim) Quinn Plumbing Ltd. v. Avtec Engineering Inc.*¹⁹ In this case, the wife of a principal officer and director was relieved of liability for breach of trust because apart from punching figures into a computer and responding to requests for information, she had played no part in the operation of the company. She undoubtedly enjoyed some of the financial benefits of participation in the company, but it could not be said that she knew or ought to have known that the conduct of the company involved a breach of trust. The situation would have been different had there been any evidence of direct personal benefit by the wife. An element of personal benefit in a breach of trust case will always attract personal liability.²⁰

¹⁹ [1997] O.J. No. 1775 (Ont. Gen. Div.).

The relative sophistication of the officers and directors in question is a relevant consideration in the application of a “deemed knowledge” standard of liability. In *Shield Sprinkler & Fire System Ltd. v. Fahuki Construction Inc.*,²¹ the directors of the general contracting corporation were found to be well educated and well experienced in the construction industry. Accordingly, it was held by the Court in that case that the directors knew or ought to have known that the payment out of funds received from the owner towards their company’s own overhead expenses would constitute a breach of trust as long as subcontractors remain unpaid. The directors were found jointly and severally liable together with their corporation.

The problem is particularly acute with closely held corporations, where the dividing line between that which is corporate and that which is personal is easily blurred. In such cases, breach of trust is not always a matter of greed, it may simply be a matter of bad accounting practices. For example, in *Jacobson v. Basile’s*

²⁰ *Andrea Schmidt Construction Ltd. v. Glatt et al.* (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.).

²¹ (1996), 30 C.L.R. (2d) 156 (Ont. Gen. Div.).

Developments Ltd.,²² the owner advanced money to the defendant contractor, a closely held corporation. The corporation advanced a portion of those funds to its shareholder and director for doing work on the contract. The project failed and the owner sued for an accounting. It was held that the company's advances to its shareholder were not proper expenditures even though that person had actually done work and contributed value to the project. The decision is explained on policy grounds that the trust funds were not only for subcontractors and suppliers, but also for the owner on the facts of the case. The individual behind the closely held corporation was held liable for breach of trust together with the corporation.

Personal liability may ensue even from the smallest expenditure. In one reported case, the president of a corporate defendant was found personally liable for breach of trust simply by having used \$1,000 of progress monies to pay for hotel bills for his workers.²³

²² (1983), 45 B.C.L.R. 199 (B.C. S.C.).

²³ *Acme Commercial Painting (Victoria) Ltd. v. Hoju Holdings Ltd.* (1984), 5 C.L.R. 66 (B.C. Co. Ct.).

In a British Columbia case involving a closely held construction company,²⁴ the sole officer and director managed one general corporate bank account through which all the company's money and trust funds were channeled. When the company ran into financial problems, the bank applied the balance in the account in partial satisfaction of the company's operating loan. The trade creditors were left to their remedies and a supplier eventually obtained a judgment upon which it could not collect. The supplier then sued the sole shareholder for breach of trust. The sole shareholder was found liable. Although he did not directly or deliberately breach the trust provisions of the British Columbia statute, he had allowed trust money to be co-mingled with other funds in the company's general account and therefore "ran the risk" of withdrawal by a third party, such as the bank, for a purpose inconsistent with the trust. This was sufficient to attract liability. It was held to be irrelevant that the director acted innocently, since, as we have seen above, liability is not based on mental state but on how the trust fund is actually used. It appears from this line of cases that it is particularly important for closely held corporations to

²⁴ *Henry Electric Ltd. v. Farnwell* (1985), 11 C.L.R. 67 (B.C. Co. Ct.); affirmed (1986), 22 C.L.R. (2d) 273 (B.C. C.A.); leave to appeal to S.C.C. refused 75 N.R. 160 (note) (S.C.C.). See also *Horsman Brothers Holdings Ltd. v. Panton* [1976] 3

implement adequate accounting controls, or else they will lose the protection of limited liability.

The fact that personal liability may flow from inadequate corporate accounting practices was also made clear in *Wilson v. Parkin Enterprises Ltd.*²⁵ There, the personal defendants were officers and directors of the defendant construction company who, in what they thought was the ordinary course of their business, deposited progress payments into a general account used for both personal and general purposes. The theory of the personal drawings on this account was that they represented compensation for services provided to the projects upon which the funds were earned. Upon closer examination, however, it was found that the defendants' course of business was far from ordinary. Not only had the defendants failed to set up separate accounts for progress payments, they had also blended draws from many projects, including direct payment of bills for the construction of the personal defendants' private residences and direct payments to mortgagees on the personal defendants' homes. This direct link to the personal

W.W.R. 745 (B.C.S.C.); *J. (Jim) Quinn Plumbing Ltd. v. Antec Engineering Inc.* [1997] O.J. No. 1775 (Ont. Gen. Div.).
²⁵ (1988), 32 C.L.R. 63 (Man. Q.B.).

defendants' homes allowed the plaintiff to seek and obtain certificates of *lis pendens* and eventual sale of those properties. The Court considered sections 4(1) and (3) of the Manitoba *Builders' Liens Act*,²⁶ which codified the trust provisions with respect to monies in the hands of contractors, and particularly section 27(5) thereof:

Where the person primarily liable for payment under a contract is a corporation, and that person makes payment under the contract without deducting and retaining the holdback in accordance with this Act, if the corporation is unable to satisfy the liability under subsection (2), the directors and officers of the corporation who knowingly assented or acquiesced in the failure to deduct or retain the holdback are jointly and severally liable for the amount for which the corporation is liable under subsection (2) and which the corporation fails to satisfy.

The liability of the personal defendants in this case was not limited to the value of the holdback, but extended to all improper payments. The Court adopted the reasoning in *Scott v. Riehl*,²⁷ holding that where the conduct of an officer or director goes beyond mere

²⁶ R.S.M. 1987, c. B91, C.C.S.M. B91.

²⁷ (1958), 25 W.W.R. 525, 15 D.L.R. (2d) 67 (B.C.S.C.).

negligence or mistake in judgment and consists of a wrongful act knowingly done, that director may be directly liable to third parties. In short, where a person is an active party to an improper disposition of trust property, although not actually a trustee, that person is liable for breach of trust.

3. Directors' Liability Insurance

In larger corporations, the question may arise whether director's or officer's liability insurance would cover any liability incurred under section 13. Section 136(4) of the Ontario *Business Corporations Act*²⁸ provides as follows:

- (4) A corporation may purchase and maintain insurance for the benefit of any person referred to in subsection (1) against any liability incurred by the person,
 - (a) in his or her capacity as a director or officer of the corporation, except where the liability relates to the person's failure to act honestly and in good faith with a view to the best interests of the corporation.

²⁸ R.S.O. 1990, c. B16. See also *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 124(4); *Alberta Business Corporations Act*, S.A. 1981, c. B-15, s. 119(4); *British Columbia Company Act*, R.S.B.C. 1979, c. 59, s. 152(4); *Manitoba Corporations Act*, R.S.M. 1987, c. C225, s. 119(4); *Newfoundland Corporations Act*, R.S.N. 1990, c. C-36; *Saskatchewan Business Corporations Act*, R.S.S. 1978, c. B-10, s. 119(4).

In light of the recent decisions of high authority discussed above which make clear that officers and directors do not attract personal liability for merely being officers or directors, but actually have to assent to or acquiesce in conduct they know or reasonably ought to know amounts to a breach of trust, it seems difficult to construct a case in which such conduct could be considered to be honest and in good faith. It is respectfully submitted, therefore, that the personal liability for breach of a construction trust is not a liability that insurance is available for.

There is a good deal of support for such a proposition in the decision at first instance in *Ontario Electrical Construction Ltd. v. S.I. Guttman Ltd.*²⁹ There, the Court was reported to consider a defence under section 35 of the *Trustee Act*,³⁰ which reads as follows:

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

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

³⁰ R.S.O. 1990, c. T.23.

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.

Justice Hoilett doubted whether any breach of statutory trust could meet the standard of good faith required.³¹

4. Solicitor's Liability for Client's Breach of Trust

It has been held, in British Columbia, at least, that solicitors into whose account construction funds or trust receipts have been deposited may be considered statutory trustees and consequently should avail themselves of the provisions of the Trustee Acts of the various provinces to assist in distribution.³²

³¹ See also McKinlay J.A.'s comments on this point in *Dietrich Steel Ltd. v. Shar-Dee Towers (1987) Ltd.*, supra.

³² *Hills, Re*, [1984] B.C.J. No. 1103 (S.C.).

There are other examples. In *Wayne & Harold Smith Construction Ltd. v. Dedi-Care Centres Ontario Ltd.*,³³ a vendor and a purchaser had entered into an agreement to be administered by a purchaser's solicitor to the effect that certain funds arising out of the sale of property would be held back to correct deficiencies. These funds in the purchaser's solicitors' account were held to be a trust fund for the benefit of the contractor notwithstanding that the contractor had no contractual relationship with either the purchaser or the solicitors. The purchaser's solicitors were found to have erred in blindly accepting the deficiency claims of their client and they were wrong to believe that their client was entitled to unquestioned allegiance. Their breach of duty to the contractor was that they did nothing. They at least had a duty to interplead the funds. *Gautreau J.* held that:

[The solicitors] had knowledge of the facts, they were the numbered company's solicitors and were involved in the negotiations. They took possession of the monies subject to the same limitations that were imposed on their client. They knew that [the contractor] was the contractor which had lifted its lien in return for the undertaking of payment. They received the

³³ [1992] O.J. No. 3130 (Ont. Gen. Div.).

funds under a transmitted fiduciary obligation and were constructive trustees, taking on the obligations that rested on the shoulders of their principals. See *Fonthill Lumber Limited v. Bank of Montreal* 1959 O.R. 451. But matters do not rest here. They had a legal duty to make enquiries as to the exact nature of the trust and how they were to deal with the monies. This is the point recently made in *Royal Bank v. Fogler, Rubinoff* (1991), 5 O.R. (3d) 734 at 741-3 (C.A.).

They knew or should have known that [the contractor] had rights to the money under the *Construction Lien Act* over and above any rights that they might have had under the Agreement. There was no satisfactory evidence that I saw which justified [the solicitors] in believing that their client was entitled to hold back or control the purchase funds to the prejudice of the contractor Smith Construction. Their client's allegations are not sufficient. [The solicitors] were wrong in blindly accepting the deficiency claims of their client or believing that their client was entitled to unquestioning allegiance.

[The solicitors'] breach of duty to [the contractor] was that they did nothing; they had a duty to do something – even if it was only interplead. By doing nothing they favoured their client and stonewalled the plaintiff to its prejudice.

This is an interesting and, for many solicitors, rather troubling decision. While it seems to make perfect sense to hold strangers to a

trust liable under the knowing assistance and knowing receipt standards recently clarified by the Supreme Court of Canada, discussed *infra*, it is an entirely different standard to impose upon solicitors an affirmative duty to interplead, which, according to the Court in this case, was the very least the solicitors had to do. With all due respect, this appears to go beyond the obligations of a stranger to the trust outlined by the Supreme Court of Canada and, as discussed later, may conflict with a solicitor's duties toward his or her client.

In *Tetreault Construction (North Bay) Ltd. v. Wright*,³⁴ the owner withheld certain sums from its bankrupt contractor and set off against these sums professional fees owing on other matters. The owner and the professional firm were aware of the existence of unpaid trades when this transaction occurred. In fact it was the very purpose of the withholding. The Court held that because of this knowledge, the professional firm was a constructive trustee of all sums so withheld. Where an owner was aware that his bankrupt contractor had left unpaid trades and then used monies retained

³⁴ (1982), 45 C.B.R. (N.S.) 257 (Ont. Dist. Ct.).

from the bankrupt contractor to pay professional fees owing in other matters, the professional firms that received these monies were held to be constructive trustees for the benefit of the said trades. In light of the recent case law on liability of strangers to a trust, discussed *infra*, this decision seems to stand on a firm basis.

In a further Ontario case, *Budinsky v. Breakers East Inc.*,³⁵ the purchasers' deposits on a major condominium project were paid into the trust account of the developer's law firm. When the purchasers began to rescind their agreements, they looked to the vendor's law firm to return these deposits. The developer successfully defended the purchasers' applications but substantial legal bills were incurred in the process. As the collapse of the condominium market continued, the developer was placed into receivership and became unable to pay its solicitor's accounts. The remaining fund, made up of deposits, was also claimed by the developer's bank under its general assignment of book debts and other security. The solicitors sought a charging order under section

³⁵ (1993), 12 C.L.R. (2d) 243 (Ont. Gen. Div.). See also: *Striemer v. Nagel* (1911), 17 W.W.R. 189 (Man. K. B.); *C.L.B.C. v. Gray* (1987), 59 O.R. (2d) 414 (Master); and *Hubbard v. Everyman's Saving & Mortgage Ltd.* (1985), 59 C.B.R. (N.S.) 251 (Alta. Master), *L. & D. Cartage & Development Co. v. Sterling Construction Co.*, [1963] 2 O.R. 420, 39 D.L.R. (2d) 726 (H.C.) and *Tots & Teens Sault Ste. Marie Ltd. Re* (1975), 11 O.R. (2d) 103 (S.C.).

34 of the *Solicitors' Act*.³⁶ It was held that the solicitor's lien ranked in priority to the security of the bank, however a group of lien claimants argued that any charge in favour of the law firm on deposits and proceeds was subject to a trust in favour of the lien claimants under the vendors' trust sections, section 9(1) of the *Construction Lien Act*. The Court held that in a situation where funds held in a solicitor's trust account are subject to equities in favour of third parties, such as contractors under the *Construction Lien Act*, the procedure of a charging order was inapplicable and declined to grant such an order.

A similar priority issue was argued in the British Columbia case of *Dunhill Construction Ltd. v. Ledcor Industries Ltd.*³⁷ It was held that where there is a priority issue between a solicitor's lien and a beneficiary of a builder's lien trust, the beneficiary of the builder's lien trust would take priority on the theory that the trust fund never became the property of the debtor. As the debtor has no equity in a trust fund upon which any solicitor's lien could attach, there is, in reality, no contest. Similarly, in *115 Place Co-operative Housing*

³⁶ R.S.O. 1990, c. S-15.

³⁷ (1993) 85 B.C.L.R. (2d) 112 (S.C.).

Assn. v. Burt,³⁸ an agreement was made between an owner and a subcontractor and its solicitor to deposit a final progress advance to an especially set-up trust account, pursuant to the solicitor's undertaking that the monies be held in trust until deficiencies in the contractor's/client's work were rectified. The plaintiff agreed with the release of half of the money in the trust account. No agreement was reached with respect to the balance of the funds. The funds eventually disappeared. The owner successfully sued the law firm and trust company in which the funds were deposited. The British Columbia Court of Appeal considered that the law firm had given an undertaking allowing the Court to exercise its summary jurisdiction over solicitors and an order requiring re-instatement of the fund could be properly made against the law firm. As the trust company was not subject to the same summary jurisdiction of the Court and as the case was sufficiently weak without this fact to deny summary judgment, the trust company's appeal succeeded.

³⁸ (1992), 70 B.C.L.R. (2d) 166, [1992] C.C.L. 10124 (S.C.), reversed in part 94 B.C.L.R.(2d) 60, [1994] 10 W.W.R. 20, 48 B.C.A.C. 181, 78 W.A.C. 181, (*sub nom. 115 Place Co-operative Housing Assn. v. Burke, Tomchenko, Duprat*) 116 D.L.R. (4th) 657 (C.A.).

While the relatively recent Supreme Court of Canada decisions of *Gold v. Rosenberg*³⁹ and *Citadel General Assurance Co. v. Lloyds Bank of Canada*⁴⁰ dealt with the liability of banks, there seems to be no reason, subject to a solicitor's obligations toward his or her clients, not to apply the standards outlined in these cases to cases concerning solicitors.

These two cases had a profound impact on the issue of banks' liability as strangers to trusts. The Supreme Court considered and ruled on the issue of attribution of trust liabilities to strangers to common law trusts. Aside from the long established liability as *trustee de son tort*, there are two other traditional sources of stranger's liability: "knowing assistance" and "knowing receipt". The *Gold* and *Citadel* decisions have now established the distinction between the two and the quality of proof required in each case.

The decisions have been commented on in much detail recently, so that it will suffice here to outline the main propositions brought

³⁹ (1997), 152 D.L.R. (4th) 385 (S.C.C.).

⁴⁰ (1997), 152 D.L.R. (4th) 411 (S.C.C.).

forward in both cases. The decisions were released together in the fall of 1997. The majority of the Court in each case stressed the fundamental difference between the two sources of liability. Knowing assistance was described as a fault-based accessory's liability, as opposed to knowing receipt. The latter was held to be a receipt-based liability demanding a restitutionary remedy. Unlike the accessory liability of knowing assistance, the act of knowing receipt necessarily 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. Consequently, while actual knowledge is required to attract liability for knowing assistance, constructive knowledge, i.e. the knowledge of facts which would put a reasonable person on inquiry, was held to be sufficient for cases of knowing receipt.

Courts will not hesitate to use bank cases for guidance in cases concerning professional firms such as accountants or solicitors.⁴¹

⁴¹ See *Tetreault Construction (North Bay) Ltd. v. Wright* (1982), 45 C.B.R. (N.S.) 257 (Ont. Dist. Ct.).

The duties imposed upon solicitors in these cases may and often do conflict with their duties to their clients. To begin with, solicitors have a duty to carry out their clients' instructions. The English Court of Appeal, in *Groom v. Crocker*,⁴² held that:

The retainer when given puts into operation the normal terms of the contractual relationship, including in particular the duty of the solicitor to protect the client's interests and carry out his instructions in the matters in which his retainer relates, by all proper means.

This decision was applied in Ontario in *Rowswell v. Pettit*,⁴³ and the same passage was cited by the Supreme Court of Canada in 1993 in *BG Checo International Ltd. v. British Columbia (Hydro and Power Authority)*.⁴⁴ It has further been held that:

[A] solicitor's paramount duty is to do all that he properly can for his client. He owes no such duty to those who are not his clients and may in fact injure them by his acts on his client's behalf.⁴⁵

⁴² [1939] 1 K.B. 194 (C.A.).

⁴³ [1968] 2 O.R. 81 (Ont. H.C.).

⁴⁴ [1993] 1 S.C.R. 12 (S.C.C.).

⁴⁵ *Seaway Trust Co. v. Markle* [1991] O.J. No. 479 (Ont. Gen. Div.), referring to *Ross v. Caunters* [1980] 1 Ch. 297.

Aside from this general duty, there are very detailed provisions in every Province that govern the handling of trust funds in a solicitor's account. Until recently, section 14 of Ontario Regulation 708⁴⁶ under the *Law Society Act*,⁴⁷ for example, listed the obligations of a solicitor in this regard as follows:

14.(1) Every member who receives money in trust for a client, except money hereinafter expressly exempted from the application of this section, shall forthwith pay the money into an account at a chartered bank, provincial savings office or registered trust corporation to be kept in the name of the member or in the name of the firm of which he or she is a member or by which he or she is employed and designated as a trust account.

[...]

(8) Money shall not be drawn from a trust account other than:

- (a) money properly required for payment to or on behalf of a client;
- (b) money required to reimburse the member for money properly expended on behalf of a client or for expenses properly incurred on behalf of a client;
- (c) money properly required for or toward payment of the member's fees for which a billing or other written notification has been delivered;

⁴⁶ R.R.O. 1990, R. 708.

⁴⁷ R.S.O. 1990, c. L.8.

(d) money that is directly transferred into another trust account and held on behalf of a client;

(e) money that may by inadvertence have been paid onto the trust account in contravention of this section,

but in no case shall the money so drawn exceed the unexpended balance of the money held in the trust account for the client.

The majority of Regulation 708, including section 14, was revoked in January 1999 by Ontario Regulation 32/99. The Law Society of Upper Canada has since enacted numerous by-laws, the one of interest here being By-Law 19.⁴⁸ Excerpts of this by-law read as follows:

Money received in trust for client

2.(1) Subject to section 3, every member who receives money in trust for a client shall immediately pay the money into an account at a chartered bank, provincial savings office, credit union or a league to which the *Credit Unions and Caisses Populaires Act, 1994* applies or registered trust corporation, to be kept in the name of the member, or in the name of the firm of members of which the member is a partner or by which the member is employed, and designated as a trust account.

⁴⁸ Made January 28, 1999, amended February 19 and May 28, 1999.

Interpretation

(2) For the purposes of subsection (1), a member receives money in trust for a client if the member receives from a person,

(a) money that belongs in whole or in part to a client;

(b) money that is to be held on behalf of a client;

(c) money that is to be held on a client's direction or order;

(d) money that is advanced to a member on account of fees for services not yet rendered; or

(e) money that is advanced to the member on account of disbursements not yet made.

[...]

Withdrawal of money from trust account

4.(1) A member may withdraw from a trust account only the following money:

1. Money *properly required* for payment to a client or to a person on behalf of the client;

2. Money required to reimburse the member for money *properly expended* on behalf of a client or for expenses *properly incurred* on behalf of a client;

3. Money *properly required* for or toward payment of fees for services performed by the member for which a billing has been delivered;

4. Money that is directly transferred into another trust account and held on behalf of a client;

5. Money that under this By-Law should not have been paid into a trust account but was through inadvertence paid into a trust account.

[...] (emphasis added).

A solicitor is further bound by the Law Society's Rules of Professional Conduct. In Ontario, Rule 4 provides that:

The lawyer has a duty to hold in strict confidence all information concerning the business and affairs of the client acquired in the course of the professional relationship, and should not divulge any such information unless expressly or impliedly authorized by the client or required by the law to do so.

It can, of course, be argued that money required for payment to a client in a potential breach of trust situation is not "properly" required for the purposes of subsection 4.(1) number 1 of By-Law 19. It is, however, difficult to see how, in practice, a solicitor instructed by his or her client to pay funds out of trust funds can refuse to do so in light of the duties just outlined. It is even harder

to see how an affirmative duty to interplead, as suggested in one Ontario case,⁴⁹ can be fully reconciled with these obligations.

Although it flies in the face of day to day construction law practice, it would seem that solicitors should be most circumspect in handling construction payments through their firm trust accounts. Where it is impossible to avoid receiving construction draws into trust, it is imperative that solicitors be made aware of the new standards of trust liability.

II. Parties and Costs: Who Sues, Who Pays?

As in most actions, costs in trust actions are generally awarded as compensation to the successful party.⁵⁰ The difficulty with trust actions is that they often require an expert forensic accounting report and perhaps an investigator's report. An award of party-and-party costs does not begin to reflect the costs that are actually incurred in such an action. Especially in cases of obvious greed, often bordering on criminal behavior, as many trust cases tend to

⁴⁹ *Wayne & Harold Smith Construction Ltd. v. Dedi-Care Centres Ontario Ltd.* [1992] O.J. No. 3130 (Ont. Gen. Div.).

be, the assembly of a factual basis is time and money consuming and a successful plaintiff often feels entitled to complete indemnification for all costs reasonably incurred in the course of prosecuting or defending the action, i.e. solicitor-and-client costs.⁵¹ In *Young v. Young*, Madam Justice McLachlin, for the Supreme Court of Canada, outlined the situations in which such costs should be awarded:

Solicitor-and-client costs are generally awarded only where there has been reprehensible, scandalous or outrageous conduct on the part of one of the parties.

A year later, the Ontario Court of Appeal, in *Mortimer v. Cameron*,⁵² adopted with resounding approval the following passage from *Orkin on Costs*:⁵³

Costs on the solicitor-and-client scale should not be awarded unless special grounds exist to justify a departure from the usual scale.

⁵⁰ *Young v. Young* [1993] 4 S.C.R. 3 (S.C.C.).

⁵¹ M.M. Orkin, *The Law of Costs*, 2nd ed. (Aurora: Canada Law Book, 1998) at 1-10; *Apotex v. Egis Pharmaceuticals* (1991), 4 O.R. (3d) 321 (Ont. Gen. Div.); *Bargman v. Rooney* (1998), 30 C.P.C. (4th) 259 (Ont. Gen. Div.).

⁵² (1994), 17 O.R. (3d) 1 (Ont. C.A.); motion for leave to appeal to S.C.C. dismissed with costs August 11, 1994 (S.C.C.).

⁵³ M. M. Orkin, *The Law of Costs*, 2nd ed. (1993), pp. 2-91 to 2-92:

Such orders are not to be made by way of damages, or on the view that the award of damages should reach the plaintiff intact, and are inappropriate where there has been no wrongdoing.

An award of costs on the solicitor-and-client scale, it has been said, is ordered only in rare and exceptional cases to mark the court's disapproval of the conduct of a party in the litigation. The principle guiding the decision to award solicitor-and-client costs has been enunciated thus:

[S]olicitor-and-client costs should not be awarded unless there is some form of reprehensible conduct, either in the circumstances giving rise to the cause of action, or in the proceedings, which makes such costs desirable as a form for chastisement. (Footnotes omitted)

Recently, in *Toronto-Dominion Bank v. Grande Caledon Developments Inc.*,⁵⁴ the Ontario Court of Appeal reversed an award of solicitor-and-client costs where a bank had pressed a claim which, according to the trial judge, it knew or ought to have known to be unfounded. The case concerned a claim against a wife on her guarantee of her husband's loan. The wife defended with *non est factum* and undue influence. The trial judge awarded solicitor-and-client costs solely on the basis that despite the fact that the bank must have known at the commencement of trial that it had no case,

it proceeded with the action and focused on the woman's credibility, thereby financially destroying her. The Court of Appeal held that the bank had a *prima facie* case and the onus to refute the allegations was on the wife. The bank had a right to put the wife's credibility to the test, and doing so was neither reprehensible, scandalous or outrageous.⁵⁵

While "scandalous" and "outrageous" appear to be high standards, any beneficiary of a trust fund that disappeared will argue that the conduct of the party responsible for the disappearance was reprehensible, especially as courts have made it clear that "reprehensible" should be given a wide meaning.⁵⁶ It has been held to include behaviour "deserving of rebuke",⁵⁷ "unconscionable",⁵⁸ or "reprehensible, motivated by bad faith or bordering on chicanery".⁵⁹

⁵⁴ (1998), 39 O.R. (3d) 93 (Ont. C.A.).

⁵⁵ See also *Mancha Consultants Ltd. v. Canada Square Development Corp.* (1999), 117 O.A.C. 312 (Ont. C.A.).

⁵⁶ See M.M. Orkin, "Party-and-Party Costs in Transition", paper delivered at *Costs: The Bottom Line*, a conference held by the Law Society of Upper Canada in Toronto, October 20, 1999; referring to the following three cases.

⁵⁷ *Leung v. Leung* (1993), 15 C.P.C. (3d) 42 (B.C. S.C.).

⁵⁸ *Hatch v. Muskoka (District Municipality)* (1990), 71 O.R. 611 (Ont. S.C.).

⁵⁹ *University of Saskatchewan v. Fireman's Fund Insurance Co. of Canada* [1996] 5 W.W.R. 599 (Sask. Q.B.).

The *Colella* case of the contractor who was reprimanded for his arrogant attitude towards his trades⁶⁰ comes to mind.

A review of the breach of trust cases discussed in this paper shows, however, that courts are extremely reluctant to award solicitor-and-client costs. The Ontario Court of Appeal's decision in *Ontario Electrical Construction Ltd. v. Guttman* seems to be the exception. This case, however, should encourage beneficiaries to claim an award of costs on that scale in cases of obvious greed or blatant disrespect for the rights of trades.

III. Problems of Proof and Collection

1. Proof

A plaintiff in a trust action has to satisfy the Court that on a balance of probabilities, a trust existed and was breached.⁶¹ It has been held that once the person alleging breach of trust establishes a *prima facie* breach of trust, the onus shifts to the defendant to account for

⁶⁰ *Colella Excavating Ltd. v. All Types Excavating & Grading Inc.* (1997), 34 C.L.R. (2d) 132 (Ont. Gen. Div.).

⁶¹ *Union Electric Supply Co. v. Glups* [1990] B.C.J. No. 41 (B.C. Co. Ct.).

all proceeds.⁶² In *Fonthill Lumber Ltd. v. Bank of Montreal*,⁶³ it was held that the onus was on the plaintiff trades to prove that the money for which they sued were, to the knowledge of the defendant bank, trust funds. It was not enough merely to prove that the bank had acted negligently. In order to succeed, it must be established not only that the money belonged to the customer, but that the customer had no right to permit this money to be credited to his personal account. In *Tam-Kal Ltd. v. Stock Mechanical Inc.*,⁶⁴ the plaintiff argued that the defendant, in order to discharge its onus, was required to illustrate that it could trace every single dollar received by it to a payment to a legitimate trust fund beneficiary. Ground J. disagreed:

In my opinion, a contractor or subcontractor has satisfied the onus placed upon it if it can establish that, in respect of a particular project, it has paid out to subcontractors or suppliers on that project an amount equal to or more than the trust funds it has received in respect of that project and it is not necessary that every dollar received by the contractor in respect of a particular project be directly traceable to a payment to a trust fund beneficiary in respect of that particular project.

⁶² 977724 *Ontario Inc. v. Godard* (1997), 33 C.L.R. (2d) 54 (Ont. Gen. Div.).

⁶³ (1959), 16 D.L.R. (2d) 746 (Ont. H. C.), reversed on other grounds (1959), 19 D.L.R. (2d) 618 (Ont. C.A.).

In light of the recent Ontario Court of Appeal decisions discussed *supra*,⁶⁵ the decision in *Tam-Kal* ought to be read with some circumspection.

In British Columbia, it has been held that the onus to prove that monies were paid on account of the contract price so as to constitute trust funds, lies on the purported beneficiary claiming those funds.⁶⁶

In *Fundy Ventilation Ltd. v. Brunswick Construction Ltd.*,⁶⁷ the New Brunswick Court of Appeal held that where a contractor wished to take advantage of an exception to the trust provisions by way of defence, in that case created by section 3(3), the onus lay on the defendant to prove compliance. Because the contractor did not lead sufficient evidence to substantiate its defence, the Court held that the onus was not discharged. No deductions from the trust fund were permitted. Decisions to the same effect can be found in

⁶⁴ (1998), 43 C.L.R. (2d) 94 (Ont. Gen. Div.).

⁶⁵ *Rudco Insulation Limited v. Toronto Sanitary Inc.* (1998), 42 O.R. (3d) 292 (Ont. C.A.); *Dietrich Steel Ltd. v. Shar-Dee Towers (1987) Ltd.*, (1999), 170 D.L.R. (4th) 475 (Ont. C.A.).

⁶⁶ *109250 Canada Ltd. v. Isaac* [1988] B.C.J. No. 866 (B.C. Co. Ct.).

⁶⁷ (1982), 40 N.B.R. (2d) 484, (C.A.).

other provinces.⁶⁸ It has also been established in the case of *Re Johnson Construction Ltd.*,⁶⁹ that the onus is on a person claiming entitlement to the trust, such as a supplier, to show that not only its supplies were expended or incorporated into the relevant project to which the trust pertains, but also that it was the intention or anticipation of that supplier that the impugned items be so expended or incorporated.

Material suppliers generally have an onus of showing not only that their supplies were expended or incorporated into the project, but that they intended them to be so expended or incorporated.

The most effective means of proving a trust case is through the use of accounting expertise. The experts who are usually in the best position to trace the flow of money are those with a forensic or investigative background, such as a Certified Fraud Examiner. The usefulness of such experts in breach of trust cases was commented on by Hoilett J. in *Ontario Electrical Construction Co. v. S.I.*

⁶⁸ *ASL Paving Ltd. v. Magnus Construction Ltd.* (1994), 13 C.L.R. (2d) 253 (Sask. C.A.); *Clarkson v. Canadian Bank of Commerce* (1966), 57 D.L.R. (2d) 193 (S.C.C.); *Perlmutter Shore Ltd. v. Bank of Montreal* (1981), 34 O.R. (2d) 577 (Ont. H.C.).

⁶⁹ (1983), 4 C.L.R. 113, 52 N.B.R. (2d) 219 (Q.B.).

*Guttman Ltd.*⁷⁰ In that case, the court heavily relied on the affidavit of a chartered accountant and chartered business valuator who was associated with a firm of investigative accountants, holding that the affidavit served to illuminate the issues to be decided.

In rare cases, it may be necessary in order to facilitate the work of such experts by applying for an order preventing the trustee from tampering with the evidence. An *Anton Piller* order may be granted in very limited circumstances permitting the plaintiff to seize or inspect, copy and photograph the defendant's documents and property.⁷¹ Such orders may be granted if:

1. The plaintiff has an extremely strong prima facie case;
2. The damage, potential or actual, is very serious for the plaintiff;
3. There is clear evidence the defendants possess incriminating documents or property; and
4. There is a real possibility that the defendant may destroy such material before a motion on notice can be made.⁷²

⁷⁰ (1996), 29 C.L.R. (2d) 146 (Ont. Gen. Div.), aff'd (1997), 104 O.A.C. 232 (Ont. C.A.).

⁷¹ See *Bardeau Ltd. v. Crown Food Service Equipment* (1982), 38 O.R. (2d) 411 (Ont. H.C.).

⁷² *Nintendo of America Inc. v. Coinex Video Games Inc.* (1982), 34 C.P.C. 108 (Fed. C.A.); See generally *Anton Piller KG v. Mfg. Processes Ltd.* [1976] 1 All E.R. 779 (Eng. C.A.); Holmsted and Watson, *Ontario Civil Procedure*, Volume 3

2. The Remedy of an Accounting

There are a number of remedies available to beneficiaries in cases of breach of trust, among the most useful of which are accounting and tracing. The common law proprietary actions of conversion, detinue and replevin are both rare and of limited use⁷³ and will not be discussed in this context.

The remedy of an accounting is equitable in nature and is one of the most useful remedies available to a construction trust beneficiary. An action for accounting serves the purpose of making known what has happened to the trust property and to have a court adjust and settle the accounts between trustee and beneficiary. In British Columbia, for example, the owner is a possible beneficiary of the contractor's trust and is therefore entitled to an accounting from the contractor upon establishing that the contractor improperly diverted monies advanced to it under the contract.⁷⁴ This feature of British

(Toronto: Carswell, 1993) 45-5 to 45-7; R. J. Sharpe, *Injunctions and Specific Performance* (Aurora: Canada Law Book, 1998) at 2.1100 to 2.1300.

⁷³ See Eileen E. Gillese, *The Law of Trusts* (Concord: Irwin Law, 1997) at 160.

⁷⁴ *Jacobson v. Basile's Developments Ltd.* (1983), 45 B.C.L.R. 199 (B.C. S.C.).

Columbia trust practice is most beneficial and Canada's other trust jurisdictions would do well to adopt it. At present, in Ontario for example, a trustee has no right to an accounting as such and no absolute right to ensure that trust funds are reaching trades and suppliers unless they claim liens or sue for breach of trust.

In Ontario, the remedy of accounting is effected through referral to the Master's office pursuant to Rule 55 of the Ontario Rules of Civil Procedure. The rule constitutes a complete code and directs a procedure in the nature of an inquiry by the Master, with broad jurisdiction as to parties, scope, evidence and experts. The Master's office may and often does in such cases direct advertisement and become pro-active in seeking out and joining necessary parties.

3. The Remedy of Tracing

In equity, property must remain identifiable in order to be traced.⁷⁵

While at common law, no action was available once the funds were mixed with the trustee's own funds, courts developed an approach

⁷⁵ E. E. Gillese, *supra*, note 51 at 160-1.

where an equitable action would allow a claimant to follow the his or her property into a mixed fund.⁷⁶ The reason for that development was explained by Jessel M.R., in the seminal case of *Re Hallett's Estate*.⁷⁷ As it provides an eloquent outline of the law of tracing, a rather lengthy excerpt will be reproduced:

The modern doctrine of Equity as regards property disposed of by persons in a fiduciary position is a very clear and well-established doctrine. You can, if the sale was rightful, take the proceeds of the sale, if you can identify them. If the sale was wrongful, you can still take the proceeds of the sale, in a sense adopting the sale for the purpose of taking the proceeds, if you can identify them... But it very often happens that you cannot identify the proceeds. The proceeds may have been invested together with money belonging to the person in a fiduciary position, in a purchase. He may have bought land with it, for instance, or he may have bought chattels with it. Now, what is the position of the beneficial owner as regards such purchases? I will, first of all, take his position when the purchase is clearly made with what I will call, for shortness, the trust money, although it is not confined, as I will shew presently, to express trust. In that case, according to the now well-established doctrine of Equity, the beneficial owner has a right to elect either to take the property purchased, or to hold it as a security for

⁷⁶ D.W.M. Waters, *Law of Trusts in Canada*, 2nd ed. (Toronto: Carswell, 1984) at 1036-7.

⁷⁷ (1880), 13 Ch. D. 696 (C.A.).

the amount of the trust money laid out in the purchase; or, as we generally express it, he is entitled at his election either to take the property, or to have a charge on the property for the amount of the trust money. But in the second case, where a trustee has mixed the money with his own, there is this distinction, that the *cestui que trust*, or beneficial owner, can no longer elect to take the property, because it is no longer bought with the trust-money simply and purely, but with a mixed fund. He is, however, still entitled to a charge on the property purchased, for the amount of the trust-money laid out in the purchase; and that charge is quite independent of the fact that of the amount of the amount laid out by the trustee. The moment you get a substantial portion of it furnished by the trustee, using the word 'trustee' in the sense that I have mentioned, as including all persons in a fiduciary relation, the right to the charge follows. That is the modern doctrine of equity. Has it ever been suggested, until very recently, that there is any distinction between an express trustee, or an agent, or a bailee, or collector of rents, or anybody else in a fiduciary position? I have never heard, until quite recently, of such a distinction suggested... I say on principle it is impossible to imagine there can be any difference. In practice we know there is no difference, because the moment you get into a Court of Equity, where a principal can sue an agent as well as a *cestui que trust* can sue a trustee, no such distinction was ever suggested as far as I am aware...

I have only to avert to one other point, and that is – supposing, instead of being invested in the purchase of lands or goods, the moneys were simply

mixed with other moneys of the trustee, using the term again in its full sense as including any person in a fiduciary relation, does it make any difference according to the modern doctrine of Equity? I say none. It would be very remarkable if it were to do so. Supposing the trust money was 1000 sovereigns, and the trustee put them into a bag, and by mistake or accident, or otherwise, dropped a sovereign of his own in the bag. Could anyone suppose that a Judge in Equity would find any difficulty in saying that the *cestui que trust* has a right to take 1000 sovereigns out of that bag? I do not like to call it a charge of 1000 sovereign on the 1001 sovereigns, but that is the effect of it. I have no doubt of it. It would make no difference if, instead of one sovereign, it was another 1000 sovereigns; but if instead of putting it into his bag, or after putting it into his bag, he carries the bag to his bankers, what then?⁷⁸

As pointed out later in the decision, the fact that the money is placed in a bank should not make any difference to the general proposition. Equity therefore both extended the group of trustees and allowed the beneficiary to follow his assets into mixed funds.⁷⁹ No action will lie in equity, however, against a third party who is a *bona fide* purchaser for value without notice, as in those cases, the

⁷⁸ As cited in J.S. Kelly, "Tracing of Property Co-Mingled or Converted by Fiduciaries – A Discussion of the Principles and Rules Relating Thereto" (1984), 46 C.B.R. (N.S.) 189.

⁷⁹ See also *Sinclair v. Brougham* [1914] A.C. 398 (H.L.); *Re Diplock* [1950] 2 All E.R. 1137 (H.L.); *Re 389179 Ontario Ltd.* (1980), 29 O.R. (2d) 304 (Ont. S.C.).

equities are equal.⁸⁰ The principle that still applies to mixed funds today is that the beneficiary can look to the whole of the mixed fund as trust property to recover his or her part of the fund.⁸¹ The Ontario Court of Appeal, in the recent decision of *Law Society of Upper Canada v. Toronto-Dominion Bank*,⁸² held that in cases of rival claims of innocent beneficiaries of a mixed fund, the fund was to be shared rateably by all contributors regardless of the timing of their respective contributions. In this case, a solicitor had misappropriated client moneys that had been deposited in his mixed trust account with the appellant bank. The bank deposited funds into the account the day after the last misappropriation occurred. The bank attempted to rely on the so-called “lowest intermediate balance” rule to the effect that the funds it deposited would not form part of the moneys for distribution. According to that rule, once a beneficiary’s money left the fund because of misappropriations, it could not be traced into subsequent additions to the fund deriving from the contribution of others. Blair J. held that the bank’s attempt to invoke this rule was nothing but an attempt to re-invoke the rule in *Clayton’s Case*, which had been

⁸⁰ E. E. Gillese, *supra*, note 51 at 161.

⁸¹ *Ibid.*

rejected by the Ontario Court of Appeal and the Supreme Court of Canada in *Ontario (Securities Commission) v. Greymac Trust Co.*⁸³ The Court held that the lowest intermediate balance rule was both cumbersome to apply and arbitrary and preferred the so-called “*pari passu ex post facto*” approach. This approach, adopted by the English Court of Appeal in *Barlow Clowes International Ltd. (in liq.) v. Vaughan*,⁸⁴ involves a simple ratable sharing of the remaining funds based upon establishing the total quantum of the assets available and sharing them on a proportionate basis among all the investors who contributed to the assets, regardless of the date of the respective contributions. An application for leave to appeal was submitted to the Supreme Court of Canada on October 5, 1999.⁸⁵

Construction trust statutes in effect codify the equitable principle of tracing. Second only to judicial accounting, the equitable remedy of the tracing of funds taken in breach of trust into the hands of those who “knew or ought to have known” of the breach is a powerful

⁸² (1998), 169 D.L.R. (4th) 353 (Ont. C.A.).

⁸³ (1986), 30 D.L.R. (4th) 1 (Ont. C.A.), aff'd (1988), 52 D.L.R. (4th) 767 (S.C.C.).

⁸⁴ [1992] 4 All E.R. 22 (C.A.).

⁸⁵ [1999] S.C.C.A. No. 77 (S.C.C.).

remedy for trust beneficiaries. The statutes that create statutory construction trusts assist by legislating a form of tracing of trust funds into the assets of directors, officers and persons in control, but this does not displace the common law of tracing. Frequently, the benefit of monies taken in breach of trust are found farther afield than in the hands of officers, directors and persons in control. In cases of greed, trust actions are particularly useful in using common law tracing to track funds into assets such as boats, automobiles, and vacation homes registered in the name of strangers to the trust. In a typical case, where a desperate contractor has diverted funds into an unrelated speculative development, tracing permits an excellent remedy to affect title to such property or even shares in a holding company and to prevail in any eventual competition with secured creditors.

IV. Conclusion

While courts have made it very clear that the mere status as officer or director is not enough to attract personal liability for breach of trust under the Lien Acts, they will not hesitate to liberally interpret

a person's conduct as assent or acquiescence to a corporation's breach of trust. A number of factors have emerged that courts will consider in this respect. First of all, an element of personal benefit will usually be conducive against a personal defendant. With regard to the knowledge requirement, the standard that an individual is held to will vary depending on that person's sophistication and experience notwithstanding a judicial effort toward an objective standard. The courts will look at a trustee's attitude toward beneficiaries and punish arrogant or blatantly inconsiderate behaviour. Finally, poor accounting practices and comingling of funds may well attract personal liability.

Solicitors can draw but one conclusion from the case law discussed here, and that is to avoid bringing themselves in situations where they will be held to be constructive trustees. Avoid the administration of construction funds through your trust account. The duties imposed on solicitors by courts seem to place solicitors, in the real world of day to day practice, between the proverbial rock and a hard place.

Beneficiaries have not been overly successful in obtaining orders for costs on a solicitor-and-client scale, which is surprising to these writers, but such awards should become more frequent following the Ontario Court of Appeal's decision to uphold such an award.