

CONSTRUCTION LIENS LITIGATION UPDATE

TRUST CLAIMS AND THE POSITION OF BANKS

I. Introduction

This topic, trust claims and the position of banks, goes to the heart of construction lien law: the uneasy relationship between free enterprise and public policy. In favor of free enterprise it could be argued that no substantial business could be done in the construction industry without money borrowed from banks and therefore banks should be entitled to carry on their business unimpeded by legislation designed to protect creditors in that industry. The contrary argument is that the unique rights of banks, their virtual monopoly on capital, their ability to monitor solvency and control cash flows, should be coupled with certain balancing responsibilities, including a responsibility not to abuse their rights so as to enhance their position at the expense of trade creditors. On another level, this dispute carries over into the day to day business practices of construction companies and their banks. The simple business expedient of blended bank accounts on its own has accounted for much litigation; similarly, more creative business practices, such as “mirror” accounting systems, for example, have also resulted in much litigation.

The oral presentation on this topic will take a developmental approach, while the balance of this paper will concentrate on an explanation of the statutory and common law legal framework within which banks and trust fund claimants now co-exist.

II. Bank Acts

The first of the two competing policies identified above, being the desire to encourage banks in making capital available to the construction industry in Canada, is reflected, in part at least, in federal *Bank Act* provisions which would appear to relieve banks from the consequence of 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*¹ 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 version² and section 96(1) of the 1953-54 *Bank Act*³ 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 1890.⁴ From the beginning, though, it has been clear that while this section, read literally, would appear to

¹ S.C. 1991, c.46.

² R.S.C. 1985, c.B.-1.

³ 1953-54 (Can.) c. 48.

⁴ Crawford and Falconbridge, *Banking and Bills of Exchange*, vol. 1, 8th ed. (Toronto: Canada Law Book, 1986) 537.

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.⁵ The law on point has been helpfully summarized as follows in the leading text on Banking and Bills of Exchange:

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

⁵ 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.

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.⁶

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?⁷ In *Fonthill Lumber Ltd. v. Bank of Montreal*,⁸ 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*,⁹ 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 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

⁶ Crawford and Falconbrige, *supra*, note 4 at 538-9.

⁷ *Arthur Andersen Inc. v. Toronto-Dominion Bank* (1994), 17 O.R. (3d) 363 (Ont. C.A.).

⁸ [1959] O.R. 451 (Ont. C.A.).

⁹ S.C. 1953-54, c.48.

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*:¹⁰

[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.*,¹¹ 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*,¹² ruled on the scope of the relevant *Bank Act*¹³ provisions as follows:

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

¹⁰ [1971] 4 W.W.R. 191 (Man. Q.B.).

¹¹ (1994), 17 C.L.R. (2d) 273 (Man. Q.B.), affirmed (1996), 27 C.L.R. (2d) 151 (Man. C.A.).

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?

III. Construction Lien Act Trusts

The second competing policy, being a desire to balance rights with responsibilities or obligations, can be seen in the enactment of *Construction Lien Act* trusts. While it is a good thing that banks provide capital to the construction industry and should be empowered to do so, we see here the balancing requirement that banks not use their power to (a) shift all credit risks onto trades, and (b) appropriate the value of work done by trades and suppliers without giving value in return.

This point can best be addressed by example. In *John M. M. Troup Ltd. v. Royal Bank*,¹⁴ the bank's customer, a builder, deposited a cheque into its Royal Bank account representing the final payment of the contract price. The account was used for several active projects. It was proven that to the knowledge of the bank, this money was a substantial part of the holdback required under s. 11 of the then *Mechanics' Lien Act*.¹⁵ The funds were deposited and were then applied to reduce the contractor's overdraft. As you could expect, the customer's overdraft was well secured by bonds, a general assignment of book debts, two guarantees and an assignment of life insurance. The bank

¹² (1994), 17 O.R. (3d) 363 (Ont. C.A.).

¹³ R.S.C. 1985, c. B-1.

¹⁴ [1962] S.C.R. 487, (1962), 34 D.L.R. (2d) 556 (S.C.C.).

received the deposit and completed the reduction of the customer's overdraft. It had no information regarding any kind of financial difficulties of the contractor. Nevertheless, the contractor was bankrupt and the subcontractors commenced actions against the bank, claiming that the bank had participated in a breach of trust. At trial in the Ontario High Court, Wells J. found that the money had been deposited to the contractor's credit in the ordinary course of business and was therefore not subject to the trust in the hands of the bank. On appeal to the Ontario Court of Appeal, the majority, Porter C.J.O. and Gibson J.A., in dismissing the appeal, held that the evidence did not establish that the bank knew of any unpaid accounts or that they would not be paid, nor were there circumstances to put the bank on inquiry at the time the payment was deposited. The majority of the Supreme Court of Canada, Locke J. dissenting, agreed that there was no breach of trust in these circumstances. The bank was said to have had no reason to inquire about a breach of trust in the facts of this case. The cheque in question had been received for value and in the ordinary course of the relationship between bank and customer. The Supreme Court held that:

[With] an amply secure overdraft and no reason to press for payment, a bank does not participate in a breach of trust merely because it receives payment by a cheque drawn by a third party in favor of a customer and deposited in the customer's bank account.

The appellants had argued that as the bank held an assignment of book debts from the customer which expressly provided that all monies received by the customer from the collection of the debts under assignment were to be considered to have been received in

¹⁵ R.S.O. 1950, c.227.

trust for the bank, and that, as the bank's trustee, the customer, received these monies already subject to the prior statutory trust created by the *Mechanics' Lien Act*, the bank could be in no better position than its customer. Judson J. for the majority of the Supreme Court, held that:

The fallacy of this argument is that the contractor did not receive this cheque under the assignment of book debts as trustee for the bank. The bank made no use of this assignment and served no notice on the [owner] under it. The assignment of book debts, it is true, was registered but until notice was given, it could have no effect on a payment made in the ordinary course of business by the [owner] to the contractor. Both judgments in the Courts below properly distinguish a claim by the bank as assignee from the present one. There was no stakeholder against whom competing claims were being made by the bank as assignee of book debts and by s.3(1) claimants as beneficiaries of a trust. The appellants' claims on this ground were properly rejected.

The Supreme Court's comments should be read in light of the assignment terms of contemporary general security agreements. A standard form agreement provides that:

And the Undersigned for good and valuable consideration assigns, transfers, and sets over unto the Bank all debts, accounts, choses in action, claims, demands, and moneys now due or owing or accruing due or which may hereafter become due or owing to the Undersigned, including (without limiting the foregoing) claims against the Crown in the right of Canada or of any province, moneys which may become payable under any policy of insurance in respect of any loss by fire or other cause which has been or may be incurred by the Undersigned (collectively called "Book Debts"), together with all contracts, securities, bills, notes, lien

notes, judgments, chattel mortgages, mortgages and all other rights, benefits and documents now or hereafter taken, vested in or held by the Undersigned in respect of or as security for the Book Debts hereby assigned or intended so to be or any part thereof and the full benefit and advantage thereof, and all rights of action, claim, or demand which the Undersigned now has or may at any time thereafter have against any person or persons, firm or corporation in respect thereof. The Undersigned further hereby covenants, promises, and agrees to and with the Bank to well and truly execute or cause to be executed all or any such further or other document or documents as shall or may be required by the Bank to more completely or fully vest in the Bank the Book Debts hereby assigned or intended so to be and the right to receive the said moneys or to enable the Bank to recover same and will from time to time prepare and deliver to the Bank all deeds, books, vouchers, promissory notes, bills of exchange, accounts, letters, invoices, papers, and all other documents in any way relating to the Book Debts. Provided that this assignment is and shall be a continuing collateral security to the Bank for the Obligations. *All money or any other form of payment received by the Undersigned in payment of any Book Debts shall be received and held by the Undersigned in trust for the Bank* (emphasis added).

We now appear to have competing trusts, the express and usually prior trust declared by the general security agreement in favor of the bank and the statutory trust under the *Construction Lien Act* that comes into existence upon the receipt or deemed receipt of trust monies. It remains to be seen how this affects the body of established case law, if at all.

Just a few years after *Troup*, when appeal was as of right, a similar case came before the Supreme Court of Canada.¹⁶ Once again, *Clarkson Co. Ltd. v. Canadian Bank of Commerce* involved a case in which a contractor deposited an interim payment by the owner into a single blended account. A credit arrangement had been agreed on between the contractor and the bank which involved lodging with the bank a series of pre-signed promissory notes which were discounted by the bank and applied to any overdrafts. It became clear during trial that the bank knew that there were liens in the project from which the interim payment was received and that the contractor was in obvious financial difficulty. It came out in evidence that the bank's head office had even instructed the branch to withdraw the operating credit, which the manager failed to do. On the strength of the deposit of the interim payment in question, the contractor issued cheques to several subcontractors. Without warning or notice of any kind to the customer, the bank applied the deposit to the customer's overdraft and dishonoured all of the subtrade cheques when presented. At trial in the Ontario High Court, the plaintiff sought a declaration that the funds applied by the bank to the overdraft were appropriated by the bank although they belonged to the plaintiff and others, such as subcontractors, under the provisions of then s. 3 of the *Mechanics' Lien Act*.¹⁷ Gale J., arguing that at the time of the appropriation, the bank, through its manager, knew that the sum was received by the contractor on account of the construction contract and that a number of trades had gone unpaid, found for the plaintiff. The Ontario Court of Appeal allowed the appeal. Roach J.A. held that:

¹⁶ *Clarkson Co. Ltd. v. Canadian Bank of Commerce* [1966] S.C.R. 513, (1966), 57 D.L.R. (2d) 193 (S.C.C.).

¹⁷ R.S.O. 1960, c. 233.

When the \$31,999.01 came into the hands of [the contractor] it did constitute a trust fund but for the reasons stated [the contractor] was entitled to retain it for its own use by way of recoupment for moneys expended out of its own pocket for labour and material that had gone into the job and for payments made to subcontractors without thereby committing a breach of the trust. This it did by putting that money within the reach of the bank which, as it was entitled to do, applied it on [the contractor's] indebtedness. That indebtedness had been incurred in the first place when the bank advanced moneys to [the contractor] so that [the contractor] could thus expend it. The appeal should be allowed with costs and the action dismissed with costs.

On further appeal to the Supreme Court of Canada, the appeal was allowed and the trial judgment was restored. The majority of the Supreme Court of Canada, Judson J. dissenting, held that the amount received by the bank under these circumstances constituted a trust fund under the then *Mechanics Lien Act*. Cartwright J. held that:

It having been established that the \$31,999.01 came into the possession of [the contractor] impressed with the trust created by s-s. (1) of s. 3 of the *Mechanics' Lien Act* and that there were unpaid subcontractors who were *prima facie* entitled to the trust fund, the onus of proving the facts, if they existed, which would bring the case within the exception created s-s. (3) lay upon the bank and that onus was not satisfied.

Some 16 years later, in *Ellis-Don Ltd. v. Norton*,¹⁸ Anderson J. considered the relevant considerations in determining the issue of bank liability for breach of trust.

¹⁸ (1982), 5 C.L.R. 281 (Ont. H.C.).

While stating that that the list was not exhaustive, Justice Anderson identified the following six factual considerations:

1. Knowledge that the customer of the bank was in financial difficulty;
2. Concern on the part of the bank that its loan was in jeopardy;
3. Refusal on the part of the bank to renew credit;
4. Pressure on the customer to reduce a loan or overdraft;
5. Knowledge on the part of the bank that its customer's cheques had been from time to time dishonoured;
6. That the impugned payments were made at the initiation of the bank.

Two years later, in *Osbourne v. Jackson Mill Services Ltd.*,¹⁹ a British Columbia County Court Judge, without citing *Ellis-Don v. Norton*, adopted the following statement from an unreported British Columbia case²⁰ as the most concise summary of the applicable law on a bank's liability for breach of trust in that Province:

A bank will be held to have participated in a breach of trust where it knows of the existence of the trust and also knows that the trust is being breached. Those were the facts upon which Judson J., speaking for the majority of the Supreme Court of Canada in the *Troup* case, distinguished it from the *Fonthill Lumber* case. Cases subsequent to *Troup* have shown that a bank will also be found to have acted in breach of trust where, although it had no actual knowledge that a breach was being committed, the

¹⁹ [1984] B.C.J. No. 924 (B.C. Co. Ct.).

²⁰ *Canadian Electric Co. Ltd. v. Royal Bank of Canada*, 27 April 1981, County Court of Westminster No. A800985.

circumstances were such that the bank was put upon enquiry and ought to have known that a breach of trust was being committed.

The contractor in the *Osbourne* case had received payments due from two different projects and, once again, had paid them into one single blended account. There were no signs whatsoever at the time of the deposits indicating that the contractor was experiencing or about to experience any financial difficulty. In anticipation of succeeding in a tender for a new contract, the contractor spent the funds received from the two projects on equipment and was therefore short of cash to pay the plaintiff. Hutchinson Co. Ct. J. referred to the fact that there had been no signs such as dishonoured cheques or calls from creditors or any other hints that would have indicated to the bank that trades were unpaid. The bank was therefore held not to have had any actual knowledge of the breach of trust, nor was it recklessly blind or indifferent to a breach of trust. The action was dismissed.

By way of comparison, in *McEachern v. Royal Bank of Canada*,²¹ a bank was found to have actually assisted a customer in committing a breach of a trust by setting up a consolidated account and then failing to make inquiries as to the operation of the account. This was a case involving a mortgage broker, not a contractor. The mortgage broker moved his banking business from his regular bank to the defendant bank. The customer's former bank had insisted on holding the mortgage proceeds in a segregated trust account. In order to persuade the broker to switch banks, a so-called "consolidated offset balance control program" was offered, which was purportedly designed to facilitate the

consolidation of funds on a daily basis and to allow the payment of interest on net balances over a stated amount. In setting up the new facility, the defendant bank's manager received copies of the former bank's statements and was therefore aware of the fact that trust monies were involved, and that these had been held in a segregated trust account at the former bank. The new bank therefore was deemed to know that some of the monies placed into the new account might be impressed with a trust. In these circumstances, the trial judge held that the defendant bank owed the plaintiff customer two duties of care: first, to ensure that the funds deposited were not trust funds and, second, to inquire whether trust funds could be administered under the consolidation program. The bank did neither. The bank was held to have been a constructive trustee of the commingled funds and found liable to the plaintiff for assisting in a breach of trust.

A more recent and authoritative case in Ontario, which has effectively settled the issue of a bank's liability to a beneficiary as stranger to a trust, is the 1994 decision of the Ontario Court of Appeal in *Arthur Andersen Inc. v. Toronto-Dominion Bank*.²² This case involved a real estate company, Penta Stolp, and its subsidiaries and associated companies. Together, the group of companies actively participated in a large number of real estate projects. The defendant bank handled the accounts for all of the interrelated corporations. Originally, it was agreed that every company should have separate accounts, and that separate accounts would be assigned for each individual project. As the business grew and the projects proliferated, this system became difficult and expensive to administer, and the bank developed and urged upon Penta Stolp what came

²¹ (1991), 2 C.B.R. (3d) 29 (Alta. Q.B.).

²² (1994), 17 O.R. (3d) 363 (Ont. C.A.).

to be called a “mirror accounting system”. The idea in its simplest form was that a “mirror” or offset account would be set up corresponding to each working or “designated” account. According to the mirror accounting agreement that was eventually signed, at the end of each business day, an amount equal to the debit balance in the “designated” account would be deposited from the corresponding “mirror” account. Similarly, a credit in a “designated” account would be matched with a debit and the balance credited to the “mirror” account. At the end of each business day, therefore, each “mirror” account would offset the balance in its “designated” account, resulting in a combined balance of zero. A so-called “concentration” account was then created to offset any withdrawals from or deposits into any mirror account. Obviously this system created no problems as long as the concentration account was in a credit balance. When it was not in a credit balance, the bank would require the group of companies to fund the shortfall. The real estate market declined. The bank became concerned about its exposure and terminated the agreement, seizing most of the money in the concentration account with the result that many trade creditors went unpaid. At one point, a 1.3 million dollar overdraft in the concentration account was eliminated by the deposit of credit balances from mirror accounts. The relevant issue was whether the periodic transfers of positive balances to the concentration account amounted to a breach of trust.

The claimants were successful at trial. The trial judge found the bank liable for breach of trust on the grounds that the bank knew the Stolp group of companies to be in the construction business and therefore that all deposits were trust monies. The trial judge cited an internal bank memorandum indicating an awareness on the part of the bank of an

uncertain business climate for builders and developers. Finally and most significantly, the trial judge held that the mirror accounting system itself was unsuitable for the construction industry.

On appeal to the Ontario Court of Appeal, the respondents' argument was that the mirror account system and the daily transfers involved made it inevitable that there would be daily breaches of trust of which the bank had to be aware, as accounts with the trades could not have been settled on a daily basis. This argument, as interesting as it is, was held by the majority to be "surely untenable". Justices Grange and McKinlay ruled that:

The result of [that argument] would be that in a case where a contractor had only one project and only one account with a bank, an overdraft accommodation by a bank could never be satisfied by future deposits without the bank being deemed to have notice of a breach of trust by its customer, because there would inevitably be some trade creditors who were unpaid. Placing such a high duty on a bank would be to require it to be aware of the status of each and every trade debt of its construction customer on a daily basis – an impossible task.

In essence, the Court of Appeal thought that the argument was a good argument in theory, but "impossible" in application. With regard to the question of the bank's duty of care, the same majority held that:

It is important to note that the only named trustees under the *Lien Act* are owners of land (as defined), contractors, and subcontractors. Therefore, a bank can only be liable for breaches of

trust where there has first been a breach by one of the named trustees who is a customer of that bank. There was no evidence that any Stolp officer warned the Bank that Stolp companies were in breach of the trust provisions as a result of non-payment of trades. Nor was there evidence that the Bank was made aware from any other source, before the very end of the relationship, that any of the Stolp companies were in breach of their trust obligations under the *Lien Act*. Therefore, the Bank could only be liable if it had a duty to inquire as to the state of the accounts between the individual Stolp companies and their trades. No one would suggest that a bank has a duty to monitor, on a daily basis, the operations 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*, R.S.C. 1985, c. B-1, specifically states that a bank is not bound to see to the execution of any trust, 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?

In the absence of sufficient facts or circumstances indicating a “good possibility” of trust beneficiaries being unpaid, there was no duty of inquiry on a bank to determine if trades had actually been paid or were going to be paid. The relationship between Stolp and the bank had been mutually satisfactory for eight years, overdrafts were always eliminated, numerous projects had been successfully completed and there was no indication that trades were about to go unpaid before November 29, 1990, the date on

which the bank met with Stolp officers and learned of cash flow problems. On these facts, the only breach of trust could have occurred if, after November 29, the bank had used for its own benefit money held on trust for trade creditors. The appeal was therefore allowed and a reference directed to determine the amount, if any, appropriated by the bank after November 29, 1990.

This decision, referred to by practitioners as the “Penta Stolp” decision, has been criticized by commentators as allowing banks to induce breaches of trust. One learned author argued that:

The effect of the majority decision in the *Stolp* case is to permit banks and other third parties to actively promote and assist in the transfer of trust monies by trustees to the benefit of those third parties during the course of a construction project, without regard for the fact that those monies are obviously construction trust funds...

The upshot of the Court of Appeal decision is that a bank may effectively induce breaches of the *Construction Lien Act* trust provisions until the breaches are so blatant that the bank must certainly be aware that trust beneficiaries must go unpaid.²³

Arthur Andersen Inc. v. Toronto-Dominion Bank was followed in 1995 in *Alta Surety Co. v. Toronto-Dominion Bank*,²⁴ a case arising out of the same underlying contractual arrangement with the bank. In this case the bank argued that as it had not obtained any benefit from a breach of trust, it could not be liable for the breach. The subcontractors

²³ K. P. McGuinness, *Construction Lien Remedies in Ontario*, 2nd ed. (Scarborough: Carswell, 1997) § 8.109.

²⁴ (1995), 23 C.L.R. (2d) 221 (Ont. Gen. Div.).

argued that the mere fact that the bank had successfully prepared, marketed and sold its “mirror accounting system” was a sufficient benefit to the bank to hold it liable for a breach of trust. The Court found in favor of the bank and sent the case back with a reference to the Master as to the amount to which the plaintiff was entitled.

A series of Manitoba decisions has shed further light on this issue. In *Glenko Enterprises Ltd. v. Ernie Keller Contractors Ltd.*,²⁵ the Manitoba Court of Appeal considered a relatively typical fact situation in which a bank had applied trust funds received by a building contractor to reduce an overdraft. The contractor was involved in two unrelated projects. When funding from the federal government for one of the projects was delayed, the contractor, Keller, required support for its cash flow and the bank increased Keller’s operating line from \$650,000 to \$1.2 million. Keller then used funds received from the second project to cover the deficit in the first project in breach of the statutory trust provisions of s. 4 of the Manitoba *Builders’ Lien Act*, R.S.M. 1987, c.B91. The Manitoba Court of Appeal followed the Ontario Court of Appeal decision in *Arthur Anderson* and the Supreme Court of Canada’s decision in *Troup*. Again, the fact that the customer was a contractor was held only to be relevant to the extent that the bank must be deemed to have been aware at all times that trust funds were being deposited regularly into the account. Furthermore, Keller had run into financial difficulties both because of an unpaid receivable from the first project and an unexpected loss in operations overall. The bank was aware of the first problem but not the second. In order to address the first problem, the bank made extensive inquiries, reinstated monthly financial reporting by the contractor and had scheduled regular meetings with the contractor. The bank took

further security when it restructured the Keller loan. As the bank was not actually aware of the second problem, the unexpected operating loss, the question was whether there existed facts and circumstances which put it on notice to make further inquiries. The Court held that the duty to make inquiries was circumscribed by reasonableness, and that reasonableness was to be determined, among other factors, by the length and nature of the relationship between customer and bank. The evidence established that Keller had been the bank's customer for 25 years. It was very highly regarded as a customer, had been successful and had always paid its trades in the past. There was nothing in Keller's conduct to alert the bank to any problem. Based on these facts, both the trial judge and the Court of Appeal held that the inquiries made by the bank at the time were reasonable and that no further inquiries were required.

Based on *Glenko*, the Manitoba Court of Queen's Bench, in *G.D. Johnson Ltd. v. Royal Bank*,²⁶ asked the following four questions to determine whether or not the defendant bank was liable for participation in a breach of trust:

1. Did the bank know that the monies being deposited by the customer were trust funds subject to statutory trust conditions?
2. Did the bank have actual knowledge of the fact that there were trust beneficiaries whose accounts were unpaid?
3. If the bank did not have actual notice of unpaid trust beneficiaries, did it have knowledge of facts and circumstances sufficient to put it on inquiry? If so, did it make reasonable inquiries?

²⁵ (1996), 27 C.L.R. (2d) 151 (Man. C.A.).

4. Did the bank receive and apply the funds in the ordinary course of business without knowledge of any unusual circumstances?

In *G.D. Johnson*, the customer and its bank had entered into what they called a “revolving demand load agreement”, under which the bank would maintain a balance in the customer’s single account sufficient to cover incoming cheques. As soon as the balance dropped below an agreed level, the bank’s computer system would automatically transfer funds from the revolving credit to top up the balance. The customer came to experience financial problems and the bank asked it to move its account. The customer entered into an agreement with the bank to purchase the bank’s security at a reduced price. In addition, the customer sold some of its equipment and deposited the proceeds into the customer’s account, which thereby showed a positive balance. The bank withdrew the positive balance. The customer’s owner bought out the bank’s security and placed the company into receivership. An unpaid trade sued the bank for breach of trust.

Beard J. held that in order to determine whether the bank had participated in a breach of trust by applying the funds to reduce the overdraft, the question to be asked was not whether the bank had knowledge of the fact that there were trust beneficiaries whose accounts were unpaid, but whether the bank had knowledge of trust beneficiaries whose accounts would not be paid in the ordinary course of business. While the bank had no actual knowledge of unpaid trust beneficiaries, it knew that the customer was in financial difficulties. If it knew that its loans were at risk, it was reasonable to assume that other creditors, i.e. trust beneficiaries like the plaintiff, were at risk as well. The bank also

²⁶ (1997), 33 C.L.R. (2d) 269 (Man. Q.B.).

knew that the customer had slowed in the payment of payables as a form of financing. The bank was therefore put on inquiry. Having been put on a duty of inquiry, the Court considered the following steps in discharging that duty:

1. It met with the customer to discuss cash flow problems;
2. It required a cash injection from the owner of the company;
3. It downgraded the customer's credit rating;
4. It took financial statements from associated corporations to confirm the value of the loan guarantees, and from a prospective purchaser of the company;
5. It made regular visits to the customer's premises;
6. It reviewed in detail the customer's plan to adjust its operations to resolve its financial difficulties;
7. It prepared alternative loan conditions and financial controls to enable it to continue to finance the customer;
8. It notified the customer that it would no longer fund the operations and giving it one month to find alternative financing;
9. It negotiated with the owner of the company to sell the bank's security for the purpose of reducing the bank's exposure;
10. It extended interim credit to fund operations while the "buy out" deal was being implemented;
11. It effected and carrying out the "buy out" agreement;
12. It agreed to the continued operation of the customer's account after the 'buy out' and assignment of security.

The Court held that these were reasonable inquiries and as a result, the bank was held not to have participated in a breach of trust.

In *Buhler Electric Inc. v. North Battleford Knights of Columbus Council 2094 Inc.*,²⁷ a credit union applied a progress advance to the contractor's overdraft. Immediately afterwards, the contractor declared its insolvency and unpaid subcontractors applied for directions as to whether the funds had been improperly applied. Relying on the decisions in *Troup, Arthur Andersen and Glenko*, Krueger J., for the Saskatchewan Court of Queen's Bench, dismissed the application. Interestingly, the Court noted that no liens had been filed. It makes interesting speculation to wonder what the result would have been if there had been registered liens. The account of the contractor was operating as it had in the past, and the credit union's security position had not been eroded. While the subcontractors argued that the fact that the contractor declared its insolvency immediately after the application of the advance was an indication that the credit union had advance knowledge of the situation, Krueger J. held that:

[The contractor] had personally guaranteed the indebtedness of his company to [the credit union]. He would gain by having the overdraft reduced. That is how the situation might have been viewed in retrospect. Yet there was nothing that can be gathered from the events as they took place which could or should have caused [the credit union] to suspect [the contractor] had or was breaching its trust... On the facts of this case, I am satisfied that [the credit union] did not know and could not reasonably be expected to have known

²⁷ (1997), 39 C.L.R. (2d) 196 (Sask. Q.B.).

of the breach. Without knowledge of facts that would have at least caused it to suspect a breach, it could not have participated in the breach of trust.

IV. Knowing Receipt and Knowing Assistance

Two cases decided by the Supreme Court of Canada in 1997, *Gold v. Rosenberg*²⁸ and *Citadel General Assurance Co. v. Lloyds Bank Canada*,²⁹ have 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 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

²⁸ (1997), 152 D.L.R. (4th) 385 (S.C.C.).

²⁹ (1997), 152 D.L.R. (4th) 411 (S.C.C.).

the recipient's part and a lower requirement for proof on the beneficiary's part. Consequently, 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.

The Ontario Court of Justice (General Division) applied *Gold and Citadel in Tampa Hall Ltd. v. Canadian Imperial Bank of Commerce*.³⁰ In this case, on a motion for an order certifying an action as a class proceeding, the statement of claim contained the following passage:

The plaintiff states that as Cadillac's corporate banker, the defendant C.I.B.C. knew, or ought to have known, that Cadillac was engaged I work in the construction industry, that the funds received by Peat Marwick on behalf of the C.I.B.C. were trust funds under the *Construction Lien Act*, that Cadillac was indebted to trade creditors, including the plaintiff, on various construction projects, and that the plaintiff and other trade creditors were therefore beneficiaries of the said trust funds. The plaintiff states that by virtue of the said knowledge of the C.I.B.C., the C.I.B.C. was a trustee of those funds.

Before the Supreme Court decisions discussed had been released, the defendants, based on the Ontario Court of Appeal decision in *Bullock v. Key Property Management Inc.*,³¹ had argued that the law required actual knowledge of the trust's existence and actual knowledge that what was being done was in breach of that trust. After reviewing *Gold and Citadel*, Haines J. held that:

³⁰ (1998), 37 C.L.R. (2d) 274 (Ont. Gen. Div.).

I am satisfied, and the defendants now concede, that the statement of claim does disclose a cause of action on the basis of the principles of law enunciated in *Citadel and Gold*.

Citadel was distinguished in *Transamerica Occidental Life Insurance Co. v. Toronto-Dominion Bank*.³² While this case also dealt with insurance premiums collected by an agent, there was no evidence whatsoever that it had been the intention of the parties to create a trust relationship. Lacking such intention, Sharpe J. found no genuine issue for trial on the assertion of a trust and allowed an application by the bank for summary judgment dismissing the action.

In *Peppiatt v. Nicol*,³³ Nicol sold equity memberships in a planned golf course. Memberships were secured by letters of credit and promissory notes. According to the agreement with the purchasers, the letters of credit would be released if a certain number of memberships were not sold by a certain date. The bank took an assignment of the letters of credit posted and provided the financing on this basis. Nicol began construction but the sale of memberships declined after environmental concerns related to the construction became known. In order to meet the required number of sales by the specified date, Nicol himself bought 92 memberships. Nicol then improperly drew down the letters of credit and applied the funds against the construction loans before being petitioned into bankruptcy. The investors commenced a class proceeding against Nicol and the bank.

³¹ (1997), 33 O.R. (3d) 1 (Ont. C.A.).

³² [1998] O.J. No. 1273 (Ont. Gen. Div.).

Having found that the relationship between the investors and the bank was a trust relationship, the court had to determine whether the bank, as a stranger to the trust, was liable to the investors. In applying the doctrine of knowing receipt to the facts in this case, Chadwick J. held that the bank was aware of the relationship between Nicol and the investors, and it knew that that relationship was one of trust. Although the bank knew that certain conditions had to be met before the letters of credit could be drawn down, it treated those letters of credit as “clean and irrevocable”. Monies received for the membership fees and from the letters of credit were deposited into one blended current account and then transferred by the bank to be applied to the construction loan. The agreement had provided that the membership fees and the letters of credit were to be held until all conditions were satisfied, failing which the investors were entitled to a full refund or return of the promissory note and letter of credit. Chadwick J. held that:

All monies collected from the letters of credit were deposited in the common bank account of the Nicol companies and immediately transferred to the bank for the purpose of paying down the golf course construction loan. Notwithstanding the loan had been for the purpose of constructing the golf course and the monies were applied to that loan, I am satisfied the bank received the trust property for its own benefit and their position was enhanced at the expense of the investors. These facts satisfy the knowing receipt requirement.

With regard to the bank’s degree of knowledge, the court held that the bank was aware of the fact that the letters of credit had to be called down soon or they would

³³ [1998] O.J. No. 3370 (Ont. Gen. Div).

expire. The bank was aware that the letters of credit were subject to conditions, and it was careful not to call down the letters itself and made arrangements to leave that task to Nicol. When assisting Nicol to draw down the letters of credit, it did not make any inquiry as to whether the conditions had been met. It accepted a statement from Nicol and an associate as to the number of sold memberships. A second condition to be met was the availability of the golf course to the members six months after the call-down of the letters of credit. While the bank was aware of the fact that there were serious concerns regarding zoning, it again relied on Nicol's representation that the land was subject to a non-conforming use. While in hindsight, the bank was correct regarding the zoning issue, that was far from clear at the time. Consequently, Chadwick J. found that:

I am satisfied that the bank did not act prudently. They made no inquiries to see if the conditions had been properly satisfied, even though they had been alerted. They did not want to receive any information or legal advice which would impede the call down of the letters of credit and the eventual transfer of the funds to the bank. I am satisfied that the second part of the knowing receipt test has been satisfied. As such the plaintiff investors will also be entitled to a restitutory relief from the bank.

V. Banking Industry's Submissions Regarding Lien Legislation

In light of what has been said up to this point, it is not surprising that the banking industry was very involved in the processes leading up to the implementation of the various Lien Acts. The Canadian Bankers' Association has outlined the concerns of the

financial industry in this area in submissions to the various responsible ministries. In November 1980, the Ontario Ministry of the Attorney General released a Discussion Paper entitled “The Draft Construction Lien Act” and invited comments from individuals, trade associations and labour unions. An advisory committee was established and submitted a report in April 1982, and the *Construction Lien Act* was introduced for first reading in the Ontario Legislature on 8 June 1982. One of the industry groups submitting comments on the proposed legislation was the Canadian Bankers’ Association. On behalf of Canada’s chartered banks, the association expressed its concerns regarding the Act’s priority provisions and trust provisions. In a letter dated September 27, 1982, the Association held that the report mentioned as its guiding principle the minimization of impediments to the flow of construction funds. According to the bankers, it was unlikely to succeed on this point:

Our review of the priority provisions and the trust provisions of Bill 139, however, gives us real concern that their enactment may in fact reduce the funds available to the construction industry to finance its projects.

On the trust provisions in particular, the bankers commented:

As we indicated, we are also concerned about the possible adverse consequences of the enactment of several of the trust provisions in their present form. It appears to us possible that a trust will be imposed by subsection 7(3) on monies in the hands of or to be received by the owner after the certification or declaration of substantial performance, before the owner is under any obligation under the contract to make payment. The effect of this provision may be

to reduce the funds that would otherwise be available to the owner for other business transactions and to make it more difficult for the owner to obtain financing from its bank for other projects. We also envisage difficulties with section 9 which places lenders in the position of having to verify that no unregistered and unexpired liens exist against the proceeds from the sale of a property before accepting such proceeds from a customer in payment of a debt and releasing any collateral securing the debt. As such verification would entail additional administrative work by lenders, it could be expected to result in higher costs which may be passed on to the borrower. Moreover, it may delay the closings of sales of new or recently improved properties.

With regard to section 13 of the Act, the Association argued that it might be possible that a bank officer, a receiver, an agent or consultant of a bank in charge of monitoring the construction customer's affairs on behalf of the bank was deemed, for the purpose of s. 13, to have effective control of the corporation. The bankers argued that it might be necessary to protect themselves with indemnity insurance, the cost of which would have to be carried by the customer. Finally, the Association lamented the removal of the limitation period for breach of trust actions and the resulting removal of an element of certainty for the lending institution when receiving monies impressed with a trust.

The Newfoundland branch of the Bankers' Association submitted comments on proposed changes to that province's *Mechanics' Lien Act* in June, 1985. Holding that "several of the steps taken in Ontario have proven unsatisfactory", greater caution was urged in Newfoundland, where the construction industry was said to rest on less certain

foundations than its counterpart in Ontario. The Association's comments on the proposed trust sections in Newfoundland are based on a review of the trust sections in Ontario:

It is very difficult to evaluate the Ontario trust provisions as very many important issues appear to have been left for determination by the courts. Will the trust remedy be pursued as an alternative or supplement to the claim against statutory holdbacks? Will the judicial tendency to apply the trust provisions even in the absence of a valid lien continue? Will the possibility of dual proceedings bear the risk of enhanced costs? Two other difficult questions which have been frequently before the courts remain unresolved – When are funds “received” by a trustee, as it is clear from the jurisprudence that actual physical possession is not necessary? And when can trust funds be followed into the hands of third parties? The latter matter raises the notable complexity of the remedy of tracing in the law of trusts.

One possible implication of trust provisions, such as those which exist in Ontario, is that banks will unwittingly become implicated in a breach of trust by an owner or contractor. Similarly, if funds in a bank account are impressed with a trust, the bank may lose its common-law right to set-off monies in the account against other debts owed by the customer to the bank. It is clear that if the bank has actual knowledge that funds are trust funds it may attract liability if it deals with the funds in a manner inconsistent with the trust. It is equally clear that a bank's flexibility with respect to set-off is unimpaired if it possesses absolutely no knowledge of the existence of a trust. The difficulty is the potential breadth of the middle-ground which might be characterized as “constructive notice”. Would a bank have to closely scrutinize every disposition of funds which involve improvements to land, even to the point of searching registries for mechanic's lien claims? To avoid such extremes, it would be preferable if any trust provisions to be considered contained an express exemption of lenders from liability as a

constructive trustee (or for waiver of the right of set-off) unless the claimant shows that the bank had actual knowledge of the trust arrangement.

VI. Position of Banks in the United States

For the purposes of this paper, it will suffice to outline the position of banks in the United States by taking a short look at two major jurisdictions, California and New York.

Section 952 of the *California Financial Code*³⁴ provides that:

Notice to any bank of an adverse claim (the person making the adverse claim being hereinafter called “adverse claimant”) to a deposit standing on its books to the credit of or to personal property held for the account of any person shall be disregarded, and the bank, notwithstanding the notice, shall honor the checks, notes, or other instruments requiring payment of money by or for the account of the person to whose credit the account stands and on demand shall deliver that property to, or on the order of, the person for whose account the property is held, without any liability on the part of the bank; subject. However, to the exceptions provided in subdivisions (a) and (b):

- (a) If an adverse claimant delivers to the bank at the office at which the deposit is carried or at which the property is held an affidavit of the adverse claimant stating that of the adverse claimant’s own knowledge the person to whose credit the deposit stands or for whose account the property is held is a fiduciary for the adverse claimant and that

³⁴ West’s Ann.Cal.Fin. Code § 952.

the adverse claimant has reason to believe the fiduciary is about to misappropriate the deposit or the property, and stating the facts on which the claim of fiduciary relationship and the belief are founded, the bank shall refuse payment of the deposit and shall refuse to deliver the property for a period of not more than three court days (including the day of delivery) from the date that the bank received the adverse claimant's affidavit, without liability on its part and without liability for the sufficiency or truth of the facts alleged in the affidavit.

- (b) If at any time, either before, after, or in the absence of the filing of an affidavit by the adverse claimant, the adverse claimant procures and serves upon the bank at the office at which the deposit carried or at which the property is held a restraining order, injunction, or other appropriate order against the bank from a court of competent jurisdiction in an action in which the adverse claimant and all persons in whose names the deposit stands or for whose account the property is held are parties, the bank shall comply with the order or injunction, without liability on its part.
- (c) This section shall be applicable even though the name of the person appearing on the bank's books to whose credit the deposit stands or for whose account the property is held is modified by a qualifying or descriptive term such as "agent", "trustee", or other word or phrase indicating that the person may not be the owner in his or her own right of the deposit or property
- (d) [...]

While California legislators do not seem to give too much weight to the ideal of clarity of the law, this provision allows a bank to disregard adverse claims to accounts unless they are made in one of the two authorized forms.

Section 953 of the *California Financial Code*³⁵ reads as follows:

When the depositor of a commercial or savings account has authorized any person to make withdrawals from the account, the bank, in the absence of written notice otherwise, may assume that any check, receipt, or order of withdrawal drawn by such person in the authorized form or manner, including checks drawn to his personal order and withdrawal orders payable to him personally, was drawn for a purpose authorized by the depositor and within the scope of authority conferred upon such person.

These sections have been interpreted recently in *Chazen v. Centennial Bank*³⁶ to the effect that a bank generally has no duty to monitor trust accounts for breaches of fiduciary duty. In the 1970 Supreme Court of California decision in *Blackmon v. Hale*,³⁷ an action by a client against his attorney and the bank which held a trust account, the Court held that:

The bank is not liable for the misappropriation of trust funds by the trustee, however, unless the bank has the knowledge, actual or constructive, of such misappropriation.

The Court of Appeal, in *Chazen*, held that the *Blackmon dicta* should not be interpreted in a manner that would undermine the statutory principles outlined above:

³⁵ West's Ann.Cal.Fin. Code § 953.

³⁶ 71 Cal.Rptr.2d 462 (Cal.App.1 Dist. 1998).

³⁷ 463 P.2d 418 (Cal.Sup. 1970).

We regard the *dicta* as a prudent judicial qualification, recognizing that banks may in some extreme circumstances engage in wrongdoing affecting a fiduciary account that would merit the imposition of liability.

In a construction case, the California Court of Appeal, Third District, dealt with the degree of knowledge required to put a bank on inquiry. In *Chang v. Redding Bank of Commerce*,³⁸ a general contractor built a hotel for Chang and requested a \$219,000 progress payment to pay subcontractors for work completed on the project, which it deposited into a checking account it had maintained for the last five years. The contractor had borrowed \$500,000 on a promissory note, which was secured by the funds in the checking account, against which the bank could offset the contractor's indebtedness in case of default. When the bank's loan officer received information that the contractor was in financial trouble, that it was filing for bankruptcy and closing shop, the bank immediately declared the note due and setoff its claim against the business account. Checks issued by the general contractor to the subcontractors were returned by the bank. The subcontractors subsequently filed mechanics' liens against the project, which were settled by the owner. The owner, Chang, then commenced an action against the bank for unjust enrichment and imposition of a constructive trust, arguing that the progress payment was paid for the sole benefit of the subcontractors and further arguing that the bank knew or should have known that its client was a general contractor engaged in work in progress and that the progress payment was for the benefit of the subcontractors. Justice Blease held that:

The rule is that when the funds are trust funds and the bank knows or has knowledge of facts sufficient to put it on inquiry that the funds are held by the depositor in trust, the bank may not, as against the beneficiary, apply those funds to the depositor's individual indebtedness to the bank.

On this point, the Court of Appeal relied on the 1935 California Supreme Court decision in *Purdy v. Bank of America National Trust & Savings Association*.³⁹ The bank conceded that it was aware that the client was a general contractor who received funds from owners and subsequently paid subcontractors. Consequently, it had knowledge of the "general purpose" of the funds in the account. The day after the deposit of the progress payment, the bank posted as "paid" a check written by the general contractor to an excavating subcontractor. The day after that, the bank appropriated the funds in the account. The bank was therefore held to have had knowledge of facts which would lead a reasonably intelligent and diligent person to inquire whether the general contractor was acting as a trustee of the funds, but it did not conduct any such inquiry.

The California Court of Appeal in *Chazen*, however, made clear that the *Chang* decision does not imply that the bank may never accept payments from a trust account in satisfaction of the trustee's indebtedness to the bank:

The propriety of such withdrawals from the trust account is governed by Financial Code section 953. The bank acts improperly only when it charges the account to enforce a right of

³⁸ 35 Cal.Rptr.2d 64 (Cal.App.3 Dist. 1994).

³⁹ 40 P.2d 481 (Cal.Sup. 1935).

offset; it is protected under section 953 when it receives funds through the order of the depositor.

As early as 1941, the Court of Appeals of New York, in *Grace v. Corn Exchange Bank Trust Co.*,⁴⁰ held that if a bank has knowledge that an account of a trustee contains trust funds, it participates in the diversion of those funds when it sets off the funds in satisfaction of the trustee's personal indebtedness. In *Gerrity Co. v. Bonacquisty Construction Co.*,⁴¹ the New York Supreme Court, Appellate Division, Third Department, held that if a bank knows that a customer's account was substantially composed of trust funds and also knows that a setoff would substantially deplete the account, the bank can "no longer disavow bad faith due to a lack of knowledge of outstanding trust claims of statutory beneficiaries at the time of setoff". The Court held that:

Under present Lien Law article 3-A, the trust is created when any asset thereof comes into existence, irrespective of whether there was also then existing a beneficiary of the trust, and continues until all claims have been paid or all trust assets have been expended for the purposes of the trust. It follows from the foregoing that [the bank's] status as a good faith purchaser will turn on factors such as its awareness of whether [the bank's customer] used its checking account as the principal, regular repository of Lien Law trust assets, and its knowledge of [the customer's] financial condition at the time of the setoff, i.e., the latter's resources to pay trust claims when due.

⁴⁰ 38 N.E.2d 449 (N.Y.App. 1941).

⁴¹ 525 N.Y.S.2d 926 (A.D. 3 Dept. 1988).