

Construction Bits and Bites

This is the fifth in a series of newsletters entitled "Construction Bits and Bites." The series addresses topics of interest to the construction industry in a short, "bite-sized" format. This newsletter outlines the rights and obligations contained in Part II of the *Construction Lien Act* ("CLA") which gives special treatment to 'trust funds' and can have serious ramifications.

Introduction

All amounts received by an owner, contractor or subcontractor in connection with the making of an improvement are impressed with a trust. Every trust imposes upon the trustee of that trust fund certain obligations in favour of the beneficiaries of the trust. Failure to meet the trust obligations constitutes a breach of trust on the part of the trustee for which the beneficiaries may have redress. Officers, directors, agents and key employees of a corporate trustee may be personally liable for breach of trust, as can other participants in the breach.

Types of Trust Funds

1. Contractor's and Subcontractor's Trust

A contractor is a person hired directly by the owner or the owner's agent. All amounts received by a contractor, or owed to a contractor by the owner, are trust funds for the benefit of the subcontractors and other persons who have supplied services or materials to the improvement and who are owed amounts by the contractor. As the trustee of the trust fund, the contractor cannot appropriate or convert any part of the trust fund to its own use or to a use inconsistent with the trust until the beneficiaries have been paid in full.

A subcontractor is any person that has not contracted directly with the owner or the owner's agent. All amounts received by a subcontractor, or owed to a subcontractor by a contractor or another subcontractor, are trust funds for the benefit of persons who have supplied services or materials to the improvement, and who are owed amounts by the subcontractor. As the trustee of the trust fund, the subcontractor cannot appropriate or convert any part of the trust fund to its own use or to a use inconsistent with the trust until the beneficiaries have been paid in full.

2. Owner's Trust

The owner is a trustee of the following trust funds and the owner cannot appropriate or convert any part of these trust funds to its own use or to a use inconsistent with the trust until the contractor has been paid in full:

- Amounts received by the owner (except the Crown or a municipality) that are to be used in the financing of the improvement;
- Where amounts are payable on the certificate of a payment certifier, an amount equal to the amount so certified, that is in the owner's hands or which is received by the owner thereafter; and
- Where a contract has been certified or declared to be substantially performed, an amount equal to the unpaid price of the substantially performed portion of the contract in the owner's hands or received by the owner thereafter.

An example where rent monies received by an owner/landlord were held to be a trust fund can be found in the case of *Structural Contractors Ltd. v. Westcola Holdings Inc.* The Court of Appeal confirmed that, where a contract has been certified as substantially performed, rent received by the owner thereafter is a trust fund for the benefit of the contractor.

3. Vendor's Trust

If an owner sells the improved premises, the net proceeds of sale constitute a trust fund, which cannot be appropriated by the former owner or used for any other purposes until the contractor has been paid all amounts relating to the improvement.

Proving Breach of Trust

In a claim for breach of trust, the initial onus is on the claimant to prove the existence of the trust by demonstrating that the defendant received money on account of the project to which the claimant supplied services or materials for which payment was not received. Then, the onus shifts to the defendant to show that it complied with the trust provisions of the *CLA*.

The defendant is only permitted to make payment from the trust fund to persons who supplied services or materials to the improvement. The issue of whether general overhead costs could be paid from progress draws was put to rest with the Court of Appeal decision in *Rudco Insulation Ltd. v. Toronto Sanitary Inc.* Expenses, such as payroll, insurance, rent, membership fees, interest payments on loans, legal and accounting fees, advertising,

promotion, etc., if paid from the trust funds, are improper and constitute a breach of the trust. The *CLA* creates a separate trust fund for each project and contemplates separate accounting for each trust fund. Co-mingling of trust funds with non-trust funds is not prohibited by the *CLA*. However, failure to maintain separate accounting for each trust fund will make it difficult to defend an action for breach of trust.

Liability of Persons Other than Trustee

Every director or officer and any person (including an employee or agent), 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 have known amounts to a breach of trust by the corporation is also personally liable for the breach of trust. If the corporation commits a breach of trust and the principals knew or ought to have known of the relevant factual elements of the corporation's conduct, then the requirements under the *CLA* are met and the individual is liable.

Other 'participants' in a breach of trust may also be liable for knowingly receiving trust funds or knowingly assisting the breach. In *Arthur Andersen Inc. v. Toronto-Dominion Bank et al*, the bank was made to disgorge amounts it had taken from its customer's accounts in order to reduce the customer's indebtedness to the bank because the money was taken in circumstance where the bank knew or ought to have known doing so would leave trade beneficiaries unpaid.

Right to Information

The *CLA* provides a mechanism by which the information necessary to determine whether a breach of trust may have occurred can be obtained. Section 39 of the *CLA* enables beneficiaries of a trust, to make written demand for useful information, including the state of accounts on a contract or subcontract, from other persons involved in the project.

Breach of Trust and Bankruptcy

Historically, the *CLA* and the *Bankruptcy and Insolvency Act* ("*BIA*") have not been happy bed fellows. Recently, the two pieces of legislation have collided more than usual.

In the Ontario decision of *Royal Bank of Canada v. Atlas Block Co. Limited*, the Receiver of *Atlas Block*, applied for directions as to whether a supplier of materials incorporated into *Atlas Block's* manufactured products, had a trust claim under section 8 of the *CLA*. Paragraph 67(1)(a) of the *BIA* excludes from the estate property divisible among the creditors of the bankrupt "any property held by the bankrupt in trust for any other person." In *Atlas Block*, the Court held that for the provincial deemed trust under the *CLA* to be valid, it must also have the attributes of a valid trust at common law. These attributes are certainty of intention, certainty of object and certainty of subject matter. Any trust funds which *Atlas Block* may have received were co-mingled with other funds, which were not subject to a trust. Because it was no longer possible to identify the trust fund, the court found that the test for certainty of subject matter was not met.

The priority between the trust provisions of Alberta's *Builders' Lien Act*, and the *BIA*, came before the courts in *Re. Iona Contractors Ltd*. The contractor, *Iona*, went bankrupt, the Surety paid its subcontractors and claimed entitlement to the trust funds from the project. The lower court held that the trust funds formed part of the bankrupt's estate. However, the Alberta Court of Appeal reversed the decision and found that a valid provincial trust existed and, therefore, the Surety, who was subrogated to the rights of the subcontractor beneficiaries was entitled to the trust funds. Leave to appeal sought by the Trustee to the Supreme Court of Canada was denied on April 14, 2016, thereby upholding the reasoning in the Alberta Court of Appeal and making it the last appellate word on the subject.

Pallett Valo LLP Construction Practice

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