

## **Breach of Trust Claims**

Breach of trust claims are often overlooked by contractors and their lawyers. A breach of trust claim has several advantages over a breach of contract claim and even a lien claim.

A breach of trust claim often allows you to sue an individual, rather than a company which may be insolvent. A breach of trust claim gives you the status of a secured creditor, should the defendant go bankrupt. By proving a breach of trust, you also have rights to trace the trust funds into other property that was purchased with trust funds. You also have more time to bring a breach of trust claim than the many short deadlines present in lien claims.

In recent years the courts have broadly interpreted the trust provisions in the Act.

As an example, in Structural Contractors Ltd. v. West Cola Holdings Inc. (2000) 48 O.R. (3d) 417 (C.A.), the Ontario Court of Appeal dealt with renovations to an underground parking garage of a commercial building.

The Court held that the rents received by the owner of the building were trust funds under Sections 7 (3) and 7 (4) of the Act. It was no defence that the rent money was used to pay the operating expenses of the building. The Court stated that the trust obligation was not limited to the profit component of the rental payments. Other cases have held that contractors are not entitled to pay overhead from trust funds at the expense of subcontractors (Section 8 of the Act). The Court of Appeal also held the sole officer and controlling mind of the corporate owner, personally liable. His evidence was that he was not aware that the rent payments received by his company might be viewed as trust funds or that the payment of overhead expenses could constitute a breach of trust. The Court of Appeal indicated that the test is an objective one and as the sole officer, director, controlling mind and person

who signed all the cheques ought to have known the payments of overhead expenses amounted to a breach of trust.

Some contractors have tried to stretch the trust provisions even further. One example is the case of Elmford Construction Company Ltd. v. South Winston Properties Inc. (1999) 45 O.R. 3<sup>rd</sup> (588) a decision of Justice Dunnet of the Superior Court of Justice. In that case, the contractor brought a breach of trust claim against the Town of Oakville and the Bank of Nova Scotia. The developer South Winston Properties had defaulted in its obligations under a subdivision agreement and the Town of Oakville drew on a letter of credit to pay contractors to complete work on the project. There were further funds that remained to be drawn upon. As well, the bank had realized on its security in the property after the developer defaulted and its obligation is to the bank.

In any breach of trust claim, the recent decision of the Supreme Court of Canada in Soulos v. Korkontzilas (1997) 32 O.R. (3<sup>rd</sup>) 716 should be considered. That case expanded the notion of constructive trusts by holding that a constructive trust may be imposed where there has been a breach of a fiduciary obligation, even if the defendant was not enriched by his breach of duty.

## TRUST CLAIMS

The trust provisions are found in part two of the Act.

1. The trust claim is an additional remedy to the lien on the land and the charge on the holdbacks.

*A trade can rely on his trust claims and his lien claim and pursue them both. The only limit obviously is that one can recover no more than what one is owed.*

1. When does the trust remedy arise?

*The trust provisions do not apply if the project does not come within the definition of "improvement" as defined in the Construction Lien Act. For example, the supply of portable school rooms, machinery in a factory that is not permanently affixed to the building or to the Crown or a municipality as owner. See section 7(1). But in a project where the Crown or municipality is the owner, the general contractor and subcontractor still have trust obligations. As well, if the Crown of*

*municipality sells the land, it has the usual trust obligation under section*

*9. Some cases however, have been very liberal and allowed a supplier of materials, who supplies on credit in the usual course of business, and to its customers' premises rather than to the site, and without a specific project in mind, still has a trust claim. A trade can rely on his trust claim and his lien claim and pursue them both. The only limit obviously is that one can only recover no more than what one is owed. See for example Maple Leaf Homes vs. Zoellner Windows, Steeplejack Services Ltd. vs. Stow Nut & Bolt Co. and re Richmond Brothers Insulation Inc. for examples where a supplier was entitled to the trust remedy even when he did not know the improvement to which his materials were intended or were used.*

*As another example, even though an architect was not until recently, entitled to the benefit of a lien, they were entitled to trust rights, at least as long as they supply services to an improvement. Also, the trust obligations will apply to contractors and subcontractors even where the owner is exempt from the Construction Lien Act - for example where improvement is made on an Indian reserve, a railway, highway, etc.*

2. There are several trust funds or trust claims on each project. - Sections 7, 8 and 9

*Each trust obligation imposed by the Act creates a separate trust that arises and exists independently of the others. Section 7 isolates certain monies in the hands of an owner and impresses them with the trust. Then as the owner pays that money down to the contractor, section 8 creates new trust obligations upon the contractor, and so on as the money is paid down the pyramid.*

3. The trust claim is a personal action which should not be joined with the lien claim - Section 50(2).

*However, when you analyze section 85 (1) of the Act, it makes sense when there are several trust claimants competing against the same fund, to consolidate trust claims with lien claims, or postpone the resolution of the trust action until the lien claims are resolved, because priority is given to those trust claimants who have proven liens. Given the requirements of section 85 (10 and 53 (1), one could argue that section 50 (2) deals with trust claims against a person other than the payer with whom the trust/lien claimant has privity of contract or to those trust claims involving some element of tracing which are not part of the enforcement of the typical claim for lien. Alternatively, you could have the 2 actions tried one after the other with trust action trial coming last.*

*There are no special time limits for trust claims under the Act - the ordinary limitation periods found in the Limitations Act of Ontario apply, as does the equitable doctrine of Laches.*

4. The trust provisions attempt to ensure that subcontractors and suppliers are paid in full, partly by insulating those funds from claims by other creditors of the trustee.

*Section 67 of the Bankruptcy and Insolvency Act provides that the property of a bankrupt does not include “property held by the bankrupt in trust for any other person”. On the right facts, a trust claimant can trace trust funds that have been applied contrary to the Construction Lien Act, into property acquired with those funds - see Clarkson Co. v. CIBC (1996) 57 D.L.R. (2<sup>nd</sup>) 193 (SCC). Trust beneficiaries have priority over most government claims, except the Minister of National Revenue if it issues a demand under section 224 of the Income Tax Act.*

*The trust rights of trust beneficiaries take priority over the rights of a receiver under an assignment of accounts - see Guaranty Trust of Canada vs. Beaumont [1967] 1 O.R 479 (CA).*

5. A payer/trustee is only liable for the greater of its trust obligations or its holdback obligations. These obligations would be owed to 2 different persons.
  
6. The 3 types of trusts:
  - owner's trust Section 7
  - contractor's trust Section 81

- subcontractor's trust Section 9(1)

*Although some people believe that a person who supplies materials only is not subject to any trust obligations, that is incorrect. The term "materialman" is not a defined term under the Act. A materialman can be a contractor or subcontractor, depending upon whether he supplies his materials to the owner or to a contractor. A materialman is then subject to the same trust obligations as any other contractor or subcontractor.*

*Unlike the owners' trusts, the trust imposed on the contractor or subcontractor only extends to monies received by it or owing to it, rather than to its own general funds.*

7. The 4 trust obligations imposed upon an owner:

- the financing money, trust and the purchase money trust  
Section 7(1)
- the funds certified trust Section 7(2) and 7(3)
- the substantial performance trust Section 7(3)
- the vendor's trust Section 9(1)

*The trust under section 7(1) of the Act does not extend to money borrowed by an owner for general business purposes, for example an ongoing line of credit, and it does not extend to the general funds of the owner. The trust in section 7(2) only applies on projects where there is a payment certifier. Once funds are certified as payable to a contractor, then that amount becomes a trust fund even against the*

owner's general funds. Under subsection 7(3), once substantial performance has been certified, that amount equal to the unpaid price of the substantially performed portion of the contract becomes trust funds.

The case of Andrea Schmidt Construction Ltd. vs. Glatt (1980) 28 O.R. 2nd 672(CA), held that the trust obligation on an owner applies whether any money is then due and payable to the contractor or not.

Section 9 is directed primarily to residential home construction market where it is common for a builder to finance construction of a subdivision through a blanket mortgage.

8. Privity of contract is required for a trust claim. E. Stephens Associates vs. G. L. Trenching (1989) 40 CLR 161 (Ont. H.C.) I refer you to the wording of subsections 7(4), 8(2), 9(2) and 10. But see Don Park Inc. v. S.E. Mechanical (1998) 43 C.L.R. (2d) 7 (C.A.).

*However, a trustee does have a holdback obligation to those down the rung.*

9. Exceptions to the trust provisions:
  - (a) Section 10 - payments on account
  - (b) Section 11(1) and 11(2) - reimbursing non-trust funds

*Section 11(2) can be used in a manner contrary to the assumed intention of the Act. If a contractor borrows money and uses that money to pay one of his subcontractors on project A, and then the contractor receives funds from the owner on project B, he can use those funds to pay off the bank instead of paying his other subcontractors from project A.*

*A case decided last year is a good example of how far the courts might go. Construct Ltd. was a residential builder. St. Mary's Cement supplied concrete to Construc for various projects. Construc went out of business. St. Mary's Cement sued Construc and its principal officer, a Mr. Guido, Paniccia.*

*The evidence at trial showed that Construc received payments from various owners on several projects and mixed these payments in its bank accounts. It did not keep a separate account for each project. Construc could therefore not show that the funds received on any particular project from the owner were used only to pay the trades on that project. The Court found Construc to be in breach of trust.*

*On one of the projects reviewed by the Court, Construc proved that it received \$90,000.00 from the owner and that a total of \$83, 325.81 was paid out by Construc to suppliers and trades on that project. One would think, therefore, that Construc would only be liable for breach of trust to the extent of \$7,000.00 relating to that project. However,*

*Construc could not prove that the \$90,000.00 in payments received from the owner on that project was the exact money that was used up to pay the \$83, 326.00 in trade payments. The Court therefore, concluded that there was no evidence that the funds received from the owner had been used to pay the beneficiaries of the trust on that project.*

*But then Construc and Mr. Paniccia argued that Construc was entitled to set off under Section 11 (1) of the Act, the \$83,000.00 it paid to the trades on the project.*

*Section 11 (1) states:*

*...a trustee who pays for the supply of services or materials to an improvement out of money that is not subject to a trust, may retain from trust funds an amount equal to that paid.*

*However, the Court rejected that defence as well and held that Construc could not prove that the \$83,000.00 it paid to trades on the project had not come from payments from owners on other projects.*

*Those payments would be subject to trusts relating to those projects.*

*Even though there were no subtrades from those other projects before the Court, or other evidence that there were any unpaid subtrades on those projects, the Court nevertheless, concluded that there had been a breach of trust. The decision was appealed, but the appeal was abandoned.*

- (c) Section 12 - set-off against the party who supplied the services or materials.

*The key word in Section 12 is “retain”. Several cases have held that a trustee is only entitled to retain the trust funds by way of set-off, he cannot spend those funds. For example, if a contractor feels that one of its subcontractors did work poorly and damages resulted and the contractor has a good claim for deficiencies, the contractor cannot simply pay the subcontractor the difference and then expend the amount he is setting-off. He must retain those trust funds until the Court rules on his right of set-off.*

*In the Datasphere case, Justice Koo held that the trust funds alleged to be subject to set-off had to be either physically isolated (in a separate account) or paid into Court, pending a final determination of the claim for set-off.*

Datasphere Sales Ltd. vs Universal Light & Power Corp. (1991) 48 CLR 25 (Ont. GD)

Arborform Countertops Inc. vs. Stellato (1996) 29 OR (3d) 129 (GD)

St. Mary's Cement Corp. v. Construc Ltd. (1997) 32 O.R. 3<sup>rd</sup> 595  
Madame Justice Malloy

## 10. Problems

(a) *The Construction Lien Act does not state how conflicts among the Construction Lien trusts themselves should be resolved.*

(b) *The Act does not state how conflicts between the Construction Lien Act trusts and the Common Law trusts are to be resolved.*

(c) *Many people believe that an owner cannot "rob Peter to pay Paul", or in other words, use funds borrowed for project A to pay the general contractor on project B. However, the Act arguably allows that, given the wording of subsection 7(2) and 7(3), those section constitute any money in the owner's hands as trust funds, whether they arise from financing provided on another project or otherwise.*

(d) *The various trust provisions can work to impress with a trust more monies than are actually owed by the owner to the contractor. (Page 33 McGuinnes article). A trustee can easily end up in a situation with a trust deficiency even if he is not committed a breach of trust, i.e. all payments he has made are expressly contemplated by the Act. (see McGuinnes page 29).*

11. If you are or may be in receipt of trust funds, and you are not sure how to proceed, the safest thing is to apply to Court under Section 66 of the Act for directions.

## 12. Scheme of Priority on Insolvency of trustee - s. 85

*(a) If there are trust claimants who have proven a lien and those who have not, those who have proven a lien have priority.*

*(b) Amongst those who have proven a lien, the priority of their trust claim is the same as the priority of their lien claim - those furthest down the pyramid come first.*

*(c) For those who have not proven liens, priority is determined amongst them on the same basis as if they had valid liens.*

13. Pro-rata payments are not required unless the payer is insolvent -  
Sections 10 and 85

*Although there is a general rule of equity that requires a trustee to deal impartially between all beneficiaries of the trust, this rule is impractical to apply in the construction context. For example, on a subdivision project, you would not expect the builder to wait until the project is finished and then make ratable payments to all trades. The*

*builder pays those who work on the project first. As well, individual contracts may differ - one subcontract may provide for payments on a house by house basis or monthly basis, whereas other contracts may provide for single lump sum payment upon final completion.*

*However, payments made by a trustee which constitute a fraudulent preferences under the Fraudulent Preferences Act of Ontario, can be challenged under that legislation.*

14. Payment of overhead expenses from trust fund is not allowed. See Heritage Masonry vs. The Building Team Ltd. et al (1995) 28 C.L.R. (2d) 101 (OCGD). Dietrich Steel v. Sharp Contracting (1992) 42 O.R. (3d) 749 (C.A) and Structural Contractors Ltd. v. West Cola Holdings Inc. (2000) 48 O.R. (3d) 417 (C.A).

*Until a few years ago, the Courts were fairly lenient and allowed contractors to set-off overhead expenses from trust funds. Within the last three to five years, the trend has been in the opposite direction. As examples, recent Court Decisions have held a general contractor to be in breach of trust for attempting to pay the following types of expense with trust funds, before ensuring that all subcontractors were paid in full:*

- *the portion of its head office rent that could be attributable to the project in question;*

S *leasing charges for vehicles used on the project;*

S *site telephone charges;*

S *hotel bills for its employees while on the job;*

S *bonuses to employees;*

S *wages to employees;*

S *liability insurance premiums;*

S *legal fees to contest lien claims;*

S *loan interest charges and service charges on its construction financing.*

16. Persons who can be liable for breach of trust.

(a) Statutory trustees - Sections 7, 8 and 9 -  
(owners, GC & SC)

(b) Directors and officers - Section 13(1)(a)

(c) Any other persons - Section 13(1)(b)

(d) Banks and mortgagees at common-law

*The persons listed in section 13 of the Act will be liable for breach of trust, even if they did not convert the trust funds for their own use or did not otherwise benefit from the breach of trust. Also, it is not necessary to show that a director or officer had effective control of the corporation to make him liable. However, a finding of breach of trust by the corporation is a prerequisite any finding of liability against a director, officer or person in control. Additionally, a corporation can still be liable for breach of trust even though none of those persons in effective control is so liable. Although it is necessary to prove breach of trust by the corporation to recover against a director or officer, it is not necessary to bring an action against the corporation for breach of trust.*

*A director, officer or other controlling mind of the Company will be liable*

*for the breach of trust by his Company if he knew or ought to have known*

*of the conduct by the Company which constituted the breach of trust and he assented to the conduct, or acquiesced in it. He need not know as a matter of law that that conduct amounts to breach of trust.*

*A trustee in bankruptcy can be found personally liable for breach of trust*

*as being a person with effective control of a construction firm in bankruptcy, if it assented to or acquiesced in the breach of trust.*

*Under general principles of trust law, a person other than a trustee who knows, or reasonably ought to know of the existence of a trust and who deals with trust property in a manner inconsistent with that trust, will be held to be a constructive trustee and liable for that breach of trust to the trust beneficiaries. This principle has been applied to banks, usually where a bank has used trust monies to repay a loan it made for a purpose unrelated to the trust. Banks have also been held liable even where they do not pay themselves but pay some third party with the trust funds. Most cases have held that where a bank receives funds in the ordinary course of business from its customer and applies those funds to reduce an overdraft or pay down a loan, or any other use inconsistent with the customer's trust obligations, the bank will not*

*be liable unless there were unusual circumstances that should have put it on notice as to a possible breach of trust.*

*One common situation where a bank can be held liable for a breach of trust is when it takes monies from a general contractor's account that are trust funds. If the bank knows the contractor is in financial difficulties, knows that the subcontractors have not been paid in full and the bank knew, or ought to have known, that the contractor could not pay the subcontractors in full without funds in question, the bank will probably be held liable. I refer you to a case called Canadian Pittsburgh Industries v. Bank of Nova Scotia.*

*A bank has also been found liable when it accepts a cheque from a contractor to pay down his bank loan. The bank will be held liable where it has actual knowledge, or is reckless or willfully blind, as to both the existence of a trust on those funds and the dishonest intent of the contractor in using trust funds contrary to the Act. To prove willful blindness, you must prove the bank actually suspected the funds were trust funds that were being used in breach of trust. A failure to make reasonable inquiries on these two issues is not enough, unless there is already present a suspicion that that is the case.*

16. Practical considerations

*The Construction Lien Act does not actually require a trustee to keep a separate trust account for each contract, even though some cases have held this or suggested it as prudent practice. The reality is that it is practically impossible for a general contractor to keep separate account for each project. The onus is on the plaintiff to prove a breach of trust claim by proving:*

- (a) the funds in question were held in trust for his benefit;*
- (b) the funds have been put to an unauthorized purpose; and*
- (c) the purported trustee is a person properly liable to account for the misapplication of those funds to this plaintiff.*

*There are several rights of setoff in the Act that a trustee may rely upon. However, a trustee cannot rely upon these rights of setoff if he has paid the money down the chain.*

17. The right to information - Section 39(1)
  
18. Criminal breach of trust - Sections 283 and 336 of the Criminal Code.