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THE TRUST FUND PROVISION OF THE MECHANICS' LIEN ACT

J. W. MIK*

Introduction

After a decade of obscurity, the trust fund provision of The Mechanics' Lien Act¹ has in recent years increasingly become a subject of litigation. Its current prominence before the courts is testimony to the popularity of this sweeping and flexible remedy as well as to the difficulty inherent in applying the trust concept in the variety and complexity of commercial transactions. Broadly, the cases fall into two categories: first, dealing with the situation where the contractor has made an assignment of the moneys he is to receive under the contract, and; secondly, where the contractor has paid those moneys into his overdrawn bank account.

In considering the first situation, the Courts have applied the rule *nemo plus juris ad alium transferre potest quam ipse habet*

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¹ R.S.O. 1960, c. 233, s. 3 (1) All sums received by a builder or contractor or a subcontractor on account of the contract price are and constitute a trust fund in the hands of the builder or contractor, or of the subcontractor, as the case may be, for the benefit of the proprietor, builder, or contractor, subcontractors, Workmen's Compensation Board, workmen and persons who have supplied material on account of the contract, and the builder or contractor or the subcontractor, as the case may be, is the trustee of all such sums so received by him, and until all workmen and all persons who have supplied material on the contract and all subcontractors are paid for work done or material supplied on the contract and the Workmen's Compensation Board is paid any assessment with respect thereto, may not appropriate or convert any part thereof to his own use or to any use not authorized by the trust. (This provision first made its appearance in 1942, c. 34, s. 21.)

(2) Every builder, contractor or subcontractor who appropriates or converts any part of the contract price referred to in subsection 1 to his own use or to any use not authorized by the trust is guilty of an offence and on summary conviction is liable to a fine of not more than \$5,000 or to imprisonment for a term of not more than two years or both, and every director or officer of a corporation who knowingly assents to or acquiesces in any such offence by the corporation is guilty of such offence in addition to the corporation.

(3) Notwithstanding the other provisions of this section, where a builder, contractor or subcontractor has paid in whole or part for any materials supplied on account of the contract, or any workman or subcontractor who has performed any work or services or placed or furnished any material in respect of such contract, the retention by such builder, contractor or subcontractor of any amount so paid by him shall not be deemed an appropriation or conversion thereof to his own use or any use not authorized by the trust. (This provision was added to the Act in 1952, c. 54, s. 1.)

See also the Mechanics' Lien Act of British Columbia (s. 3), New Brunswick (s. 2A), and the Manitoba Builders and Workmen Act (s. 3).

and held that the fund remains subject to the trust: lack of knowledge on the part of the assignee of the breach of trust is not material in the face of the rule that assignments are subject to equities. The question of how much knowledge is necessary to constitute participation in a breach of trust and what is the nature of the trust created by s. 3 of The Mechanics' Lien Act arises with full force where the contractor, who is operating a current account at an overdraft, receives payment on the construction project and, without paying his sub-contractors, suppliers or workmen, deposits the money at the bank, which applies it against the overdraft. Federal banking legislation providing that a bank is not obliged to see to the execution of a trust has not proven to be a decisive factor in the solution of this particular problem, which has fallen to be decided by the common law. The general principle arrived at by the courts is that where money is paid into a bank account in the ordinary course of business, in a banker-customer relationship, the bank, in the absence of knowledge of the breach of trust, takes free of the trust.

Several incidental problems such as the independence of this remedy from the other provisions of The Mechanics' Lien Act, the apportionment of trust funds, at what point of time the trust arises, and to what moneys the trust will attach, have also been the subject of judicial consideration. Surprisingly, the consideration devoted to the nature of the trust created by the Act has been in inverse proportion to the prolific litigation, and, apart from some *dicta* in a few cases, the courts have contented themselves with the mechanical application of the rules stated above. The question whether the trust created by s. 3 is a statutory trust or a creature of equity—assuming that there is a distinction between the two—remains to be canvassed by the courts. If a claimant under s. 3 has a right to all the benefits and protection which courts of equity have traditionally accorded to the *cestui que trust*, and the contractor is subject to all the duties of the traditional trustee in his dealing with moneys received on a construction contract, the consequences will be far reaching indeed.

An attempt will be made through a consideration of the individual problems raised in the reported cases to analyze some of the salient features of the trust created by The Mechanics' Lien Act and their consequences.

Assignments of Moneys Due Under a Contract

In *Minneapolis-Honeywell Ltd. v. Empire Brass Mfg. Co. Ltd.*² I & R had obtained a subcontract to install heating plants in four schools for which M-H supplied the automatic heating controls. E was I & R's principal supplier on this and other contracts and had obtained from them an assignment of all present and future book accounts as security for an indebtedness of \$20,000. Notice of the assignment was given to the general contractor and subsequent pay-

² [1955] S.C.R. 694, 3 D.L.R. 561. See also, Maxwell Bruce, Case and Comment (1956), 34 Can. Bar Rev. 855.

ments were made by cheque payable to I & R and E jointly. The practice was for the parties to decide together what accounts of I & R should be paid, and then the surplus was applied against the indebtedness to E. M-H, who had not been paid, lost its right to a lien by failure to file a claim within the prescribed time, but, when I & R went into liquidation asserted that the moneys received by E under the assignment were trust funds by virtue of s. 19 of the British Columbia Mechanics' Lien Act³ and claimed an accounting. The appellant was successful at trial⁴ but the decision was reversed on appeal.⁵ O'Halloran and Sidney Smith J.J.A. held that any rights which s. 19 purported to give could be invoked only by a person who was at the time of the institution of the action entitled to a lien upon the property in respect of which the work had been done or the materials supplied.⁶ The Supreme Court of Canada⁷ was unanimous in holding that the rights created by s. 19 were independent of the right to a lien under the Act.⁸ Speaking for the majority Rand J. stated that by dint of s. 19 "the contractor and subcontractor are made trustees of the contract moneys and the trust continues while employees, materialmen or others remain unpaid".⁹ The appellants were, therefore, *cestuis que trustent* of the moneys received by the subcontractor. E, as assignee of the moneys from I & R, acted through the right and power of the assignor and must either see to the satisfaction of the rights under the trust or run the peril of participating in a breach of it. "If this were not so, the entire purpose of the section could be nullified by an assignment contemporaneous with the contract".¹⁰ Locke J. dissented on the grounds that the trust attached only to moneys actually received by the subcontractor, but because of the assignment, the moneys did not come into his hands. Rand J., however, declared:

I cannot interpret the word "received" in s. 19 as not including money paid to an assignee. The money "received" on account of the contract is the same as that paid by the contractor: payment the correlative of receipt. The assignee acts through the right and power of the assignor; and the receipt by him is likewise that by the creditor.¹¹

In the Supreme Court of Ontario, LeBel J. independently and contemporaneously arrived at the same conclusion. In *Bank of Mont-*

³ R.S.B.C. 1948, c. 205.

⁴ [1954] 1 D.L.R. 678, 11 W.W.R. (N.S.) 212 (B.C. S.C.).

⁵ [1954] 4 D.L.R. 800, 13 W.W.R. (N.S.) 449 (B.C. C.A.).

⁶ 13 W.W.R. 449, at pp. 453, 464.

⁷ *Supra*, footnote 2.

⁸ [1955] S.C.R. 694, at p. 703 per Locke J. "I find no ambiguity in the language of s. 19 and, while the adding of this additional protection for the interests of labourers and materialmen may create difficulties for contractors seeking credit, as pointed out by Richards J.A. in *Castelein v. Boux* (at p. 106) and while the section lacks any direction as to the manner in which the trust fund declared is to be apportioned among those entitled, these considerations do not, in my opinion, afford any sufficient reason for failing to give effect to the plain meaning of the language employed or to read into the section a provision that the rights given may be exercised only by those who then have a right to a lien upon the work."

⁹ *Ibid.*, at p. 696.

¹⁰ *Ibid.*, at p. 697. Followed in *Royal Bank of Canada v. Blick* (1963), 39 D.L.R. (2d) 36 (Man. C.A.).

¹¹ *Ibid.*

real v. Township of Sidney,¹² a contractor who had made an assignment in favour of the bank prior to entering into a contract with a municipality to construct a drain, became bankrupt before completion of the work, and was indebted to the bank as well as to subcontractors. The municipality having paid the holdback into the court, the bank asserted priority over the subcontractors on the basis that it took its assignment for valuable consideration without notice of any claim against the contractor.¹³ The learned trial judge found the bank's contention startling since if it were given effect to, claims for liens could be defeated by the simple expedient of the contractor assigning the moneys payable to him under his contract before the first lien arose. LeBel J. considered the various safeguards for subcontractors, workmen and suppliers created by The Mechanics' Lien Act¹⁴ and observed that:

As a further safeguard for the benefit of those the Act is designed to protect, all moneys received by the contractor from the person primarily liable are, by s. 3, expressly said to be and to constitute a trust fund in his hands for the benefit of those other persons. Until those persons have been paid, he must not appropriate or convert any part of it to his own use or any use not authorized by the trust.¹⁵

The trial judge concluded:

It is unnecessary to consider whether the assignment to the Bank amounted to an appropriation or conversion in this case, because it is plain that any sum received by a builder or contractor on account of the contract price does not become his property "until all workmen and all persons who have supplied material on the contract and all subcontractors are paid for work done or materials supplied on the contract". An assignor may not give his assignee a better title to property than he has himself.¹⁶

Litigation has continued over the meaning of the phrase "all sums received by a builder or contractor or a subcontractor on account of the contract price". In *Royal Bank of Canada v. Blick, Wilson et al.*,¹⁷ the subcontractor had failed to complete a contract for R, which was itself a subcontractor, on a building project for the University of Manitoba. Before entering into the contract, R had obtained from another party, B, a collateral guarantee of performance of the contract and now required him to complete it. When, on completion of the project, R received payment, there arose a competition between the bank, claiming through an assignment of book debts from the subcontractor, the workmen of the subcontractor, who relied on s. 3 of the Builders and Workmen Act,¹⁸ and B who claimed to be subrogated to the rights of R. R paid the balance of the money into court. Freedman J.A. stated that the rights and obligations

¹² [1955] O.W.N. 581 (Ont. H.C.).

¹³ LeBel J. pointed out that the bank could not have had notice of a lien before such lien arose, but it did know that its assignment was of moneys payable under a building contract for the construction of a municipal drain: mechanics' liens were thus a definite possibility.

¹⁴ R.S.O. 1950, c. 227.

¹⁵ *Supra*, footnote 12, at p. 583.

¹⁶ *Ibid.*, at p. 584.

¹⁷ (1963), 39 D.L.R. (2d) 36 (Man. C.A.).

¹⁸ R.S.M. 1954, c. 28.

arising under s. 3 are referable only to the specific contract affecting the parties.¹⁹ The workmen claiming under s. 3 were not parties to a contract with R. The obligations of the subcontractor under s. 3 would not arise until moneys were in fact "received" by the subcontractor. The subcontractor, by his abandonment of the contract prior to completion, was precluded from claiming the trust money held by R to the extent necessary to complete the contract.²⁰ The cost of completion was deducted before arriving at the amount payable to the subcontractor and B could claim this deduction by subrogation to R's rights. The surplus was distributed among claimants under s. 3 in priority to the bank.

Where money is paid into court by an owner and there are conflicting claims against the funds by a judgment creditor of the contractor and suppliers and workmen who rely on the trust fund provision of the Act, the money is "received" on account of the contract price and is subject to the trust.²¹ There is no difference in substance between the owner paying the money into court by agreement with the contractor and then the judgment creditor obtaining an order for payment out to him of the money in court, and on the other hand the contractor assigning the money to his judgment creditor and the owner then paying the money to the judgment creditor direct.²² Where, however, the money has not been paid into court and the judgment creditor obtains a garnishment order against the money owed by the owner on the contract, the trust does not arise in favour of the suppliers and workmen of the contractor because it is not money which has been "received" by him on account of the contract price.²³

It would . . . be most unreasonable and oppressive, as well as contrary to the usual notions of a trust, to make the contractor a trustee of the contract price before he has received it, and no less unreasonable and oppressive to make the owner a trustee of the contract price for the bare reason that he owed it.²⁴

¹⁹ *Supra*, footnote 17, at p. 40.

²⁰ *Len Ariss & Co. v. Peloso et al.*, [1958] O.R. 643, 14 D.L.R. (2d) 178 (Ont. C.A.).

²¹ *Re Watson and Murchison* (1963), 40 D.L.R. (2d) 1047 (B.C. S.C.); *Edwards Welding Limited v. Howe & Wilson Construction Limited* (1959), 27 W.W.R. 689 (B.C. Cty. Ct.).

²² *Re Watson and Murchison*, *supra*, footnote 21, at p. 1054, *per* Atkins J.

²³ *Castelein v. Boux* (1934), 42 Man. R. 97, 3 D.L.R. 351 (Man. C.A.).

²⁴ *Ibid.*, D.L.R. at p. 352 *per* Prendergast C.J.M. In a dissenting judgment Dennistoun J.A., concurring with Robson J.A., stated: "The moment the defendant [the contractor] stretches out his hand to touch these moneys and exercise an act of ownership over them, they are as much in his possession as if in his bank account. A creditor can have no higher right by means of execution over the property of his debtor than the debtor himself has, and if the debtor has no power to alienate the fund from the preferred creditors, the execution creditor can have none."

Richards J.A., who concurred with the majority, recognized (at p. 358) the "great force" of the dissenting judgments, "but the conclusion arrived at would have such far reaching effects in limiting and lessening the necessary credits to many builders and contractors, who have in the past obtained legitimate loans on the security of contracts, that it would be difficult for them to carry on their important businesses". Similar solicitous concern was [footnote continued on next page.]

It is difficult to discover a satisfactory basis of distinction between these cases, and to reconcile *Castelein v. Boux*²⁵ with the purpose of the trust fund provision as expressed in *Minneapolis-Honeywell Ltd. v. Empire Brass Mfg. Co. Ltd.*,²⁶ *Bank of Montreal v. Township of Sidney*,²⁷ and numerous other cases.²⁸ The case was relied upon by Locke J. in his dissenting judgment in the *Minneapolis-Honeywell*²⁹ decision to support his contention that the contract moneys had not been "received" by the contractor. It was not, however, expressly overruled by the terse majority decision delivered by Rand J. and has been subsequently referred to with approval by the Manitoba Court of Appeal³⁰ and distinguished without reasons in the Supreme Court of British Columbia.³¹

There is one exception to the rule that a charging order cannot be made against money which has been paid into court and is subject to the statutory trust created by s. 3(1). In *Re L & D Cartage and Development Co. Ltd. v. Sterling Construction Co. Ltd.*,³² the bankrupt subcontractor recovered \$34,713.59 from the contractor in a mechanics' lien action, in which the supplier to the subcontractor and a bank holding an assignment of book debts closely co-operated. The subcontractor's solicitor was entitled to charge his costs, which were slightly more than the judgment paid into court, against the fund, notwithstanding that it was "a trust fund . . . for the benefit of . . .

expressed by the Canadian Bankers Association in a brief they submitted to the Standing Committee on Banking on Dec. 10, 1963, calling for the repeal of s. 3 of the Ontario *Mechanics' Lien Act*. (See (1964), 22 U of T Fac L R 107). In view of the fact that Toronto ranked third among the cities on the continent in the number of building permits issued in 1964, these dire consequences do not appear to have materialized.

²⁵ *Supra*, footnote 23.

²⁶ [1955] S.C.R. 694, 3 D.L.R. 351.

²⁷ *Supra*, footnote 12.

²⁸ *Beaver Lumber Co. Ltd. v. Sieffert, Villeneuve et al.* (1965), 48 D.L.R.

(2d) 146 where Smith J. at p. 152 stated: "Insofar as the effect of s. 3 of the *Builders and Workmen Act* is concerned, I see no difference between the position of a garnishor and that of an assignee, or a trustee in bankruptcy". The judgment was affirmed by the Manitoba Court of Appeal on the grounds that the registered lienholders had priority over the garnishee as regards the moneys as yet unpaid on the contract (See *The Mechanics' Lien Act*, R.S.O. 1960, c. 233, s. 13(1), for the parallel Ontario provision), but Guy J.A. who delivered the principal judgment stated at (1965), 48 D.L.R. (2d) 155, "Although I have arrived at the same result as did Smith J., he did so by reason of the effect of the *Builders and Workmen Act*. Since the matter can, in my opinion be adequately decided on the basis of the *Mechanics' Lien Act*, it is unnecessary for me to consider the ground upon which Smith J. disposed the matter". It is submitted that the Manitoba Court of Appeal is dragging its feet and that *Castelein v. Boux*, *supra*, footnote 23, would not be followed elsewhere.

²⁹ See footnote 2.

³⁰ *Royal Bank of Canada v. Blick*, *supra*, footnote 17.

³¹ *Re Watson and Murchison*, *supra*, footnote 21.

³² (1963), 39 D.L.R. (2d) 726 (Ont. H.C.).

all persons who have supplied material on the contract"³³ and notwithstanding the assignment of book debts to the bank.³⁴

These cases illustrate the difficulty in arriving at a precise definition of the nature of the trust, to what it attaches and when it comes into existence. When money is paid into court or to the contractor there is a readily ascertainable sum to which the trust can attach. From the wording of s. 3(1) it appears immaterial that the sum received by the contractor or paid into court on account of the contract price is in excess of the amount actually owing to unpaid suppliers or workmen. The section categorically states:

*All sums received by a builder or contractor . . . on account of the contract price are and constitute a trust fund in the hands of the builder or contractor . . . and the builder or contractor . . . is a trustee of all such sums received by him, and . . . may not appropriate or convert any part thereof to his own use or to any use not authorized by the trust.*³⁵

Since in most cases the moneys received by the contractor will not be the exact amount owed to subcontractors and materialmen, and the Legislature cannot be taken to intend that a supplier should be beneficially entitled to more than what is owing to him, the trust would appear to be in the nature of a charge or lien against the fund, or to rephrase the concept, what is created by s. 3(1) is a charge or lien in the nature of a trust against money received by a contractor.³⁶ The other possible approach to this problem would be to

³³ The Mechanics' Lien Act, R.S.O. 1960, c. 233, s. 3(1).

³⁴ —Or Bien, sans crier davantage,

Rapportons-nous, dit-elle, à Raminagrobis.

C'était un Chat, vivant comme un dévot ermite,

Un Chat faisant la chattemite,

Un saint homme de Chat, bien fourré, gros et gras,

Arbitre expert sur tous les cas.

Jean Lapin pour juge l'agrée.

Les voilà tous deux arrivées

Devant sa majesté fourrée.

Grippeminaud leur dit: Mes enfants approchez,

Approchez, je suis sourd, les ans en sont la cause.

L'un et l'autre approcha, ne craignant nulle chose.

Aussitôt qu'à portée, Il vit les contestants,

Grippeminaud, le bon apôtre,

Jetant des deux côtés la griffe en meme temps,

Mit les plaideurs d'accord en croquant l'un et l'autre.

La Fontaine, *Fables*, Livre VII, xvi "Le Chat, la Belette et le Petit Lapin". 11. 32-45.

³⁵ R.S.O. 1960, c. 233, s. 3(1). Italics mine.

³⁶ In a situation similar to those already considered, the Alberta Supreme Court arrived at the same result without relying on the trust fund provision which does not appear in the Alberta Act. See *Oil Well Supply Company v. Bank of Nova Scotia*, [1951] 2 W.W.R. (N.S.) 554 (Alta. C.A.). A subcontractor completed the drilling of an oil well and filed a mechanics' lien. The owner paid the moneys due on the contract into court. The Bank of Nova Scotia claimed all the moneys due under the contract by virtue of an assignment executed by the contractors before the commencement of drilling. O'Connor C.J. decided that the bank was in no better position than the contractor and was not entitled to payment of the moneys under the contract unless and until the owner has received satisfactory evidence that all the bills for material and labour, i.e. all mechanics' liens, have been paid in full. Followed in *Re Bishop, Rowe & Spaitth Construction Co. Ltd.* (1961), 35 W.W.R. 20 (Alta. S.C.). The reasoning on which such a conclusion is based is stated by Riley J. in *The Pedlar People Ltd. v. McMahon Plastering* [footnote continued on next page.]

say that the contractor receives trust money mingled with his own money and the Courts in considering the use of the mixed fund achieve a rough sort of justice by the application of the principle in *Hallett's case*;³⁷ however, such an interpretation would not accord with the express words of s. 3(1). It is clear from the result of numerous reported cases, that this charge in the nature of a trust will attach to the fund as soon as it comes into existence whether by payment to the contractor, payment into court³⁸ or by payment to a third party by virtue of an assignment by the contractor.³⁹ What of the situation where the money has not yet been paid and there is no fund in existence to which the charge can attach? It is not a very satisfactory comment on the state of the law when a judgment creditor of a contractor can successfully garnish moneys owing on the contract by the owner to the contractor,⁴⁰ yet if that money had been paid into court a charging order obtained by the judgment creditor would be of no avail against the claims of unpaid materialmen.⁴¹ If *Rand J.*⁴² and *LeBel J.*⁴³ were correct in stating the policy behind the trust provision of The Mechanics' Lien Act, would it not be consistent with that policy to hold that this charge in the nature of a trust attaches to the debt owed by the owner to the contractor, and when that debt is rectified by payment, then to that specific fund?

There is one anomalous decision of the Ontario Court of Appeal⁴⁴ which is irreconcilable with the *Minneapolis-Honeywell* line of authority. F sold a prefabricated steel building to B subject to a conditional sales contract which was assigned to IAC. A supplied the steel and constructed the building and then relying on s. 3 of The Mechanics' Lien Act⁴⁵ claimed that IAC, as an assignee, stood in the same position as F, and had become a statutory trustee for all moneys received by it. The court rejected this argument on the grounds that IAC was not a builder or contractor, or subcontractor within the meaning of those words as used in s. 3 and IAC did not fall within the scope of that section.⁴⁶ On the other hand, it might

Co. Ltd. (1961), 34 W.W.R. 315 (Alta. S.C.), at p. 318. "There is no special lien created against the holdback, but if a lien exists under s. 6 then that lien, which is primarily a charge against the land is also a charge against the fund". The circumstances in which this approach will afford protection to the supplier or subcontractor are clearly more limited than the effect of s. 3(1).

³⁷ (1880), 13 Ch. D. 696, 49 L.J. Ch. 61.

³⁸ *Royal Bank of Canada v. Blick*, *supra*, footnote 17; *Bank of Montreal v. Township of Sidney*, *supra*, footnote 12; *Re Evans Coleman and Evans Limited v. R. A. Nelson Construction Limited* (1958), 25 W.W.R. 569 (B.C. S.C.).

³⁹ *Minneapolis-Honeywell Ltd. v. Empire Brass Mfg. Co. Ltd.*, *supra*, footnote 2.

⁴⁰ *Castelein v. Boux*, *supra*, footnote 23.

⁴¹ *Edwards Welding Limited v. Howe & Wilson Construction Limited*, *supra*, footnote 21.

⁴² See *Minneapolis-Honeywell Ltd. v. Empire Brass Mfg. Co. Ltd.*, *supra*, footnote 2.

⁴³ See *Bank of Montreal v. Township of Sidney*, *supra*, footnote 12.

⁴⁴ *Argus Steel Const. Ltd. v. Burns Transport Ltd.*, [1962] O.W.N. 153.

⁴⁵ R.S.O. 1960, c. 233.

⁴⁶ *Argus Steel Const. Ltd. v. Burns Transport Ltd.*, *supra*, footnote 44, at p. 156.

be observed that a bank is also not a "builder or contractor or sub-contractor" but, nevertheless, is subject to the statutory trust when it must claim by virtue of an assignment.⁴⁷

The results of these decisions show that (a) s. 3 creates rights which are enforceable in civil proceedings,⁴⁸ (b) that the right estab-

⁴⁷ It is an invariable practice in conditional sales agreements for the purchaser to give a promissory note which is negotiated to a finance company at the same time as the contract is assigned: *Killoran v. Monticello State Bank* (1921), 61 S.C.R. 528. The holder in due course of a promissory note, unlike an assignee, takes free of any equities. A possible explanation of the case is that the negotiation of the promissory note—the headnote of the case reads: An assignee of a conditional sale contract given for the price of building materials and holder in due course of a collateral promissory note is not a trustee of money paid to him thereunder notwithstanding that such money is paid out of funds received by the buyer, maker of the note, who in the circumstances is a statutory trustee thereof for lien holders,—by F to IAC had the same effect as if the money had been completely paid to F, the moneys being trust moneys, and then paid out to IAC. Having taken for value without notice of the breach of trust IAC would not be obliged to repay the money.

⁴⁸ In *Minneapolis-Honeywell v. Empire Brass Mfg. Co. Ltd.*, Davey J. decided at trial (*supra*, footnote 4) that the trust fund provision in s. 19 created rights enforceable in civil proceedings. This point was accepted in the Supreme Court of Canada without argument. It is interesting to note that the New York Court of Appeals, consisting of seven judges, arrived at the opposite conclusion in *Raymond Concrete Pile Co. v. Federation Bank & Trust Co.* (1942), 43 N.E. (2d) 436, 288 N.Y. 452. §25(a) of the New York Lien Law provided: "The funds received by a contractor for a public improvement are hereby declared to constitute trust funds in the hands of such contractor to be applied first to the payment of claims of subcontractors, architects, engineers, surveyors, labourers and materialmen arising out of the improvement, and to the payment of premiums on surety bonds or bonds filed and premiums on insurance accruing during the making of the improvement and any contractor and any officer, director or agent of any contractor who applies or consents to the application of such funds for any other purpose and fails to pay the claims hereinbefore mentioned is guilty of larceny and punishable as provided in § 1302 of the penal law". Rippey J. speaking for the court reasoned: "Nothing in the section bars the contractor from using the moneys received for any purpose he may see fit provided he does not fail to pay all such claims out of other moneys which he may then have or which he may afterwards receive; and nothing in the section bars a banker from applying moneys, if on deposit in the contractor's account at the bank, without inquiry, upon the contractor's indebtedness to the bank. It necessarily follows that no trust arises under that section from the mere fact that the contractor received and has in his hands moneys in payment on account of a public improvement . . . The purpose of the section as may readily be seen is solely penal and not to provide civil remedies . . . In clear terms those sections were not intended to create a real trust fund to remain such under any and all contingencies from the time the contractor or subcontractor first received payment on account of public or private improvements respectively . . ." The subcontractor's remedy in these cases was to have the district attorney prosecute the delinquent contractor and collect as a fine the sum diverted plus 20%; this would be paid over to the injured party. Such remedy is of dubious value, since in these cases the contractor is invariably bankrupt. In 1942 the State Legislature amended the law and declared that the relationship between job creditors and job debtors is one of *trustee* and *beneficiary* and that henceforth a civil remedy would exist. *q.v.* N.Y. Sess. Laws 1942, ch. 808, (2).

Maxwell Bruce (*supra*, footnote 2) notes that s. 3(2) was added to the Ontario Mechanics' Lien Act after the *Minneapolis-Honeywell* decision and this raises the question whether the trust fund provision is of a penal nature and excludes, or includes in addition, a civil remedy. S. 3(1), (2) would now be the equivalent of the former N.Y. § 25(a). This problem has not materialized in subsequent cases before the Supreme Court of Canada.

lished by s. 3 is independent of the right to a lien by registration under the Act, (c) that no assignment of money due under the contract can affect the trust fund constituted by the section, and (d) that when money due under a contract is paid into court, the trust takes priority over all other charges except a solicitor's lien.

Payment Into a Bank Account in the Ordinary Course of Business

Different considerations arise when the contractor appropriates trust funds to his own use but does not assign them away. The most frequently litigated issue is encountered when the moneys are deposited by the contractor into an overdrawn bank account. This situation will be examined with a view to considering (1) the degree of knowledge required to fix a bank with liability for participation in a breach of trust; (2) the effect of payment into an overdrawn bank account in the ordinary course of business; and once again (3) the nature of the trust created by The Mechanics' Lien Act. Finally, some attention will be devoted to recent cases where there is an assignment to a bank of the moneys due under a construction contract but the proceeds come into the hands of the contractor who deposits them with the bank.

1. Degree of Knowledge

Where a contractor pays into a bank or otherwise uses for his own purposes moneys received by him on account of the contract price, and his suppliers, workmen or subcontractors remain unpaid, the question arises as to the degree of knowledge of the breach of trust necessary to make a bank or third party *trustee de son tort* for participation in the breach of trust. A knowledge of the trust character of the moneys is not in itself sufficient to fix the bank or payee with liability: the bank or payee should also know that the contractor is in serious financial difficulty and, in diverting the trust funds, will be unable to pay his subcontractors, suppliers or workmen. Thus, where a bank manager pressed a contractor for payment of the amount outstanding in excess of a secured overdraft, and had refused to honour six cheques drawn by the contractor in favour of suppliers and workmen during the week preceding the deposit by the contractor of moneys received from persons for whom he had been building houses, it was held that the bank acted in breach of trust in applying the money against the overdraft.⁴⁹ Schroeder J.A., speaking for the Ontario Court of Appeal, pointed out that the bank manager knew that all the deposits to the contractor's account consisted of money paid by persons for whom the contractor was building houses. He must be presumed to know the law and realize that by virtue of s. 3 of The Mechanics' Lien Act⁵⁰ that money was trust money. The refusal to pay the six cheques was accepted as evidence of knowledge that, at the material time, the contractor was in financial difficulty and there were unpaid accounts due by him for material

⁴⁹ *Fonthill Lumber Ltd. v. Bank of Montreal*, [1959] O.R. 451 (Ont. C.A.).

⁵⁰ R.S.O. 1950, c. 227.

and for work or services in connection with his building operations. The learned Justice then concluded that "if A holds property in a fiduciary capacity as e.g. as a trustee or an agent, and B takes from A a transfer of the property with knowledge of a breach of duty committed by A in making the transfer, then B holds the property 'under a transmitted fiduciary obligation to account for it,' to the *cestui que trust* or principal".⁵¹

The degree of knowledge required to make a bank a guilty participator in a breach of trust is a critical problem⁵² in view of federal banking legislation which provides:

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.⁵³

The argument was raised in *Fonthill Lumber Ltd. v. Bank of Montreal*⁵⁴ that s. 3 of The Mechanics' Lien Act was in conflict with s. 96(1) of the Bank Act and the latter as valid federal legislation must prevail. Schroeder J.A. replied that s. 96(1)

does not release a bank from liability if it knows not merely of the existence of the trust, but also of the commission of a breach thereof, or of circumstances which should put it on inquiry.

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. S. 96(1) has not effected an 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, e.g., 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.⁵⁵

The common law position is stated by Lord Herschell in *Thomson v. Clydesdale Bank Limited*.⁵⁶

If the person receiving the money has reason to believe that the payment is being made in fraud of a third person, and that the person making the payment is handing over in discharge of his debt money which he has no right to hand over, then the person taking such payment would not be entitled to retain the money.

The transposition of this principle into the context of The Mechanics' Lien Act presents some difficulty. It is submitted that the

⁵¹ *Supra*, footnote 49, at p. 467. See also *John Ritchie Ltd. v. Canadian Bank of Commerce*, [1963] 2 O.R. 116, reversed on other grounds (1965), 47 D.L.R. (2d) 289; *Dominion Bank v. Fassel & Baglier Construction Company Limited*, [1955] O.W.N. 709 where the issue was avoided by the Court of Appeal and the case disposed of on the basis of the law of bills of exchange. Falconbridge, *On Banking and Bills of Exchange*, 6ed, p. 619 notes that the effect of *Jones v. Waring*, [1926] A.C. 670, seems to have been overlooked by the Court in deciding the case.

⁵² Falconbridge, *op. cit.* pp. 296-99.

⁵³ The Bank Act, S.C. 1953-1954, c. 48, s. 96(1).

⁵⁴ *Supra*, footnote 49.

⁵⁵ *Ibid.*, at p. 471.

⁵⁶ [1893] A.C. 282, at pp. 287, 288.

bank must have reason to believe that; (1) the moneys about to be deposited are the proceeds from a construction contract; (2) the suppliers and workmen have not been paid; and (3) that the contractor is in financial difficulty and is unlikely to be able to meet his obligations. The status of all three of these elements is not yet clear, but it appears settled that knowledge of facts which would give the bank reason to believe that the moneys about to be deposited are the proceeds of a construction contract and that suppliers, subcontractors or workmen have not been paid constitutes the minimal degree of knowledge sufficient to fix a bank with liability for participation in a breach of trust.⁵⁷ Unless the bank had reason to believe that suppliers or workmen had not been paid, it would have no reason to believe that the moneys were trust funds, or at least that the contractor was making an appropriation not authorized by the trust. It would not be practicable to insist that a bank enquire every time a contractor deposited money, whether a trust existed, nor could such a course be reconciled with s. 96(1) of the Bank Act.⁵⁸ The third element in establishing participation in a breach of trust, that is, knowledge that the contractor is in financial difficulty and is unlikely to be able to meet his obligations, enjoys a doubtful status. In the British Columbia Supreme Court⁵⁹ Collins J. left open the possibility that even if the bank knew that all suppliers and subcontractors had not been paid but believed that the holdback was sufficient to take care of their claims, the bank would not be acting in breach of trust in crediting the deposit to the contractor's account. In contrast to the position taken by Collins J., Gale J., in *John Ritchie Ltd. v. Canadian Bank of Commerce*⁶⁰ took the view that the contractor had committed a breach of trust when he deposited proceeds from a construction contract into his overdrawn account even though it was his anticipation and intention that he would be extended credit on which he could draw to pay his subcontractors, and the bank which was aware of these facts thereby participated in the

⁵⁷ In practice all three factors have been present, since where a bank has reason to believe that subcontractors, suppliers or workmen have not been paid, it is because the contractor is in a precarious financial position. Knowledge of these two elements is usually deduced from evidence that the bank refused to honour the cheques drawn by the contractor in favour of suppliers and workmen, and pressed for payment of an overdraft and/or refused to extend further credit. See *Fonthill Lumber Ltd. v. Bank of Montreal*, *supra*, footnote 49; *John Ritchie Ltd. v. Canadian Bank of Commerce*, [1963] 2 O.R. 116, reversed by the Ontario Court of Appeal on other grounds (1965), 47 D.L.R. (2d) 289. Cf. *Ross v. Royal Bank of Canada* (1966), 52 D.L.R. (2d) 578 (Ont. H.C.), where the bank successfully deducted payment for a \$45,000 note from the proceeds of a construction contract to the credit of the contractor's current account, even though it knew the contractor was insolvent. Wells J. (at p. 593) distinguished the *Fonthill Lumber* case on the grounds that the company's business "was not confined to contracting, it also had a retail store and it was a varied business in many ways and the bank manager had no particular knowledge of the source of any of the moneys which came into the account from which all these sums were ultimately paid."

⁵⁸ S.C. 1953-1954, c. 48.

⁵⁹ *Canadian Pittsburgh Industries Ltd. v. Bank of Nova Scotia* (1963) 37 D.L.R. (2d) 120 (B.C. S.C.).

⁶⁰ [1963] 2 O.R. 116. For a comment, see (1964), 3 Osgoode Hall L.J. 116.

breach of trust. The bank contended at trial, that it could not be held liable for breach of trust unless it actually knew that the subcontractors would not be paid from other progress payments or from any other source. Gale J. rejected this contention and stated that the true test was:

Did the bank (1) know that the contractor was committing a breach of trust, and (2) did it participate therein?⁶¹

This test raises more questions than it answers. Unless one adopts the position that the moment the contractor deposits money received on a construction contract into his current account, while suppliers and subcontractors have not been paid, he is guilty of a breach of trust and subject to the penalty in s. 3(2), even though he intends to draw cheques on that account to pay suppliers and subcontractors, or has other resources from which to pay them, or intends to rely on the holdback which is sufficient to answer all claims, then the test is too imprecise to be of much practical value because the answer to the question whether the bank knew the contractor was committing a breach of trust, depends on whether the contractor might have paid the subcontractors from another source. In this case the bank manager knew that the subcontractors were pressing his customer for payment of their accounts and that it had been the practice for the contractor to pay the progress payments into his account which was operated on an overdraft, and from a fresh extension of credit to pay his subcontractors. Consequently, the bank had reason to believe that the subcontractors had not been paid and knew that the trust funds were to be paid into the account and to be applied specifically against the overdraft and no further extension of credit would be allowed. The specific appropriation of the funds by the bank is a factor from which a knowledge on the part of the bank of the contractor's precarious financial situation, and hence a breach of trust may be deduced.

The core of this problem is whether in all circumstances the payment of the money by the contractor into his account is an appropriation in breach of trust. When the problem is examined from the aspect of the legal nature of a bank deposit—which constitutes a transfer of the property in the money and makes the bank the debtor of the trust is to make a loan to a third party. However, from an economic point of view, a company maintains a bank account to enable it to preserve orderly accounts without the necessity of keeping all its capital in cash on hand, and a contractor who had just deposited a cheque covering payment on a construction project into his account in order that he might draw on it in favour of his suppliers and workmen, would find it startling indeed were it suggested to him that he was thereby guilty of a breach of trust and liable to amercement. What then is the nature of this trust created by The

⁶¹ *Ibid.*, at p. 139.

Mechanics' Lien Act? An American writer in considering the trust fund provisions of the New York Lien Law has stated:

The trust created by the lien law has, however, very different properties from the ordinary trust. The trustee of an express trust may not commingle trust funds with his general funds. He must treat all beneficiaries of the same class with strict impartiality. The crime of diversion is committed the instant he uses the funds for an improper purpose. None of the above statements apply to a lien law trustee. He may commingle with impunity, favour one trust claimant over all others, and cannot be indicted for abstracting funds if he promptly repays the money.⁶²

Although accurate in some respects, as a whole, this assessment is of questionable validity when applied to a consideration of Canadian mechanics' lien legislation. In the Supreme Court of Canada, Martland J. asserted:

by virtue of the operation of s. 3 of the *Mechanics' Lien Act* R.S.O. 1950, c. 227, the contractor became a trustee of the same money for the benefit of unpaid subcontractors, etc. This section does not purport to do more than to create a trust for the benefit of the class named in it. It does not create a statutory lien upon the sums received by a contractor. It makes him a trustee of that fund. Although the trust is created by statute, it thereupon becomes subject to the application of the rules of equity applicable to trusts.⁶³

Does this therefore mean that a contractor who receives a progress payment and deposits the cheque to his general account prior to paying his subcontractors, suppliers and workmen is to be considered in the same light as a solicitor who mingles funds held on trust for his client with his own moneys? Does a bank become a participator in a breach of trust the moment that it accepts the deposit of a contractor with reason to believe that suppliers and workmen have not yet been paid, and consequently becomes liable to the unpaid suppliers and workmen for any loss suffered by them even though it believed that the holdback was sufficient to cover their claims? Locke J. in his dissenting judgment thought otherwise:

The right of the subcontractors is not "an equitable right" as has been suggested. It is a statutory right conferred by s. 3.⁶⁴

This conflict of view over the nature of the remedy created by the trust fund provision of The Mechanics' Lien Act underlines the basic inadequacy, in the complex and ever-changing field of commercial relations, of a concept which has proved to be of immeasurable value in other areas of the law. It is submitted that the only viable approach in the definition of the nature of this remedy is that taken by Locke J. and that even if it adds another category of trust to the law, it has the advantage of sloughing off the encrustations which preceding centuries have, in other circumstances, and for other purposes, attached to the concept of trust. The recognition of the statutory basis of this remedy will permit its development within the context, and

⁶² Howard L. Meyer, *Trust Fund Provisions of the N.Y. Mechanics' Lien Law* (1960-61), 10 *Buffalo Law Rev.* 314, at p. 325.

⁶³ *John M. M. Troup Ltd. v. Royal Bank of Canada*, [1962] S.C.R. 487, at p. 505.

⁶⁴ *Ibid.*, at p. 499.

for the purposes, for which it was created, without doing violence to the definition of an institution which must answer other needs in other circumstances.⁶⁵

The question of the precise degree of knowledge required to make a bank a guilty participator in a breach of trust depends, therefore, on the nature of the "trust" created by s. 3 of The Mechanics' Lien Act and this issue has not yet been definitively considered by the Courts. The weight of judicial authority, however, leans towards the view that before a bank or payee is guilty of participation in a breach of trust, not only must it have reason to believe that the moneys are the proceeds of a construction contract and that suppliers, subcontractors and workmen have not been paid but also that the contractor is in financial difficulty and is unlikely to be able to meet his obligations.

2. *Payment Into a Bank Account*

There is a series of cases in which the contractor deposited money into his overdrawn account in the ordinary course of his business and the bank, which automatically credited the deposit against the overdraft, was exonerated from liability for breach of trust. In *Standard Electric Co. v. Royal Bank of Canada*⁶⁶ the contractor, who operated his account at a widely fluctuating overdraft, one month before his bankruptcy, made a substantial deposit of moneys received on a construction contract. At the time of the deposit, the bank had no reason to believe that the contractor was in financial difficulty, nor did the bank at any time press the contractor for payment. The plaintiff, a subcontractor on the project, claimed that the bank had applied the progress payment against the overdraft, in breach of the trust created by s. 3 of The Mechanics' Lien Act. The trial judge held that the Bank Act, s. 96(1),⁶⁷ applied to a situation of this kind where trust moneys were paid into the account of the contractor or builder and paid out from time to time in the ordinary course of business. The determining factor in the

⁶⁵ In *Re Mann Construction Ltd.*, [1965] 2 O.R. 655, 51 D.L.R. (2d) 580, (Ont. H.C.), the contractor, upon completion of the construction project, on which one of his subcontractors defaulted owing to bankruptcy, had in its hands \$3,870 due to the bankrupt subcontractor. The contractor was besieged by the trustee in bankruptcy and the creditors of the bankrupt all demanding payment. The contractor availed itself of s. 60(1) of The Trustee Act, R.S.O. 1960, c. 408, and applied to the Court for direction. The application was dismissed on the grounds that a statute by operation of which a trust is created is not an "instrument" within the meaning of the word as used in Rr. 607 and 611 (Ont.), and the applicant could not bring an application under s. 60 of The Trustee Act to determine legal rights, e.g. competing claims to money in its hands.

R. 607 also has no application to a trustee under The Bulk Sales Act: *Re Langdon* (1919), 46 O.L.R. 555. (Ont. H.C.).

Although the decision can be explained on the grounds that Rr. 607 and 611 (Ont.) envisage a specific trust created by a specific instrument—and hence the decision would have been the same in the case of an oral trust—it is submitted that there is latent in the decision an awareness that a trust created by statute is not "a trust like other trusts".

⁶⁶ [1960] O.W.N. 367 (Ont. H.C.).

⁶⁷ S.C., 1953-1954, c. 48.

view of the trial judge was whether "the payment or deposit to the credit of the account was designed or intended to be a payment for the benefit of the bank for a debt due to it on an overdraft, or was a deposit to the credit of the account in the ordinary course of business."⁶⁸ He pointed out that it would be impracticable for the bank to make inquiry as to whether or not the subcontractors who had done the work which earned this deposit had been paid in whole or in part by the contractor, and a bank account could not be operated on such a basis. There was nothing unusual to put the bank on inquiry.⁶⁹

This same problem came before the Supreme Court of Canada in the case of *John M. M. Troup Ltd. v. Royal Bank of Canada*.⁷⁰ A contractor received a cheque for \$77,000, the major portion of the holdback, and deposited it in his account which was overdrawn \$109,000. As security for the overdraft the bank held \$95,000 in government bonds, an assignment of book debts, a guarantee of another company and personal guarantees. At the time \$50,000 of the bonds were liquidated and the proceeds together with the deposit eliminated the overdraft. The action was launched by a subcontractor who had not been paid. Judson J. pointed out that the extent of the bank's knowledge at the time of the deposit was that it knew the cheque had been received as part of the contract price on a construction project but it had no knowledge of any unpaid accounts of any subcontractors nor of any financial difficulties of the contractor, nor had it any reason to suspect that the deposit in the current account of the customer was an appropriation or conversion of any part of the contract price to any use not authorized by s. 3 of the Act.⁷¹ Under the circumstances, the bank could not be charged with notice of a breach of trust. The *Fonthill Lumber Ltd.* case⁷² was distinguished by Judson J. who declared, that it had been based upon proof of knowledge of the existence of the trust under s. 3(1) and knowledge of the commission of a breach of trust.

There was in this case an assignment of book debts to the bank but the County of Lambton, for whom the work was being done, had not been given notification of the assignment. The Court was divided on the question of the relevance of the assignment to the issue but they agreed in the result. Counsel for the subcontractor ably argued that although the bank did not attempt to enforce the assignment, it was nevertheless an existing and valid instrument.⁷³

⁶⁸ *Supra*, footnote 66, at p. 369.

⁶⁹ The bank had been given a general assignment of book debts, but the bank was not making a claim as an assignee, nor was the deposit so made.

⁷⁰ *Supra*, footnote 63. For a comment, see 21 U of T Fac L Rev 135.

⁷¹ *Ibid.*, at p. 492.

⁷² *Supra*, footnote 49.

⁷³ It was argued that any money received by the contractor was by the express terms of the assignment—"all moneys received by the undersigned from the collection of the debts or any of them shall be received in trust for the Bank"—received as trustee or agent of the bank. The contractor knew of the unpaid subcontractors, and as agent his knowledge must be attributed to the bank, who therefore had notice of the breach of trust.

Judson J. rejected the relevance of the assignment in holding that the bank did not receive the cheque under the assignment because notice of the assignment had not been given to the County of Lambton, and it could have no effect on a payment made in the ordinary course of business by the County to the contractor. Cartwright J. found that when the money was deposited into the overdrawn account, neither the bank nor the construction company were acting in pursuance of the assignment but as banker and customer in the ordinary course of business, and therefore, the plaintiff's argument failed on the facts.⁷⁴ Martland and Ritchie JJ. met the plaintiff's argument head on and agreed that the contractor had in accordance with the terms of the assignment received the cheque in trust for the bank but subject to the prior trust created by The Mechanics' Lien Act, s. 3(1). On paying the cheque into the account, what occurred was that the bank which initially had only an equitable right, subordinate to that of the subcontractor, acquired legal title to the money, *bona fide*, for value, without notice of any breach of trust on the part of the contractor.

Where a trustee has overdrawn his banking account, his bankers have a first and paramount legal lien on all moneys paid in by him, unless they have notice, not only that they are trust moneys, but also that the payment to them constitutes a breach of trust.⁷⁵

In *Canadian Pittsburgh Industries Ltd. v. Bank of Nova Scotia*⁷⁶ Collins J. abstracted five significant factors from the *Troup* case: (1) the banker was not aware of any actual or intended breach of trust by the builder; (2) the owner did not pay the \$77,000 directly to the banker by reason of the assignment, or at all; (3) the owner paid the money to the builder who deposited it with his banker in the ordinary course of business; (4) although the banker had knowledge that the deposit was a substantial part of the holdback arising from a building contract, he did not know that the remainder of the holdback was insufficient to pay in full accounts, if any, of the plaintiff or other subcontractors; (5) the banker received the cheque from the builder for value in the ordinary course of business in pursuance of a banker and customer relationship. He concluded that where these factors exist, in the absence of any other significant factor, receipt by a banker of a builder's deposit in the ordinary course of business and its application in reduction of an overdraft does not result in participation by the banker in any actual or intended breach of trust on the part of the builder. Thus, where a contractor deposited money into an overdrawn account in the ordinary course of business, and then absconded, the bank, which realized that there were probably some materialmen who had not been paid, but believed that the holdback would be substantial and sufficient to pay off any sub-

⁷⁴ Cartwright J. alternatively relied on *Cave v. Cave* (1880), 15 Ch.D. 639 as authority for the proposition that knowledge on the part of an agent will not to be imputed to his principal where the agent is party to a fraud of which the principal is ignorant and which would be exposed if the agent communicated the notice to his principal.

⁷⁵ *Supra*, footnote 63, at p. 506.

⁷⁶ *Supra*, footnote 59.

contractors or materialmen, did not act in breach of trust in appropriating the money against the overdraft.⁷⁷ Similarly, where the owner provides the contractor with funds to pay for materials to be used in the construction, and the contractor wrongfully uses the money to wipe out an overdraft in his bank account and to pay off his indebtedness to another supplier for goods supplied on a different building project, the owner is in no better position than any other *cestui que trust*.⁷⁸

The recent case of *Pilkington Glass Ltd. v. Canadian Imperial Bank of Commerce*⁷⁹ injects a disquieting note into this general scheme of the consequences attendant upon an assignment of trust moneys and payment in the general course of a banker-customer relationship. In this case the contractor, who had a 'revolving credit arrangement' with the bank, made an assignment to the bank of moneys owed to him by the local School Board on a building project, of which notice was given to the School Board.⁸⁰ The latter drew some of the cheques payable to the contractor and others payable to the bank. The contractor endorsed all the cheques, irrespective of to whom they were made payable, and deposited them into his overdrawn account. Counsel for the unpaid subcontractor argued that the bank "made a boo boo"⁸¹ by taking an assignment and that the cheques made payable to the bank represented trust moneys which the bank had wrongfully applied in reduction of the contractor's indebtedness. In a manner not calculated to win favour for his cause, which to the trial judge appeared to be "based upon grounds which admittedly are very narrow and highly technical in nature",⁸² counsel volunteered his opinion that "the smart thing for the banks to do is not to take an assignment".⁸³ To this argument Sullivan J. replied:

I do not subscribe to the view that justice is to be weighed by any test of "smartness". I think that good faith and *bona fides* provide the better test.⁸⁴

The learned trial judge did not pursue this avenue further but held that cases like *Minneapolis-Honeywell* were not of great assistance in these circumstances "because they relate to claims of outside creditor-assignees whose position is not comparable to that of a banker in overdraft position who seeks to continue a 'revolving credit' arrangement with his customer".⁸⁵ Sullivan J. found as a fact that all dealings by the bank with the contractor, were conducted in the ordinary course of banker-customer relations. The trial judge's interpretation of the

⁷⁷ *Ibid.*

⁷⁸ *Drew v. Royal Bank of Canada*, (1963), 42 W.W.R. 166 (B.C. S.C.).

⁷⁹ (1964), 42 D.L.R. (2d) 504 (B.C. S.C.). See 22 U of T Fac L Rev 107.

⁸⁰ The original notice of assignment was defective in form although the School Board acted on it; a new notice was given and at least one of the cheques made payable to the bank was paid after that date.

⁸¹ *Supra*, footnote 79, at p. 509.

⁸² *Ibid.*

⁸³ *Ibid.*, at p. 510.

⁸⁴ *Ibid.*

⁸⁵ *Ibid.*, at p. 513.

facts and some *obiter dicta* are open to question, but once it is accepted that the money was paid into the account in a banker-customer relationship and not in pursuit of an assignment, then the Court's conclusions are unassailable.

This matter again became a subject of judicial consideration in *Geo. W. Crothers Ltd. v. Bank of Nova Scotia*⁸⁶ where the delinquent contractor had made an assignment of his book debts to the bank and upon the bank giving notice of the assignment most of the payments under the contract were in fact made by cheques payable jointly to the contractor and the bank—"a course of action which", Schatz J. recognized, "could only be a direct result of the assignment";⁸⁷ however, the cheques were delivered to the contractor who deposited them to his account. The court agreed that "the assignment was acted upon and was effective as an assignment"⁸⁸ but asserted that the position taken by the debtor could have no bearing upon its effect as between assignor and an assignee and that the payments received by the contractor were deposited into his account in the ordinary course of business notwithstanding the facts in respect to an assignment. Schatz J. referred to a passage in the judgment of Cartwright J. in *John M. M. Troup Ltd. v. Royal Bank of Canada*⁸⁹ in which the learned Justice stated that he did not think the assignment relevant because neither party acted upon it.⁹⁰ Schatz J. did "not consider such facts⁹¹ to be of sufficient weight to override the evidence of normal operation of the account in the ordinary course of business."⁹² He notes that this conclusion was also reached in the case of *Canadian Pittsburgh Industries Ltd. v. Bank of Nova Scotia*⁹³ and also relies on the view stated by Sullivan J. in *Pilkington Glass*

⁸⁶ (1965), 49 D.L.R. (2d) 481 (Ont. H.C.).

⁸⁷ *Ibid.*, at p. 485.

⁸⁸ *Ibid.*

⁸⁹ *Supra*, footnote 63, at p. 491.

⁹⁰ Schatz J. lays particular emphasis on Cartwright J.'s concluding words: "In view of the manner in which the dealings between the bank and the construction company were carried on the existence of the assignment appears to me to be irrelevant." It is respectfully submitted that the learned trial judge's reasoning is based on a misapprehension of the effect of Cartwright J.'s decision. The *Troup* case does not stand for the proposition that where a bank is concerned, an assignment is irrelevant, and where the assignee is not a bank (*Minneapolis-Honeywell*), the assignment is decisive, but merely that on the facts of that particular case none of the parties acted on the assignment which was in effect a dead letter. See Cartwright J. at p. 491: "The argument that the bank received it *qua* assignee or *qua cestui que trust* appears to me to fail on the facts. Neither the county nor the plaintiffs [i.e. claimants under s. 3] were aware of or parties to the assignment; the only parties to it were the bank and the construction company and so long as the former saw fit to refrain from acting upon it I am unable to see how the mere fact of its existence could improve the position of the plaintiffs." Schatz J. is making a proposition of law out of a finding of fact.

⁹¹ I.e. the existence of an assignment, notice by the bank to the general contractor, payment of the cheques to the contractor and bank jointly.

⁹² *Supra*, footnote 86, at p. 486.

⁹³ *Supra*, footnote 59. Where the assignment in express terms made the assignor *agent* of the bank to receive the moneys due under the assignment and the contractor did in fact receive the moneys and deposited them into his overdrawn account, the court found that the parties were not acting under the assignment.

Ltd. v. Canadian Imperial Bank of Commerce.⁹⁴ Schatz J. goes on to state that "even if the bank became a trustee by reason of the assignment there has been no breach of trust by the bank" and in support of this conclusion he relies on the decision of the Court of Appeal in *John Ritchie Ltd. v. Canadian Imperial Bank of Commerce*⁹⁵ which he states "held that the bank was entitled to repay to itself, from the moneys in the account, for the moneys advanced by the bank to the account".⁹⁶ However, the key to that decision rests on the fact that the contractor had expended his own funds in excess of the progress payments received and was entitled, without committing any breach of trust, to reimburse himself from the moneys received, which he in fact did by paying them into his account and which the bank applied against his overdraft. It is no answer to claim that the moneys advanced by the bank were used by the contractor in the construction project since the bank is not a "supplier" within the meaning of the Act and is not entitled to stand in the shoes of the contractor.⁹⁷ Schatz J. observed that more moneys were paid out of the account to persons entitled under the contract than were received by the contractor under the contract, and that there was no requirement that the moneys be disbursed proportionately to those entitled on the contract. He therefore considered it "unnecessary and unjustifiable to direct a reference to determine whether moneys deposited in the account were used to pay persons other than those entitled under the trust in respect of this contract"⁹⁸—although this is precisely what occurred in the *Minneapolis-Honeywell* case⁹⁹—because it would be impracticable to carry on a banking business for such contractors if the banks were obligated to police such account and verify the validity of each cheque passing through it. Schatz J. finds:

The moneys due to Robinson were deposited in the bank account in the ordinary course of business and not as a result of the assignment by Robinson to the Bank.¹⁰⁰

On the basis of this finding of fact, which is difficult to reconcile with the evidence, the result of the case is unobjectionable.

From these last few cases a trend emerges degrading the significance of an assignment where payment has already been made to a bank, which had no knowledge of the breach of trust. Until recently,

⁹⁴ *Supra*, footnote 79. "I do not think that anything turns upon the circumstances just related *i.e.* the existence of the assignment, and the issue of the cheques, made payable to the bank, but delivered to the contractor, who endorsed them and personally deposited them to the credit of his current account because in my view (whether or not the bank was 'smart' in taking the assignment and giving notice thereof) the relationship of banker and customer doing business upon a 'revolving credit' arrangement of ordinary business accommodation, was not disturbed". p. 513 D.L.R., 354 W.W.R., 271 C.B.R.

⁹⁵ [1965] 1 O.R. 197, 47 D.L.R. (2d) 289, 6 C.B.R. (N.S.) 312.

⁹⁶ *Supra*, footnote 86, at p. 488.

⁹⁷ *Re Walter Davidson Company*, [1957] O.W.N. 223.

⁹⁸ (1965), 49 D.L.R. (2d) 481, at p. 488.

⁹⁹ *Supra*, footnote 2.

¹⁰⁰ *Ibid.*, at p. 489.

very little attention was devoted to the exact meaning of the phrase "in the ordinary course of business" where a bank was concerned. A dichotomy was established between moneys received by virtue of an assignment and cash or negotiable instruments paid over the counter in a creditor-debtor relationship, and only the latter constituted a banker-customer relationship. Such a position fails, however, to take cognizance of economic reality which is abundantly clear from the number of cases in which an assignment existed alongside of payment by the depositor of money over the counter. Banks are not merely borrowers or stakeholders of their customers but also play an important role in financing the business enterprises of their customers. A revolving credit arrangement of ordinary business accommodation, secured by an assignment of book debts, is no less a part of "the ordinary course of business" of a bank than is the payment of *specie* by a depositor into a savings account, thus creating the bank his debtor. The traditional concept of the assignment and its attendant consequences of *nemo dat quod non habet*, as well as the effect of the payment of money of a debtor to a creditor who receives it in good faith and for value thus overriding all equities, have impeded the development of the law in this area and have proved to be the source of considerable confusion. Once the Supreme Court of Canada decided in the *Troup* case¹⁰¹ that the payment had not been made in pursuance of the assignment, which was therefore irrelevant, but in the ordinary course of a banker-customer relationship, the result of the contest between claimants under s. 3 and the bank, in the words of Sullivan J., depends on very narrow and highly technical grounds indeed.¹⁰² Subsequent decisions¹⁰³ have extended this principle of ignoring the assignment¹⁰⁴ by findings of fact in the teeth of the evidence, where the document of assignment expressly constituted the contractor an agent for the bank to receive the moneys,¹⁰⁵ and where cheques were, in compliance with the assignment, made payable either to the bank¹⁰⁶ or to the contractor and bank jointly,¹⁰⁷ but delivered to the contractor who deposited them into his account.

The state of the law at the present time appears to be that a bank cannot rely on an assignment in claiming priority over a supplier or workman,¹⁰⁸ but where the money has actually been paid into the account, the existence of an assignment and action by the debtor under it, at least where he delivers the cheques to the contractor who deposits them, will prove no embarrassment to the bank, which had

¹⁰¹ *Supra*, footnote 70.

¹⁰² *Pilkington Glass Ltd. v. Canadian Imperial Bank of Commerce*, *supra*, footnote 79.

¹⁰³ All of them High Court decisions.

¹⁰⁴ In the *Troup* case the decision could be justified on the facts and in the cogent reasoning of Martland J. of what would have been the result if effect were given to the express terms of the assignment.

¹⁰⁵ *Canadian Pittsburgh Industries Ltd. v. Bank of Nova Scotia*, *supra*, footnote 59.

¹⁰⁶ *Pilkington Glass Ltd. v. Canadian Imperial Bank of Commerce*, *supra*, footnote 79.

¹⁰⁷ *Geo. W. Crothers Ltd. v. Bank of Nova Scotia*, *supra*, footnote 86.

¹⁰⁸ *Royal Bank of Canada v. Blick, Wilson et al.*, *supra*, footnote 17.

no reasonable grounds for suspecting a breach of trust on the part of the contractor.¹⁰⁹ Although the courts state that the deposit was made in the ordinary course of business, implicit in the reasoning of the judgments and the *obiter dicta* is a broadening concept of what constitutes the ordinary course of a banker's business and a gradual assimilation, where a bank is concerned, of an assignment of moneys due under a construction contract, and their payment into the account in a creditor-debtor relationship. Such a course recognizes the economic reality of revolving credit arrangements of business accommodation and the bank's desire to have some security in the nature of an assignment of book debts. The refusal of the courts on the one hand to adhere strictly, in deed as well as word, to the dichotomy of assignment-payment in the course of business, and on the other hand, their inability to break away completely from these traditional strictures, have relegated this problem to a twilight zone which is bound to provoke further litigation. A greater degree of certainty would be introduced into this area of the law by appropriate legislation which would recognize the substantial effect of these cases by providing that where money has been paid into a bank account by assignment or otherwise, claimants under s. 3 of The Mechanics' Lien Act have no claim against the bank unless the latter knowingly and deliberately participated in a breach of trust in applying the money against an overdraft.¹¹⁰

¹⁰⁹ *Canadian Pittsburgh Industries Ltd. v. Bank of Nova Scotia*, *supra*, footnote 59; *John M. M. Troup Ltd. v. Royal Bank of Canada*, *supra*, footnote 63; *Pilkington Glass Ltd. v. Canadian Imperial Bank of Commerce*, *supra*, footnote 79; *Geo. W. Crothers Ltd. v. Bank of Nova Scotia*, *supra*, footnote 86.

¹¹⁰ It is interesting to note how New York State resolved this problem. The experience there was that banks would often finance a contractor on a specific construction project and provide him with funds with which to pay his suppliers, and take back as security an assignment of all moneys to become due by reason of the construction; the contractor, however, would take the money provided by the bank and expend it elsewhere meanwhile subcontracting out large portions of the work and providing the materials for the improvement by receiving credit from suppliers. When the time came for payment, the subcontractor and supplier found that the funds due from the owner or contractor to their debtor had been assigned away to a bank. As early as 1896 the Legislature required the registration of such assignments and failure to register not only invalidated the assignments as regards future payments but also required the lender to disgorge to the suppliers, subcontractors and workmen any sums he had collected under the unregistered assignment. See §73 New York Lien Law: "A party who takes as security an assignment of trust funds to become due must file a 'notice of lending' with the County Clerk wherein the property giving rise to the trust is located, or if a public improvement, with the head of the department having charge of the work and the disbursing officer. Also the assignee must prove that the moneys he advanced in consideration of the assignment were in fact used to discharge trust claims. If all of the above requirements are not met, the assignment falls and the amounts the builder received thereunder must be returned to the proper trust claimants." There were two lines of authority relating to the consequences of this section. One line of cases afforded the lender who had failed to register an equitable set off to the amount he could prove his borrower had in fact used to discharge trust claims. Another line of cases required as a prerequisite to the retention of any moneys, the proper filing of the assignment. In 1959 the law was amended to require that not only must the lender properly file his assignment but must also see that the money he lends *in fact* goes to pay trust claims.

[footnote continued on next page.]

Conflict With Other Provisions of the Act

The possibility of conflict between s. 3(1) and another provision of The Mechanics' Lien Act arose in an action between a bank, holding a general assignment of book debts from a contractor, and a sub-contractor who had supplied materials in the construction of sewers and water mains under a public highway.¹¹¹ The bank claimed that the Act did not apply to the circumstances of this case¹¹² and relied on s. 2 of the Act which provides:

Nothing in this Act extends to any public street or highway, or to any work or improvement done or caused to be done by a municipal corporation thereon.¹¹³

In the Supreme Court of Canada it was decided that the remedy provided by s. 3 was wholly independent of the general lien created by s. 5 of the Act, and the purpose and effect of s. 2 was merely to remove certain works from the consequences of the imposition of a lien on the work. The Court was not prepared seriously to contemplate the piecemeal dismemberment and sale of a public highway to realize a private debt.

What is aimed at by s. 2 is a provision producing a property effect upon a highway: there is no concern with an enumeration for descriptive purposes of kinds of work on lands generally to which the statute annexes certain legal consequences. The word "highway" in s. 2 does not include a contract for work on a highway or moneys payable under it. The only statutory effect of the Act that, in the proper sense, could extend to the "highway", as a physical object, is the lien;¹¹⁴

The Court emphasized that the trust fund provision deals with the "contractor" in a new aspect. Where there is a contract for a work mentioned in s. 5 the trust fund provision creates the equivalent of a lien on the moneys. The two securities, that is, the land and the money are completely independent of one another. The object of the trust fund provision was to give to suppliers and workmen a remedy

On this side of the border not only may a bank not rely on an assignment to claim for moneys which it had advanced to a contractor and which had actually been expended on the construction project (See *Re Walter Davidson, supra*, footnote 97), although it may recoup itself to the extent of any moneys the contractor expended on the project from any payment actually received by him (See *John Ritchie Ltd. v. Canadian Bank of Commerce*, [1965] 1 O.R. 197, 47 D.L.R. (2d) 289, 6 C.B.R. 312), but the prior registration of an assignment of book debts in compliance with local legislation provides no protection against claims brought under s. 3 of the Mechanics' Lien Act (See *Re Bishop, Rowe & Spaitth Construction Co. Ltd.* (1961), 35 W.W.R. 20 (Alta. S.C.)).

¹¹¹ *Canadian Bank of Commerce v. McAvity & Sons Ltd.* (1959), 17 D.L.R. (2d) 529 (S.C.C.).

¹¹² See also *Geo. W. Crothers Ltd. v. Bank of Nova Scotia, supra*, footnote 86, where the work was done on Crown lands and the lien provisions of the Act were unavailable to the plaintiff, who therefore brought his action under s. 3. See also *Wells H. Morton & Co. Ltd. v. Canadian Credit Men's Trust Association* (1966), 52 D.L.R. (2d) 625 (Man. C.A.). In *Regina v. Canadian Indemnity Company Limited* (1964), 41 D.L.R. (2d) 617, at p. 645, Nikitman J. held that the Crown was a "person" within the meaning of s. 3 of the Builders and Workmen Act, R.S.M. 1954, c. 28, and therefore the money paid by the Crown to the trustee in bankruptcy of a contractor was subject to the statutory trust in favour of subcontractors, suppliers and workmen.

¹¹³ R.S.O. 1950, c. 227, s. 2.

¹¹⁴ *Supra*, footnote 111, at pp. 531, 532.

supplemental to the security on the land itself which might be brought to an end by the price being paid in full to the contractor. It appeared to the Court that "it would defeat that fundamental object of the statute to deny this trust to workmen on a work on a highway and leave them without any security whatever, while giving additional security to those already entitled to a lien".¹¹⁵

In *Bank of Montreal v. Township of Sidney*¹¹⁶ one of the arguments raised by the bank was that s. 13(1)¹¹⁷ which stated that a lien was to have "priority over all judgments, executions, assignments . . . issued or made after the lien arises . . ." impliedly excluded an assignment made before the lien arose from the application of the section. LeBel J. looked to the context in which the word "assignment" appeared, that is, among certain kinds of judicial process, and decided that it did not refer to equitable or statutory assignments of money but an assignment in the nature of an assignment in bankruptcy; in any event, the section did not say that to secure priority the lien must arise before an assignment. If that were the case, the whole object of the Act would be defeated.¹¹⁸

Distribution of Trust Fund

In *Minneapolis-Honeywell Ltd. v. Empire Brass Mfg. Co. Ltd.*¹¹⁹ Rand J. stated:

Section 3 does not require that the moneys be distributed on a pro rata basis. The subcontractor has, in this respect a discretionary power, and his obligation is satisfied when the trust moneys are paid out to persons entitled, whatever their division.¹²⁰

This is a reasonable and practicable rule where the payments are made out of the trust moneys while the contractor operates a going concern, or, as in the facts of this case, an assignee is fixed with a transmitted fiduciary obligation; however, different considerations may well arise where the contractor knows that he is on the verge of bankruptcy and attempts to make a fraudulent preference in favour of certain creditors. In that event a discretionary power of

¹¹⁵ *Ibid.*, at p. 532.

¹¹⁶ *Supra*, footnote 12. The facts of the case are given *supra* at p. 80.

¹¹⁷ R.S.O. 1950, c. 227, s. 13(1). "The lien has priority over all judgments, executions, assignments, attachments, garnishments, and receiving orders recovered, issued or made after the lien arises, and over all payments or advances made on account of any conveyance or mortgage after notice in writing of the lien has been given at the address endorsed on such conveyance or mortgage pursuant to section 45 of The Registry Act to the person making such payments or after registration of a claim for the lien as hereinafter provided, and in the absence of such notice in writing or the registration of a claim for lien all such payments or advances have priority over any such lien."

¹¹⁸ *Supra*, footnote 12, at p. 582.

¹¹⁹ *Supra*, footnote 2.

¹²⁰ *Ibid.*, at p. 697.

distribution might involve a conflict with the purpose behind bankruptcy legislation and work an injustice.¹²¹

It is clear that where money subject to the trust fund provision has been paid into court upon the contractor's bankruptcy, it will be distributed rateably among the suppliers and subcontractors.

Equity requires that the payments should be made rateably when the situation arises that there will be a deficiency and while the trustee in bankruptcy in a sense stands in the same position as the debtor, i.e. the bankrupt debtor, nevertheless in such circumstances, as trustee of this fund, he is bound in equity to distribute the same rateably among the creditors whose claims are for material and work on the construction in question and without regard to the assignment to one creditor.¹²²

S. 3 of The Mechanics' Lien Act establishes a trust but makes no provision as to how the trust is to be administered. In the *Davidson*¹²³ and *Putherbough*¹²⁴ cases a reference was directed. If the fund is small, this procedure is impractical. As an alternative it is possible, if only three or four creditors are involved, to have the trustee distribute the funds after first obtaining from the creditors concerned, an agreement to indemnify the trustee if other claims appear.¹²⁵

Miscellaneous

In the British Columbia case of *Scott and Scott v. Riehl and Schumak*¹²⁶ the plaintiffs entered into a contract with Schumak & Riehl Builders Ltd. for the construction of a house. Upon completion and payment of the price, the plaintiffs discovered that the company had not paid for labour and materials going into the building, and mechanics' liens totalling \$6,447.51 had been filed. Plaintiffs negotiated a settlement of the claims and then, relying on s. 3(1),¹²⁷ sued personally the directors of the two-man company, which by then had been declared bankrupt. The Court noted that the plaintiffs as owners were within the classes of *cestuis que trustent* named

¹²¹ Once the contractor becomes bankrupt, the balance of the contract moneys owing, held by the owner, vest in the trustee in bankruptcy and must be paid over to him. The responsibility of the trustee in bankruptcy is governed by s. 39 of the Bankruptcy Act, R.S.C. 1952, c. 14, and the trust fund provision of The Mechanics' Lien Act. The money is divisible among those entitled to it by virtue of the mechanics' lien legislation. See *Regina v. Canadian Indemnity Company Limited*, *supra*, footnote 112, at pp. 643, 644; *Royal Bank of Canada v. Wilson* (1963), 42 W.W.R. 1 (Man. C.A.).

¹²² *Re Putherbough Construction Co. Ltd.*, 37 C.B.R. 6, at p. 7.

¹²³ *Re Walter Davidson Co. Ltd.*, *supra*, footnote 97.

¹²⁴ *Re Putherbough Construction Co. Ltd.*, *supra*, footnote 122.

¹²⁵ See Lloyd W. Houlden, Comment, 37 C.B.R. 10.

¹²⁶ (1958), 25 W.W.R. 525 (B.C. S.C.).

¹²⁷ R.S.B.C. 1956, c. 27, s. 3(1). "All sums received by a contractor or subcontractor on account of the contract price shall be and constitute a trust fund in the hands of the contractor or of the subcontractor, as the case may be, for the benefit of the owner, contractor, subcontractor, Workmen's Compensation Board, workmen, and materialmen; and the contractor or the subcontractor, as the case may be, shall be the trustee of all such sums so received by him, and, until all workmen and all materialmen and all subcontractors are paid for work done or material supplied on the contract and the Workmen's Compensation Board is paid any assessment with respect thereto shall not appropriate or convert any part thereof to his own use, or to any use not authorized by the trust." *Italics mine.*

in the section.¹²⁸ The plaintiffs claimed that the moneys received by the company were trust moneys held by the company as trustee for the benefit of the plaintiffs and all other beneficiaries named in s. 3(1), and that the money had not been applied on those trusts but had been appropriated to uses not authorized by The Mechanics' Lien Act. The moneys had been paid into the company's general account which was always overdrawn and from which were paid all the company's general expenses. The Court found that since Riehl had opened the account and directed its use,

he knew that moneys deposited, such as those received from the plaintiffs, must be used for the general purposes of the company in abuse of the trust created by s. 3 of the Mechanics' Lien Act. He knowingly created, maintained and operated this unlawful system. The company was the instrument of its operation, but he was the director. Directors may be liable to third parties for a company's wrongdoing if they have expressly authorized the wrongful acts complained of.¹²⁹

The director, Riehl, became a *trustee de son tort* by his participation in the breach of trust and was personally liable for the loss caused to the owner.¹³⁰

The decision in this case extends the range of parties against whom the damnified *cestui que trust* may have recourse. Since it is a universal practice for construction companies to operate their business with a general account¹³¹ the officer of the company receiving the cheque from an owner and authorizing its payment into the company account would find himself personally liable for any damage resulting to the owner caused by unpaid workmen or suppliers registering liens against the property, where he knew that the workmen and suppliers had not been paid.¹³² It is difficult to envisage circumstances, even in a large company, where the officer charged therewith would not be aware of the state of the company's accounts. As for the plethora of small one-man construction companies, the corporate veil would prove to be no protection against a wide variety of creditors, since there is no reason why this remedy should not be available to the other *cestuis que trustent*, the unpaid suppliers, subcontractors and workmen, as well as to the owner.

Where the trustee in bankruptcy pays moneys subject to the trust fund created by s. 3(1) into a bank account, the interest collected on the fund while awaiting disposition at trial belongs to

¹²⁸ In the corresponding section in the Ontario Act, the word "proprietor" is used. See R.S.O. 1960, c. 233, s. 3(1).

¹²⁹ (1958), 25 W.W.R. 525, at p. 527.

¹³⁰ 33 Halsbury 326, 307; *Minneapolis-Honeywell Ltd. v. Empire Brass Mfg. Co. Ltd.* (1954), 11 W.W.R. (N.S.) 212, at p. 223 per Davey J.; *Rainham Chemical Works Ltd. v. Belvedere Fish Guano Co. Ltd.*, [1921] 2 A.C. 465.

¹³¹ E.g. see *John M. M. Troup Ltd. v. Royal Bank of Canada*, *supra*, footnote 63; *Standard Electric Co. Ltd. v. Royal Bank of Canada*, [1960] O.W.N. 367; *John Ritchie Ltd. v. Canadian Bank of Commerce*, *supra*, footnote 51.

¹³² Presumably, the principle that an agent who commits a tort is personally liable whether he acted on behalf of a principal or not, and even if he acted for his principal's benefit would cover a case of breach of trust. For a discussion of the personal liability of an agent for tortious acts, see Powell, *The Law of Agency* (2d ed. 1961), pp. 277 *et seq.*

the s. 3 creditors;¹³³ but there is no reported case which would impose upon the contractor an obligation to pay interest on the moneys from the time he received them until he paid them out to subcontractors and suppliers.

Where the trustee in bankruptcy of a contractor received moneys from one subcontractor in settlement of an action for breach of contract, another subcontractor who completed the originally defective work was not entitled to base a claim against the moneys on s. 3(1) because they were not "moneys received on account of the contract price".¹³⁴ A sum received by way of damages for breach of contract does not constitute money received on account of the contract price.

There may be situations where the contractor receives refunds on account of a deposit made, or the return of certain sums placed as security.¹³⁵ The status of such moneys is uncertain although it appears that they would be available for distribution to general creditors, without priority to claimants under s. 3(1), because the moneys were not received on account of the contract price.

Persons claiming for the rental of equipment are not beneficiaries of the trust fund created by s. 3(1) which affords remedy for work done and materials supplied.¹³⁶ However, where a person supplies equipment and operators to a contractor and himself pays the wages of the operators and maintains such equipment at his own expense, he properly comes within the definition of subcontractor and may make a claim under s. 3(1).¹³⁷

Where lien claims are registered and are admitted as valid then claimants have a right to the whole of the moneys kept back by the owner to the extent of their claims and costs, even where moneys in excess of the statutory holdback have been withheld. Only if there is a surplus over and above the amount of the liens and costs is the money available for distribution in accordance with s. 3 of the Act.¹³⁸ Mechanics' lien claimants are, thus, the first paid out of the money in the hands of the owner to the extent of their claims and costs. Any surplus moneys are not trust funds until they are received by the contractor. S. 3 does not impose a trust on owners but on contractors and subcontractors when they have *received* moneys from the owner or head contractor.¹³⁹ In *Dominion Electric Protection Co. v. Leopold Beaudoin Construction Co.*¹⁴⁰ the plaintiff had, on the

¹³³ *In re Arthur J. Lennox Contractors Ltd.* (1959), 38 C.B.R. 97.

¹³⁴ *In Re Williams & Williams (Eastern) Limited* (1962), 3 C.B.R. 76, and Comment.

¹³⁵ *Royal Bank of Canada v. Blick, Wilson et al.*, *supra*, footnote 17.

¹³⁶ *Clarkson Co. Ltd. v. Ace Lumber Ltd.*, [1963] S.C.R. 110. For comment, see 3 Osgoode Hall L.J. 267. *In re Arthur Lennox Contractors Ltd.* (1959), 38 C.B.R. 97; *Northcoast Forest Products Ltd. v. Eakins Construction Ltd.* (1960), 35 W.W.R. 233, 26 D.L.R. (2d) 251 (B.C. S.C.).

¹³⁷ *Re Terra Cotta Contracting Co.* (1964), 43 D.L.R. (2d) 488.

¹³⁸ *Rosemount Tile and Terrazzo Ltd. v. Board of Education for the Township of North York*, (1960), 1 C.B.R. 63.

¹³⁹ See Lloyd W. Houlden, Comment, (1960), 1 C.B.R. 64.

¹⁴⁰ (1963), 5 C.B.R. 72.

order of a subcontractor, supplied and installed certain electrical equipment in a building being constructed for the federal government. When the subcontractor failed to pay, plaintiff obtained judgment against the subcontractor but this too was not paid. Plaintiff then, relying on s. 3, brought an action against the contractor. In a brief judgment Ayles J. stated:

The section appears to be chiefly in the nature of a penal statute. There is no doubt that defendant failed to comply with the provisions of s. 3, and the fact that s. 3 creates a civil liability has been fully recognized in *Minneapolis-Honeywell Ltd. v. Empire Brass Mfg. Co. Ltd.*¹⁴¹

Plaintiff was able to bring an action against defendant after having obtained judgment against the subcontractor because he relied on separate causes of action. A comment which follows the case points out:

It is unfortunate that Ayles J. did not spell out the manner in which the general contractor had failed to comply with s. 3. If we assume that the general contractor paid the subcontractor the amount owing, it would seem from the judgment that a general contractor does not discharge his trust by making payment to a subcontractor. This is indeed a startling conclusion.¹⁴²

In upholding a conviction for breach of trust under The Mechanics' Lien Act,¹⁴³ the British Columbia Court of Appeal in *Regina v. Brunner*¹⁴⁴ ruled that the provincial enactment was not *ultra vires* the province, and was not in conflict with s. 282 of the Criminal Code respecting criminal breach of trust.

Conclusion

An examination of the litigation waged over the trust fund provision of The Mechanics' Lien Act illustrates the illusionary nature of the simple rules that assignments are subject to equities and that a purchaser for value without notice takes free of a trust. The confusion in this area of the law is attributable to the inadequacy of the trust concept, owing to the characteristics which became appended to it in the course of its historical development (adequate in the times and for the purposes it served, but failing to answer this specific problem in its twentieth century context) to meet the exigencies of commercial transactions, coupled with an understandable reluctance on the part of the courts to sacrifice practical business convenience for the sake of an orderly conceptual approach to the law. The confusion centres about the nature of the trust created by The Mechanics' Lien Act and the consequences which flow from it. The problem is to be resolved either by a clear and authoritative judicial definition, which, if the law is to answer the exigencies of commercial practice, inevitably involves the abandonment of cherished but hoary concepts, or by what appears to be the more likely course, legislation. Nothing would be lost by creating a lien on the moneys received by a contractor under

¹⁴¹ *Ibid.*, at p. 73.

¹⁴² *Ibid.*, at p. 75.

¹⁴³ R.S.B.C. 1956, c. 27, s. 3(2).

¹⁴⁴ (1960), 32 W.W.R. 478.

a construction contract and imposing upon the contractor the fiduciary duty to see to it that the present *cestuis que trustent* are paid out of those funds, the lien to be lost when the funds are received from the contractor by a third party for value without notice that the contractor is acting in breach of his fiduciary duty. This would have the clear advantage of eliminating the dichotomy in the consequences of an assignment and of payment, which has led judges to make findings of fact and draw conclusions of law in spite of the evidence. A system of registration of assignments on the New York model, with the provision that the registered assignment will have priority over the lien against the moneys to the extent that the moneys advanced in consideration of the assignment were actually applied on the project, would have a salutary effect. An exception could be made in certain socially desirable cases, such as that of workmen, who are economically vulnerable in that it is not as easy for them to withhold their services when they have doubts about the solvency of their employer as it is for a large company or bank to refuse to extend credit.

Despite these problems, the remedy afforded by the trust fund provision of the mechanics' lien legislation has proved to be of great advantage to subcontractors, suppliers and workmen who, through failure to register a lien, or because a lien could not be filed against certain property,¹⁴⁵ would otherwise have found themselves without a remedy. The solution to these problems lies in reform rather than abolition, and the advocates of repeal of the trust fund provision conjure up the image of throwing out the baby with the bath.

¹⁴⁵ E.g. Crown lands, public streets and highways, interprovincial pipelines.