

Clarkson Co. Ltd. v. Canadian Bank of Commerce et al. (1966), 57 D.L.R. (2d) 193

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Commentary

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realistic approach of the common law, but also avoids rigidity and inflexibility, as has been done in other jurisdictions.⁵⁸

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MECHANICS' LIEN

Clarkson Co. Ltd. v. Canadian Bank of Commerce et al. (1966), 57 D.L.R. (2d) 193.

TRUST FUND PROVISION OF THE MECHANICS' LIEN ACT—RIGHT OF CONTRACTOR TO RETAIN TRUST MONEY FOR OWN USE—DUALITY OF THE CONTRACTOR'S ROLE AS TRUSTEE AND BENEFICIARY.

By the terms of Section 3(1) of the Mechanics' Lien Act,¹ a contractor becomes trustee of all sums received on account of the contract price and is directed not to appropriate or convert any part thereof to its own use or to any use not authorized by the trust until the terms of the trust are executed.² This section has been held to be almost absolute in its operation. The principle underlying the various cases interpreting the section is that the trust attaches, and remains firmly attached, to all sums paid on account of the contract price whether received by an assignee of book debts from an owner with notice of the assignment,³ or paid into court by the owner,⁴ or received by the contractor and applied to its overdraft by the bank upon deposit.⁵ It has most often frustrated the expectations of those

⁵⁸ MODEL PENAL CODE, § 2.09, Proposed Official Draft, 1962, (AMERICAN LAW INSTITUTE):

(i) It is an affirmative defense that the actor engaged in the conduct charged to constitute an offence because he was coerced to do so by the use of, or a threat to use, unlawful force against his person or the person of another, which a person of reasonable firmness in his situation would have been unable to resist.

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¹ R.S.O. 1960, c. 233.

² Section 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.

³ *Minneapolis-Honeywell Ltd. v. Empire Brass Mfg. Co. Ltd.*, [1955] 3 D.L.R. 561, [1955] S.C.R. 694; *Bank of Montreal v. Township of Sydney*, [1955] O.W.N. 581.

⁴ *Re Watson and Murchison*, (1963) 40 D.L.R. (2d) 1047.

⁵ *Fonthill Lumber Ltd. v. Bank of Montreal*, 19 D.L.R. 618, [1959] O.R. 451, 38 C.B.R. 68.

who undertake to extend credit to building contractors and sub-contractors. Beneficiaries of the trust recover from the assignee of book debts on the ground that assignments of trust money remain subject to the equities. The bank that applies deposited trust funds to the contractor's overdraft is held liable to the beneficiaries if it is found that the contractor has committed a breach of trust and that the bank has knowingly participated therein.⁶

The type of case in which the bank will be held to account to the beneficiaries in the latter situation is illustrated by the facts in the case of *Clarkson Co. Ltd. v. Canadian Bank of Commerce*.⁷ Gels General Contractors Ltd. had contracted to build a school for the Toronto Board of Education. In December, 1959, the defendant bank, acting through the manager of a branch where Gels did all its banking, agreed to extend \$45,000 credit to the general contractor. Until October 27, 1960, it was the practice for Gels to draw cheques in favour of unpaid sub-contractors, workers and suppliers of material and, if in so doing it incurred an overdraft, to sign notes to put the account back into credit. Subsequent payments into Gels' account, as the result of draws received on account of the contract price were appropriated by the bank to discharge these notes and thus restore Gels' credit position. This arrangement subsisted until the bank, with knowledge that Gels was being pressed for payment by the sub-contractors and that two mechanics' liens had been filed, decided to terminate the agreement. Thus, when Gels, who had no notice of the bank's intention, deposited a cheque for \$31,999.01 received on account of the contract price on October 27, the bank appropriated it to the overdraft and subsequently declined to honour cheques drawn by Gels in favour of unpaid sub-contractors. The learned trial judge, Gale J., as he then was, found that the defendant bank knew that the cheque had been received by Gels on account of the contract price and that there were sub-contractors who had not been paid for work done and materials supplied in performance of that contract. The question of the degree of knowledge required to establish participation in a breach of trust shall not be dealt with here. On these facts, the issue was decided for the plaintiff at trial⁸ and was not raised again on either appeal.⁹

⁶ The general exception to the rule is that where sums impressed with the trust are deposited in the ordinary course of business, the bank takes free of the trust. Here, the exculpatory factor is the bank's absence of knowledge of the existence of the trust. See: *Standard Electric Co. v. Royal Bank of Canada*, 24 D.L.R. (2d) 460, [1960] O.W.N. 367, 1 C.B.R. (N.S.) and *John M. Troup Ltd. et al. v. Royal Bank of Canada*, 34 D.L.R. (2d) 556, [1962] S.C.R. 487, 3 C.B.R. (N.S.).

⁷ (1966) 57 D.L.R. (2d) 193. (Supreme Court of Canada). Appeal by the plaintiff from the judgment of the Ontario Court of Appeal, (1965) 47 D.L.R. (2d) 289, sub nom. *John Ritchie Ltd. v. Canadian Bank of Commerce*, allowing an appeal from the High Court of Ontario, (1963) 38 D.L.R. (2d) 546.

⁸ (1963) 38 D.L.R. (2d) 546, at pp. 561-571.

⁹ For a thorough discussion of the subject of knowledge see Mik, J. W., *The Trust Fund Provision of the Mechanics' Lien Act*, Osgoode Hall Law Journal, Vol. 4, No. 1, April, 1966, p. 77 and particularly at p. 86.

The chief issue at all levels, trial and appellate, was whether or not Gels had been guilty of a breach of trust. Counsel for the defendant bank structured an argument which, if it had succeeded, would have served to exculpate the bank by setting it at arm's length from the operation of the trust. The facts material to his contention are to be found in the course of dealings between Gels and the sub-contractors on the one hand, and between Gels and its suppliers and workers on the other. The latter were paid by Gels as materials were invoiced or as wages fell due without waiting for a progress certificate from the architects. Payment of the sub-contractors entailed their billing Gels who in turn submitted a request for an interim payment to the Board of Education. These requisitions, which were prepared approximately once a month, included amounts claimed by Gels for work done and material supplied through its employees and suppliers. If the requisition was approved by the architects, Gels received a cheque for the sum requested, less the statutory holdback of 15%. This procedure involved a time lag of one month. The payment of October 27th, 1960, was made pursuant to a requisition dated September 30, 1960. In the meantime, further sums had fallen due to Gels and the sub-contractors. The trial judge found that Gels' out-of-pocket expenses during the month prior to October 27th exceeded the \$31,999.01 received on that date.

On the strength of these facts, counsel for the defendant submitted "that a trust did not come into existence for the reason that, as soon as the sum of \$31,999.01 was received by Gels from the owner, it was *contemporaneously or instantly freed* from any trust in favour of the other beneficiaries . . ." ¹⁰ His reasons were twofold. First, since Section 3(1) contemplates that the contract price shall be the limit of the trust, to hold that the contractor may not reimburse itself out of sums received on account of the contract price to the extent of its expenses prior to the draw would serve to give the beneficiaries security not only in the contract price, but also in an amount beyond that price equal to that sum paid to them by the contractor. Secondly, s-s.(3), particularly in view of its opening words, "*notwithstanding the other provisions of this section*", operates as an exception to the rule in s-s.(1).

3.—(3) Notwithstanding the other provisions of this section, where a builder, contractor or sub-contractor has paid in whole or in part for any materials supplied on account of the contract, or any workman or sub-contractor 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 sub-contractor of any amount so paid by him shall not be deemed an appropriation or conversion thereof to his own use or to any use not authorized by the trust.

Counsel argued that the effect of this subsection is to make the contractor a beneficiary of the trust to the extent of money paid out on the job. Accordingly, in this case Gels took the entire sum of \$33,999.01 beneficially.

¹⁰ 38 D.L.R. (2d) 546 at p. 556.

This attempt to establish the bank's immunity to the claims of the unpaid sub-contractors by severing the sum deposited by Gels from the statutory trust ultimately failed on two grounds. It was held that the facts of this case do not come within the exception. At trial, Gale, J. stated:

In other words, to make s-s(3) effective, it would have to be shown that the total of all moneys paid out by Gels on the contract prior to October 27th was at least \$31,999.01 greater than the total of draws received by it prior to that date, and the fact that Gels expended more in October than it received in that month would not automatically give it the right to keep the whole of the \$31,999.01.¹¹

The majority of the bench in the Supreme Court of Canada concurred with this view.¹²

Furthermore, the Supreme Court of Canada did not agree with respondent's interpretation of the nature of the exception. The learned Cartwright, J., speaking for the majority, held that:

Assuming, for the purposes of this branch of the matter, that in fact when Gels deposited the cheque for \$31,999.01 the total of all payments made by it out of its own funds in fulfillment of the contract exceeded by that amount the total of all payments received by it on account of the contract price, the result would not be that the \$31,999.01 was not subject to the statutory trust created by s. 3; it would be, as pointed out by Roach, J.A., that Gels was trustee of the fund and also one of the beneficiaries of the trust.¹³

In other words, s-s.(3) does not exclude the operation of the rule expressed in the opening words of s-s.(1): "All sums received by a . . . contractor . . . on account of the contract price are and constitute a trust fund in the hands of the contractor . . ." Although it is possible to argue against this position, it is clear that the Court, while willing to recognize the equity of the contractor in sums so received, has manifested an intention to exercise some supervision over those sums in order to protect the interest of the other unpaid beneficiaries. This is entirely consistent with the purpose of Section 3 of the Act.

The implications of this, particularly for the contractor's creditors, are described by Cartwright, J.:

When Gels received the \$31,999.01 it did so as trustee but had a discretionary power to pay it to one or more of the beneficiaries to the exclusion of others. It had therefore, in the assumed situation, a discretion to retain it all for itself. Gels acted throughout by its general manager, Livingstone, and it appears to me that the only reasonable inference to be drawn from the relevant evidence is that Livingstone decided not to retain the money for Gels but to pay it out to the plaintiff and the others on whose behalf the plaintiff sues.¹⁴

Normally, a trustee must distribute trust moneys *pro rata* when there is not sufficient to realize the claims of all the beneficiaries. If this principle had been applicable in this case, it may have been arguable that Gels was entitled to take a share of the \$31,999.01, in proportion

¹¹ 38 D.L.R. (2d) at p. 561.

¹² 57 D.L.R. (2d) at p. 199. The Court also "reached the conclusion that in the circumstances of this case the onus lay upon the respondents to show that Gels was entitled as beneficiary to all or part of the \$31,999.01, and that it has not discharged that onus". At p. 200, Judson, J. dissenting, at p. 204.

¹³ 57 D.L.R. (2d) at pp. 201-202.

¹⁴ 57 D.L.R. (2d) at p. 202.

to the amount claimed in the requisition of September 30th, in the capacity of beneficiary. However, it has been held that since s-s.(1) does not stipulate the manner in which the *corpus* of the trust is to be distributed, the contractor has "a discretionary power, and his obligation is satisfied when the trust moneys are paid out to persons entitled, whatever the division."¹⁵ It is the exercise of this discretion that the Court wishes to supervise.

Thus, it may be stated that if the contractor has a beneficial interest, the interest does not vest automatically. The contractor takes in its capacity as trustee and then must constitute itself a beneficiary by performing some act in relation to the trust fund that the courts will classify as a retention for its own use. In determining whether or not the contractor has decided to exercise its discretion in its own favour the courts have looked to the intention of the contractor. In this case, the trial judge made the following statement:

Livingstone probably thought that the cheque would be treated in the way in which its predecessors had been treated and that its proceeds would be employed to reduce the overdraft and thus provide the basis for the extension of further credit with which to pay the sub-contractors. But it is also certain that, at least, he knew beyond any doubt that there was an overdraft and that the cheque would be used by the bank to reduce that overdraft.¹⁶

Hence, it would appear that it was the contractor's actual intention to retain the \$31,999.01 for his own use, that is, to secure credit on the basis of which the sub-contractors would be paid in due course, particularly in light of the fact that Gels did not know that the credit agreement was about to be terminated by the bank. However, Cartwright, J. seems to have interpreted the contractor's intention differently:

Livingstone's intention . . . was to follow an established practice of depositing the trust moneys in Gels' only bank account and paying it out forthwith to its sub-contractors who were beneficiaries of the trust: that this was his intention was well known to the branch manager of the bank.¹⁷

This view can be explained only if it is assumed that Cartwright, J. preferred to ignore the form of the manner in which Gels expected the sub-contractors to be paid. That is, whether they are to be paid out of the same funds as deposited by the contractor or out of the funds made available to the contractor by virtue of its credit position being restored by the appropriation of funds so deposited to the overdraft is immaterial. The fact that the contractor issues cheques in favour of the unpaid beneficiaries is conclusive evidence of its intention not to retain the moneys for its own use.

One can foresee that it will be difficult for the courts to determine whether a contractor has exercised its discretion in its own favour or in favour of the other beneficiaries and hence, when it is competent for a bank to appropriate funds paid into an overdrawn account. In this case, it was held that:

¹⁵ *Minneapolis-Honeywell Regulator Co. Ltd. v. Empire Brass Mfg. Co. supra*, footnote 3, per Rand, J. at p. 563 D.L.R.

¹⁶ 38 D.L.R. (2d) at p. 570.

¹⁷ 57 D.L.R. (2d) at p. 203.

It is elementary that a trustee cannot delegate the exercise of a discretion committed to him by the instrument creating the trust and *a fortiori* he cannot be compelled by a creditor who is a stranger to the trust to exercise his discretion in a particular manner which will benefit that stranger to the detriment of the beneficiaries.¹⁸

Would that principle be applicable in this situation? X deposits \$40,000, to which it is beneficially entitled, into its account which is overdrawn to the extent of \$20,000. X immediately issues cheques totalling \$20,000 to unpaid beneficiaries and these cheques are honoured by the bank. Two weeks later, the bank appropriates the \$20,000 remaining in X's account to the overdraft. X, without notice of the appropriation, issues cheques amounting to \$20,000 and the bank subsequently dishonours them. At the material time, the bank knows that there are unpaid beneficiaries. Would the lapse of two weeks indicate that X had decided to retain the \$20,000 for its own use, or does that sum remain subject to the trust? There are endless variations on this simple theme, each a potential source of litigation. It is submitted that the only effective way for the banks to protect themselves is to give actual notice of an intent to terminate a credit agreement, or to appropriate sums to which the contractor is beneficially entitled, before they are deposited. This will compel the contractor to exercise its discretion in a manner that the courts will recognize as decisive proof of intention.

It is possible that the exception recognized and established by this case will restore the importance of the assignment of book debts as a security in the field of construction financing. For example, a contractor makes an assignment for valuable consideration of all sums received on account of the contract price to which it may become beneficially entitled. One can anticipate a number of issues that may arise. Does the word "retention" in s-s.(3) include a retention by an assignee? Is it competent for a trustee to make such an assignment? Are the courts prepared to hold that the contractor may exercise its discretion prior to the receipt of sums on account of the contract price? While it is not within the scope of this article to answer these questions, it is submitted that the rule that a contractor as trustee cannot bestow by assignment a better title than that which it has shall no longer be conclusive in these cases.

Finally, the case of the banker who is fortunate enough to have no knowledge of the trust, or of a contractor's breach of trust, will not be influenced by the principle laid down in this case regarding a stranger to the trust compelling an exercise of the trustee's discretion. The absence of such knowledge in the appropriate circumstances has been held to release the money from the trust and to vest legal title in the bank.¹⁹

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¹⁸ 57 D.L.R. (2d) at p. 202.

¹⁹ *Supra*, footnote 6.

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