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Article 8

Fonthill Lumber Ltd. v. Bank of Montreal

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Case Comment

FONTHILL LUMBER LTD. v. BANK OF MONTREAL—SECTION 3 MECHANICS LIEN ACT (ONT.)—TRUST FUND—DEPOSIT BY CONTRACTOR TO OVERDRAWN ACCOUNT—KNOWLEDGE OF BANK MANAGER. In 1942 the Ontario *Mechanics' Lien Act*[1] was amended to add the present section 3 which creates a trust fund in favour of materialmen and workmen of all sums received by a builder, contractor or subcontractor on account of the contract prices. In 1948 a similar amendment was made to the *Mechanics' Lien Act of British Columbia.*[2]

Despite the extensive building programme in Canada, there have been relatively few reported decisions on this section. The reported cases fall into two main categories—viz., those dealing with an assignment of book debts by the contractor to the bank and those dealing with deposits to a general checking account (usually overdrawn). The first category is exemplified by such cases as *Bank of Montreal v. Sidney*[3] and the Supreme Court of Canada decision in *Minneapolis-Honeywell Regulator Co. v. Empire Brass Mfg. Co.*[4] The present comment will be confined to a discussion of the recent cases dealing with the second category and in particular, with the decision of the Ontario Court of Appeal in *Fonthill Lumber Ltd. v. Bank of Montreal.*[5]

Since the *Fonthill Lumber* case has already been distinguished on the facts in two recent decisions, a careful examination of those facts is imperative.

A, a contractor, required funds to carry on his business and was granted an overdraft of $5000. in August, 1955, the security being the personal guarantee of his wife. On November 1, 1956 the overdraft amounted to $8796 and the bank manager began to press for payment. A, having been given a cheque for $1600. on account of a contract, deposited this amount on November 16. Between November 19 and 22 six cheques were dishonoured. This pressure succeeded, for on November 23 A deposited $7899. being cheques and cash paid to

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[1] Statute Amendment Act, 1942 (Ont.), c. 34, s. 21. See now R.S.O. 1960, c. 233.

[2] R.S.B.C. 1948, c. 205. See now R.S.B.C. 1960, c. 238.

[3] [1955] O.W.N. 581; 4 D.L.R. 87 which was considered in *Dominion Bank v. Fassell and Baglier Construction Co.*, [1955] O.W.N. 709, and distinguished in *Niagara Concrete Pipe Ltd. v. Charles Stewart Ltd.*, [1956] O.W.N. 769.

[4] [1955] S.C.R. 694; 3 D.L.R. 561 reversing (1954), 13 W.W.R. (NS) 449. This case has been followed in *Evans Coleman and Evans Ltd. v. Nelson Construction Co.* (1958), 14 D.L.R. (2d) 218; 25 W.W.R. 569 and approved in *Scott v. Riehl* (1959), 15 D.L.R. (2d) 67; (1958), 25 W.W.R. 525. An interesting comment on the *Bank of Montreal v. Sydney and the Minneapolis-Honeywell* cases written by H. Maxwell Bruce Q.C., co-author of a *Handbook of Canadian Mechanics' Liens* (Toronto, Carswell Co. 1956), may be found in (1956), 34 Can. Bar Rev. 855.

[5] [1959] O.R. 451; (1959), 16 D.L.R. (2d) 746 (trial); (1959), 19 D.L.R. (2d) 618 (C.A.); (1959), 38 Can. Bcy. R. 68.

him by persons for whom he was building houses. After the manager would not succumb to the insistence of Mr. A to allow Mrs. A to withdraw her guarantee, Mrs. A gave notice of such withdrawal. At the same time A informed the manager not to cash any future cheque which would result in his account being overdrawn. Accordingly, several cheques to cover payment for wages and supplies were dishonoured. After his proposal to his creditors was refused, A made an assignment in bankruptcy on December 12, 1956.

A supplier, the Fonthill Lumber Co., instituted an action against the bank to test the propriety of the bank applying the funds against the overdraft—especially the deposit on November 23. On having its action dismissed by Stewart J., the plaintiff advanced three grounds of appeal.

The first ground was that section 3 created a statutory trust which remained in full force as long as there were unpaid workmen and materialmen. Hence A had no title to the fund and could not transfer title to the bank. Notice of the trust character of the fund by the bank was therefore immaterial. The appellant thus tried to apply the principles of the *Minneapolis-Honeywell* decision by analogy. However, the Court of Appeal, after finding no assignment in fact, stated that "the principle applicable to an assignment of such funds would not operate to prevent the depositor from conferring title upon the banks to the moneys deposited by him *in the ordinary course of banking*".[6] It is submitted that this line is the key to the decision of this and subsequent cases. The question of fact becomes simply, what is the ordinary course of banking and has this course been followed in these circumstances?

The appellant then argued that the bank manager was aware of the money and was under a duty to make proper inquiries to ascertain if there were outstanding accounts for work and material. It was apparent from the evidence that the manager knew that the money had come from persons for whom A was building houses. The argument as to the duty of the manager was not fully canvassed by the Court of Appeal in its decision, but was dealt with recently by Smily J. in *Standard Electric Co. v. Royal Bank of Canada*[7] where he stated that such an onerous duty could become ludicrous if each deposit would have to be minutely scrutinized.

In conclusion it was argued that, in any event, the bank manager had actual knowledge that the moneys were trust funds, knew of A's financial difficulties, and knew that A was not entitled to divert those moneys to his private use or for the benefit of his wife (i.e. since she was the guarantor of the overdraft). On the question of the knowledge of the manager, the Court of Appeal disagreed with the trial judge. Stewart J. had stated:[8]

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6 [1959] O.R. at p. 465. Italics mine.
7 [1960] O.W.N. 367; (1960), 24 D.L.R. (2d) 467.
8 [1959] O.R. 451 at 456; (1959), 16 D.L.R. (2d) 746 at 747.

> "Mr. Partington states, and I accept his evidence that he did not know whether or not Anger owed for labour or materials or whether he could meet his obligations to his suppliers. He states that he did not either know or suspect that he was in any financial difficulties, but, in view of the fact that he had considerable difficulty in getting Anger to reduce the amount of his overdraft, I have some hesitancy in accepting this last statement".

Stewart J. then found that the plaintiff had not shown that the defendant was aware of the trust and was therefore not a party to the breach of trust. The Court of Appeal, speaking through Schroeder J.A., could not agree with these findings, stating that the Court below must have "overlooked" the evidence of the cheques for materials and wages which were dishonoured. The Court of Appeal went on to find that the manager knew the source of these moneys, realized that A was financially embarrassed and that there were unpaid accounts and, since he must be taken to have known the provisions of section 3 of the *Mechanics' Lien Act*, he must have known that the moneys were a trust fund.[9] Applying the law to the fact so found, the Court held that the bank was under a "transmitted fiduciary obligation" to account to the beneficiaries (unpaid workmen and materialmen) of the trust, following the leading case of *John v. Dodwell and Co.*[10] The manager knowingly participated in the breach of trust. The fact that there was a personal benefit to the bank, although not necessarily proof of privity to the breach of trust, was considered as strong evidence of such.[11] Hence the money received by the bank in such circumstances is to be held on a constructive trust for all unpaid workmen and suppliers of the bankrupt contractor.

The findings in this case may be brought into a sharper relief if shortly contrasted with the two recent Ontario cases which distinguished it. In *John M. Troup Ltd. v. Royal Bank of Canada*,[12] Wells J. found that the deposit on the facts "was made in what appears to have been the ordinary course of business by the construction company".[13] There was no evidence of knowledge by the bank of the accounts of the materialmen as was found in the *Fonthill Lumber* case. Moreover, the deposit in question was made during a time when the account balance was actively fluctuating. Hence, the action was dismissed.

The same result was reached on similar facts in *Standard Electric Co. Ltd. v. Royal Bank of Canada*.[14] Smily J. obviously had the *Fonthill Lumber* decision in mind when he found that the money "was

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[9] Thus distinguishing *Thomson v. Clydesdale Bank Ltd.*, [1893] A.C. 282 on the facts.

[10] [1948] A.C. 563. See generally, Baxter, *The Law of Banking*, (Toronto, Carswell Co. Ltd., 1956), pp. 298-303.

[11] On this point the court cited *Gray v. Johnston* (1868), L.R. 3 H.L. 1.

[12] [1960] O.W.N. 350; (1960), 24 D.L.R. (2d) 460. This case is also interesting in that there was also an assignment of book debts. However, it was never relied upon or used and it was held that the deposit was paid in virtue of the assignment—thus closing the door to a possible *Minneapolis-Honeywell* line of argument.

[13] *Ibid.* at p. 351 O.W.N.; p. 464 D.L.R.

[14] [1960] O.W.N. 367; (1960), 24 D.L.R. (2d) 467.

deposited in a general way in the ordinary course of business. It was not the result of any pressure by the bank, for there was no concern at that time on the part of the bank with respect to the financial condition of the contractor".[15] Hence on the facts the manager was not aware of either the financial difficulties, the breach of trust of the contractor, or the origin of the moneys deposited.

This result is, of course, in line with the situation envisaged in section 96(1) of the *Bank Act*[16] which states that, "The Bank is not bound to see to the execution of any trust, whether express, implied or constructive, to which any deposit made under the authority of this Act is subject". This section had been pleaded as a defence in the *Fonthill Lumber* case but Schroeder J.A. held that this section would not operate so as to release a bank from liability if it knew, not merely of the existence of the trust, but also of the commission of a breach of trust, or of unusual circumstances which should have put it on inquiry. Thus section 96(1) apparently leaves the common law unaltered.[17]

The Court of Appeal also decided that section 3 of the *Mechanics' Lien Act* was within the legislative competence of the provincial legislature and that the bank was bound by all existing laws of the province. It appears inherent in the judgment that section 3, while it "affects" banks and banking, was not passed "in relation to" banking[18] but was rather legislation in relation to contracts within the province.[19]

Thus the legislative desire to protect workmen and materialmen from impecunious contractors has been implemented in the main. It is clear from the *Minneapolis-Honeywell* decision that an assignment of book debts is not a sufficient security for a bank to accept if it is to be completely protected. It is submitted, however, that a bank may grant an overdraft and accept deposits against it unless in fact it has been a party to a subsequent breach of trust by either instigating it or knowingly acquiescing in it. Pressing for payment of an overdraft is surely "in the ordinary course" of banking but it is clear that pressure to such an extent as to knowingly force a customer to breach his fiduciary obligations is not. Due to the constrictions of the doctrine of *stare decisis* the Courts will doubtless refuse to define the precise line of demarcation at which such pressure will necessitate knowledge of the breach of trust. This is basically a problem for the practitioner rather than the theorist and as such will doubtless be more fully litigated.

It is further suggested that events have proved that the prediction of one commentator following the Ontario Court of Appeal

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[15] *Ibid*, at p. 368 O.W.N., p. 469 D.L.R.
[16] 1953-54, 2 & 3, Eliz. II.
[17] This view is in accord with that of Prof. I. F. G. Baxter at p. 355 of *The Law of Banking, supra* footnote 12.
[18] *Bank of Toronto v. Lambe* (1887), 12 A.C. 574.
[19] *Citizens Insurance Co. v. Parsons* (1882), 7 A.C. 96.

decision in *T. McAvity & Sons v. Can. Bank of Commerce*[20] that "if the chartered banks are to continue the normal financing of the operations of contractors, then a speedy repeal of section 3 appears to be indicated",[21] was unduly apprehensive. The courts are aware that there are conflicting interests between two relatively innocent parties and that the legislature has decided in its wisdom to protect the interests of the party who has the least opportunity of protecting himself. The chartered banks are surely in a better position to ascertain the present and future financial position of a contractor than is a workman. Hence, while the banks may be more cautious in the future in dealing with builders, it is improbable that they will refuse to grant credit to members of a basic industry merely on the ground that in some cases they may not have unimpeachable securities.[22]

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