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Trust Claimants vs. Secured Lenders

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There has been much discussion in recent years concerning the decision in *Royal Bank of Canada* v. *Atlas Block*. That 2014 decision of the Ontario Superior Court dealt with the conflicting rights of a secured lender and a supplier with a trust claim under the *Construction Lien Act* ("CLA") in the context of a bankruptcy. The case is being relied on by secured lenders and Receivers as authority for the proposition that 1) trust claims under the CLA do not survive bankruptcy where trust monies have been co-mingled with other monies, and 2) there is no legal obligation on a Receiver to segregate monies it collects in order to ensure that trust monies retain their status. We can expect this case to be challenged in 2017 and hopefully replaced by a more reasoned and fair approach.

By way of background, Holcim supplied cement powder to Atlas who in turn incorporated that powder into products sold to construction projects and retailers. Atlas became insolvent and its Receiver collected millions of dollars in receivables from construction projects and retailers. The Receiver co-mingled all of the funds in one account as did Atlas before the Receiver. Atlas eventually made an assignment into bankruptcy.

The Court found that while s.67(1) of the *Bankruptcy and Insolvency Act* ("BIA") excludes trust monies from the bankrupt's estate, any trust created by provincial statutes such as the CLA must strictly comply with the common law test for trusts in order to fall outside of the distribution scheme of the BIA.

The Court concluded that because Atlas and the Receiver had co-mingled all monies collected, any trust monies could not be adequately identified and therefore did not meet the common law test for a trust. The funds therefore would go to the secured lender and not the trust claimants under the CLA. More troubling was the Court's conclusion that there is no obligation on the party owed money to segregate monies collected in order to avoid the co-mingling that can destroy the trust. By extension, Receivers have no obligation to segregate monies collected in order to ensure trusts are preserved.

The decision is bad for suppliers and constructors who have trust claims against insolvent companies. The case is good for secured lenders and Receivers who assume now they have no obligation to preserve trusts by segregating monies collected. Indeed, Receivers could intentionally take steps to destroy trusts for the benefit of the secured lenders who appointed them. It is respectfully submitted that the decision is wrong. It is not consistent with existing case law and unfairly ignores the purpose of the trust provisions of the CLA.

It is anticipated that the decision in *Royal Bank* v. *Atlas* will be challenged on two fronts.

First, the Court in *Atlas* concluded that co-mingling of trust monies with non-trust monies automatically destroys the trust because trust monies are no longer traceable. This conclusion is not correct either in logic or law. It is often possible to identify and trace trust monies co-mingled with non- trust funds.

The case of *Kel-Greg Homes* is a 2015 decision of the Nova Scotia Supreme Court. In that case, Kel-Greg ("KG") was a general contractor and had one bank account into which trust and non-trust monies flowed with no means of distinguishing them. KG went bankrupt and a trustee was appointed. KG had received deposits from home buyers to be held in trust. The question was whether the funds retained their trust character.

The Court in *Kel-Greg Homes*, relying on the leading Supreme Court of Canada case of *British Columbia* v. *Henfrey Samson* (1989), concluded that the mere co-mingling of trust monies with other trust or non-trust monies does not necessarily eliminate the trust. The critical element to that determination is whether the trust monies can be either identified or traced.

After determining that co-mingling of trust funds with other funds destroys the trusts, the Court in *Royal Bank* v. *Atlas* concluded that there is no obligation on a party receiving payment on more than one construction project to segregate monies collected in order to preserve deemed trusts. This logic was extended to Receivers of insolvent companies.

In fact, a party receiving monies impressed with a trust has an obligation as a trustee to preserve those funds and allocate them as prescribed by the CLA. A trustee does not have carte blanche to treat trust monies as he pleases.

In *St. Mary's Cement Corp.* v. *Construct Ltd.*, a 1997 decision of the Ontario Superior Court, Justice Molloy held that,

> In my view, the language of s. 8(2) of the Act which sets out the obligations of the trustee is mandatory. It provides that the trustee shall not use the trust funds for any purpose inconsistent with the trust until all trades and suppliers are paid all amounts owed to them. Section 8(1) specifically provides that the trust fund is held for the benefit of persons who supplied goods and services to the improvement and who are owed money. … Allowing the trust funds to be intermingled with other trust monies and used for general purposes is inconsistent with the trustee's duty to maintain proper control of the trust fund.

It is hoped that the next time these issues are before an Ontario Court, proper recognition will be given to the fact that the deemed trust provisions of the CLA apply to money which is "owing" and not just to monies received and segregated. This distinction means that the recipients of trust monies are obliged to preserve those monies for their intended purpose. Court-appointed Receivers owe a duty of fairness to all creditors and should not be allowed to treat trust monies in a way that destroys the trust.

About the Author
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