

Certainly Uncertain: Construction Trusts After Iona

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The recent decision in *Iona Contractors Ltd. v. Guarantee Company of North America, 2015 ABCA 240 [Iona]* (PDF) (leave to appeal to the Supreme Court of Canada denied) clarifies the law regarding provincial statutory trusts in the insolvency context. The decision will be of particular interest to practitioners involved in construction projects where the insolvency of a party in the middle of the contracting chain can wreak havoc on the entire project.

Pursuant to subsection 67(1)(a) of the *Bankruptcy and Insolvency Act* (the "BIA"), property that is held in trust by a bankrupt for another person does not comprise part of the estate. Whether or not a trust exists is determined according to the "three certainties" identified at common law (certainty of intention, subject matter and object). The *Iona* decision is noteworthy because it appears to have expanded the circumstances in which a trust will be found to have been validly created. Specifically, as a result of the decision in *Iona*, a valid trust may be formed even when the settlor in fact had no subjective intention to create a trust but dealt with property subject to a provincial statute that purports to do so.

In the result, in Alberta and perhaps in other jurisdictions now, funds that are paid to a contractor by the owner of a project and which would otherwise be available for distribution to the contractor's creditors in the event of its bankruptcy are now more likely to be impressed with a trust exclusively for the benefit of subcontractors.

Legal Context

Builders' lien statutes in each of Canada's common law provinces (except Newfoundland and Labrador, where builders' liens fall under the *Mechanics' Lien Act*) include provisions purporting to create trusts (referred to herein as "construction trusts") for the benefit of persons that improve the land during a construction project. The language of such provisions are unique to the legislation of each province, but generally the idea is that monies paid, received or even held on account of construction work being performed are impressed with a trust for the benefit of contractors and suppliers.

In the ordinary course of a construction project, subcontractors are paid by the contractor as work is completed. There may be a dispute between the contractor and the subcontractor as to what is owing, but so long as the contractor is solvent the subcontractor will eventually be paid. Accordingly, construction trusts really matter only when a contractor is insolvent, at which time the federal insolvency legislation, i.e. the

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BIA, is also engaged.

Squarely before the courts in *Iona* was the interplay between two pieces of legislation: the Alberta *Builders' Lien Act* (the "BLA") and the federal BIA. Specifically, the question was whether a trust created by provincial statute would operate so as to exclude from the contractor's bankruptcy estate the funds paid (or to be paid) to the contractor by the owner. If so, the subcontractor (or, as in *Iona*, a party standing in the subcontractor's shoes) would be paid in full to the detriment of other creditors.

To succeed in establishing the existence of a valid trust, the subcontractor had to overcome two significant hurdles: (i) the well-established line of authorities invalidating provincial legislation whose primary purpose was to re-order creditor priorities in a bankruptcy; and (ii) the fact that, in this case, it was clear that the contractor had no subjective intention to hold the funds paid to it in trust for the subcontractor.

The Decision

In *Iona*, a general contractor, Iona Contractors Ltd. (the "GC") was engaged to complete a construction project at the Calgary Airport. The GC became bankrupt before the completion of the project leaving a number of subcontractors and suppliers unpaid. The owner, having learned of the GC's bankruptcy, withheld payment of contract funds to the GC.

Fortunately for the subcontractors and suppliers there was a material and labour bond in place. The surety stepped in and paid the subcontractors and suppliers and was subrogated to their rights, including any claims against the GC.

The surety argued that the statutory trust created under section 22 of the BLA meant that the funds payable by the owner to the GC were excluded from Iona's estate. The trustee of the GC's bankruptcy estate, on the other hand, argued that section 22 of the BLA was invalid as it was in substance intended to reorder creditor priorities in conflict with the BIA.

In upholding the validity of section 22 of the BLA and holding that the funds to be paid by the owner were subject to a trust for the benefit of the surety, the Alberta Court of Appeal looked to two previous SCC decisions.

Relying on *Husky Oil Operations Ltd. v. Minister of National Revenue*, [1995] S.C.R. 453, the Court rejected the proposition that the trust was automatically invalid because it ultimately affected priorities in bankruptcy. Instead, it was held that the BLA constituted a broad property scheme designed to create new civil rights for unpaid subcontractors. The holdback and trust provisions were held to be primarily in place to prevent the unjustified erosion of lien rights created by statute. The fact that the BLA had the incidental effect of reordering priorities in bankruptcy was not sufficient reason to hold that the BLA (or at least section 22 thereof) was invalid.

As to whether section 22 of the BLA actually had the effect of creating a valid trust, the Court first looked to *British Columbia v. Henfrey Samson Belair Ltd.* [1989] 2 S.C.R. 24 [*Henfrey*], which found that a "trust" for the purposes of Section 67(1) of the BIA must be a valid trust at common law, and therefore must satisfy the "three certainties".

With respect to the certainty of intention, the Court noted that traditionally the settlor must form and declare an intention to hold property in trust and then transfer such property with that intention. Conversely, a statutory trust is imposed by law and there is

no "intention" in the usual sense. To bridge the divide, the Court found that the general law can be "applied by analogy" with respect to statutory trusts and, most significantly, that the settlor's subjective intention may be substituted by an "involuntary" compliance with a statute.

The Court also considered whether in *Iona* the trust satisfied the requirement of certainty of subject matter. The subject matter of a trust is the actual property that is held for others. Courts in numerous cases have held that trusts have failed because the subject matter was uncertain or unidentifiable. In cases considering trusts created by statute where the trust does not attach to a specific fund but instead acts like a floating charge, the courts have held that there is no certainty of subject matter. Likewise, if trust funds are co-mingled with other funds, it is often held that there is no certainty of subject matter.

Unlike the foregoing situations, in *Iona*, the legislation clearly identified the property that was subject to the trust. Moreover, the funds had been held back, were clearly segregated and could be identified. In the result, the Court found that the holdback funds were subject to a valid trust, and that the surety was entitled to them.

Related Authorities

Whether *Iona* will be followed in other jurisdictions is uncertain, but the decision at least appears consistent with several cases decided in other provinces in which the courts have considered statutory trust claims under builders' lien legislation in the context of insolvency proceedings. In those cases, the courts were concerned primarily with the certainty of subject matter, particularly where trust and non-trust funds were commingled. In each case, the courts seemed to accept that certainty of intention was satisfied without delving into any real analysis of the issue.

In Ontario, the Superior Court found a trustee had no positive obligation to segregate funds received from owners into trust and non-trust accounts, and that the common law trust failed for lack of certainty of subject matter as a result of commingling: *Royal Bank of Canada v. Atlas Block Co. Limited*, 2014 ONSC 3062. In Nova Scotia, the Supreme Court decided that commingling of trust and non-trust funds was not fatal to the creation of a common law trust and applied tracing rules to satisfy the certainty of subject matter: *Kel-Greg Homes Inc. (Re)*, 2015 NSSC 274. The Supreme Court of British Columbia arrived at the same result in *0409725 B.C. Ltd. (Re)*, 2015 BCSC 561, where the court noted almost as an aside that certainty of intention was satisfied as it was "sufficiently provided by the statute in the circumstances".

Implications

The *Iona* decision is of importance to all parties who may be involved in a construction project with an insolvent contractor. The case suggests that, in Alberta at least, if funds in the possession of an insolvent contractor are sufficiently segregated, or if they have yet to be paid to the contractor, they may be unavailable to the general body of creditors, but will instead be impressed with a trust for subcontractors irrespective of whether that was the contractor's intention.

While the decision may provide comfort for subcontractors and suppliers, it may cause uncertainty for secured creditors, particularly those who provide an operating line of credit to a contractor and receive deposits in (overdrawn) accounts around the time of the contractor's insolvency. Similarly, sureties providing labour and material bonds and who have direct contractual relationships with owners might consider the implications of this decision on their risk analysis and whether they can impose additional obligations on

contractors or owners to increase the likelihood of a trust having been created, intentionally or otherwise.

Bankruptcy trustees and owners should also be aware of their positive obligations in dealing with funds that may be impressed with a trust, particularly when they are in hand and segregated. The payment provisions in the head contract and the specific lien legislation should always be considered where there is a possibility that a trust has been created. In those circumstances, the holder of funds will want to ensure they do not act inadvertently in a manner inconsistent with any trust obligations.

Note: Readers should note that the concept of trust differs in the common law and the civil law. It is therefore recommended to contact one of our lawyers in the Province of Quebec to discuss the impact of this case in Quebec.