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The Trust Fund Provisions of the Construction Lien Act (Ontario): New developments relating to Suppliers and Tracing

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6th Annual Current Issues in Commercial Litigation:

Hamilton Law Association;

March 3, 2011

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1. Introduction

The *Construction Lien Act* looks like a formidable statute to most lawyers, from both a substantive law and procedural standpoint. Filing a lien? Within strict time periods and according to technical rules? That's not for me! Looks like something to be shipped out to a specialist!

True in part, but there is one section in the *Construction Lien Act* that does not involve filing a lien, and involves basic principles of trust law. That is Section 8 of the Act.

Section 8 gives each contractor, sub-contractor and supplier a right to share in the funds owing down the chain of those who have improved the lands of an owner. Those funds constitute a trust fund for all persons below the person owing the funds.

This paper will examine two important developments relating to the trust fund provisions of the Act.

First, in its recent decision in *Sunview Doors v. Pappas*, the Ontario Court of Appeal has thrown the doors wide open for suppliers to recover under the trust fund section. Whether you act for owners, contractors or suppliers, or for a financial institution that may be embroiled in the payment of monies relating to a construction project, you should know about *Sunview Doors*.

Second, you should know about the Supreme Court's pivotal decision about tracing trust funds in *Citadel General v. Lloyd's Bank*. That decision is now being applied by lower courts to trace funds which originate under the trust fund provisions of the *Construction Lien Act*.

Both *Sunview Doors* and *Citadel General* offer new opportunities for counsel to use the trust fund provisions of the Act to pursue and trace funds relating to construction projects, and new obligations for defence counsel to creatively defend against those claims. New challenges for creative advocates!

2. The Trust Fund "Funnel"

Before we examine *Sunview Doors* and *Citadel General*, it is important to recognize that the trust fund section creates a "funnel" which requires that trust funds be passed down from one level to the next level, from the owner to the contractor to the sub-contractor to the supplier, and not diverted to other persons or purposes. So when we come to apply *Sunview Doors* and *Citadel General*, we do so in a closed universe which should have captured all the funds which started out at the owner's level and cannot be used for any other purpose than payment to those who improved the land.

Some of the principles developed in the case law which enforce the "funnel" effect of the Act include the following:

(a) Trust funds must be held by a recipient until it has paid all claims relating to the project, and not merely those outstanding at the time it receives the money. The recipient cannot divert monies simply because it has received more money at that point in time than it has obligations to then pay;[2]

[2] *Andrea Schmidt Construction Ltd. v. Gatt* (1979), 25 O.R. (2d) 567

(b) Once the plaintiff establishes the existence of the trust, the defendant must show that it has paid all the money in accordance with Act. The recipient is accountable for and must justify all expenditures from the fund. The trust takes priority over the recipient paying itself;[3]

(c) If the recipient intermingles funds from more than one job in an account, then in any tracing exercise in relation to those funds the recipient must justify what it did with the funds it received on the project on which each claimant was engaged;[4]

(d) The recipient cannot escape its trust fund obligations simply by showing that it paid out more than it received. Rather, it must trace the received monies into valid payments to valid recipients;[5]

(e) The recipient can only seek credit for payments on the basis that they were made from non-trust funds if it can affirmatively prove that its subsequent payments were not out of trust funds. If it cannot, then it cannot take a credit for those payments on the supposed basis that they came from non-trust funds;[6]

(f) The recipient cannot deduct its overhead out of trust funds;[7]

(g) A recipient does not satisfy its trust fund obligation simply by creating a separate bank account into which all the trust funds are deposited. It still has to show that all monies were paid into or out of that account in accordance with its trust fund obligations. [8]

These well-known principles provide the background context in which we may discuss *Sunview Doors* and *Citadel General*. These principles show that the net around the trust funds arising from a construction project is very tight. So when a supplier claims a remedy under *Sunview Doors*, or other claimants seek remedies against third parties under *Citadel General*, those claimants are working within a system that has already maximized the probability that there were funds upon which those remedies are operative.

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[3] *Firenze Exteriors Inc. v. Westwing Construction Group Inc.*, 2005 CanLII 5880 (ON S.C.)

[4] *Forest Trim & Doors v. Azor Woodworking Ltd* 2005 CanLII 364 (ONSC); *DST Consulting Engineers Inc. V. Towanda Timber Limited* 2007 CanLII 38565

[5] *St. Mary's Cement Corp v. Construc Ltd* 1997 CanLII 12114 (ONSC); *802798 Ontario Ltd v. McConnery* 2003 CanLII 49340 (ONSC)

[6] *802798 Ontario Ltd. v. McConnery*, 2003 CanLII 49340 (ON S.C.)

[7] *Dietrich Steel Ltd. v. Shar-Dee Towers (1987) Ltd.*, 1999 CanLII 2757 (ON C.A.); *Rudco Insulation Ltd. v. Toronto Sanitary Inc.*, 1998 CanLII 5529 (ON C.A.)

[8] *Glenko Enterprises Ltd. v. Keller*, 2008 MBCA 24; *Citadel General Assurance Co. v. Lloyds Bank Canada*, [1997] 3 S.C.R. 805; *Merritt v. Klijn*, 2002 ABQB 729 (CanLII)

3. Trust Funds owed to the Suppliers

The primary question in the appeal in *Sunview Doors Limited v. Pappas*[9] was whether Sunview Doors – a supplier – was entitled to the benefit of a statutory trust pursuant to s.8(1) of the *Construction Lien Act* (the **"Act"**).[10]

Section 8(1) creates a statutory trust fund for the amounts owing to a contractor or subcontractor, or received by a contractor or subcontractor. The trust fund is created for the benefit of the subcontractors and other persons who have supplied services or materials to the improvement and who are owed amounts by the contractor or subcontractor. There is an obligation placed on each payer and recipient not to convert any part of the fund to their own use.

Sunview supplied custom-made patio doors to Academy Doors and Windows. It knew that the doors were supplied for the purposes of improvements; however, it did not know the location of the improvements.

Sunview brought an action against Academy for breach of contract on the basis of the unpaid accounts and against Academy and the three individual officers and directors of Academy for breach of trust under ss. 8 and 13 of the Act.[11]

The trial judge based his conclusions on the decision in *Central Supply Co. 1972 Ltd. v. Modern Tile Supply Co.*[12] In that decision, a panel of the Court of Appeal sitting as the Divisional Court held that, in order for a s.8 (1) statutory trust to arise, the claimant or supplier must "intend that the material sold be used for the purposes of a known and identified improvement." Following that decision, the trial judge in *Sunview Doors* found that Sunview could not establish that, at the time it sold or supplied its doors to Academy, it intended that they be used for known and identified improvements.[13] As a result, the trial judge concluded that s.8 (1) statutory trust had not arisen.

In the *Sunview Doors* decision, the Court of Appeal for Ontario overturned the trial judge's decision and reversed the prior decision in *Central Supply*. The Court held that nothing in the wording of the Act requires that the supplier intend that the material be incorporated into a known and specific improvement at the time of sale or supply. Provided that the supplier is able to link the material to the improvement to which the subcontractor was owed money or has been paid, the supplier will be entitled to the benefit of the s.8. The connection or link need not be direct and was described by the Court of Appeal as follows:

> "[W]here the contractor or subcontractor does not allocate the supplier's material to a particular piece of land or improvement within a project, but it is clear that the contractor or subcontractor has received money on account of the contract price for the project and that the contractor or subcontractor owes money to

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[9] *Sunview Doors Limited v. Pappas*[9], 2010 ONCA 198

[10] R.S.O. 1990, c. C.30

[11] Section 13 of the Act enables the court to pierce the corporate veil by making any person personally liable for a corporations' breach of trust.

[12] (2001), 55 O.R. (3d) 783 (Div. Ct.)

[13] "Improvements" are defined in section 1 of the Act as: any alteration, addition, repair to; or any construction, erection, installation on – any land, structure or work.

> the supplier, a link to the contractor's or subcontractor's contract for the project will be sufficient to establish a s. 8 statutory trust….

In order for Sunview to establish that it was the beneficiary of a trust under s. 8(1) of the Act, it must prove that:

> (i) Academy was a contractor or subcontractor;
>
> (ii) Sunview supplied materials to the projects on which Academy was a contractor;
>
> (iii) Academy received or was owed monies on account of its contract price for those projects; and
>
> (iv) Academy owed Sunview money for those materials."

In the case at bar, the link was established because of Academy's conduct in deliberately frustrating Sunview's attempts to obtain the disclosure that would enable it to link its products to the improvements into which they had been incorporated.[14]

The Court emphasized the purpose of s.8 (1) statutory trust – to impress upon money owing to or received by contractors or subcontractors a statutory trust, a form of security, to ensure payment to suppliers: "The object of the Act is to prevent unjust enrichment of those higher up in the construction lien pyramid by ensuring that money paid for an improvement flows down to those at the bottom."[15]

In arriving at its conclusion, and, in particular in dealing with the onus of proof when the contractor has failed or refused to produce its records, the Court considered *St. Mary's Cement Corporation v. Construc Ltd.*[16] St. Mary's Cement supplied concrete blocks to Construc, a contractor, who used them in connection with a construction project on two adjacent lots. Some of the invoices did not specify to which of the two lots the materials were delivered. The contractor claimed he had no record of the amount of concrete blocks used on each lot because he had lost all his records. The trial judge held that;

> "it is common ground that there is an initial onus on the plaintiff to prove the existence of a trust under s.8 of the Act. In order to discharge that onus in this case, the plaintiff would need to show that Construc received money on account of its contract price for a particular project, that the plaintiff supplied materials on that project and that Construc owes money to the plaintiff for those materials. If all these elements are clearly proven, the trust [under s.8] comes into play."[17]

One can clearly see the broad implications of the *Sunview Doors* decision. Now, once a supplier shows that it has delivered to a contractor or subcontractor, the potential for a trust fund claim arises. Then, the burden is on the contractor or subcontractor to explain what it did with

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[14] *Sunview*, at 23

[15] *Ibid.*

[16] (1997), 32 O.R. (3d) 595 (Gen. Div.)

[17] *Ibid*.

the money it received from the contractor or owner, and to demonstrate that none of the money leaked outside the trust. To so demonstrate, the contractor or subcontractor will have to maintain a good system of records of the receipt and disbursement of funds for each project, and strictly adhere to that system.

The implications of *Sunview Doors* also apply to the directors, officers, servants and agents of the contractor and subcontractor. If the contractor or subcontractor does not maintain records to show that the trust obligation has been strictly complied with, then under Section 13, those persons may be held liable if they assented to or acquiesced in conduct that they ought reasonably to have known amounted to a breach of trust.

Even the banker or lender to the subcontractor can be implicated in the breach of trust, and to that issue that we now turn.

4. Trust Fund Liability of other Persons

In *Citadel General Assurance Co. v. Lloyds Bank Canada*,[18] the Supreme Court of Canada set forth the principles to be applied when a plaintiff seeks equitable remedies against other persons who have received trust funds. The facts of this case related to the insurance industry, but the trust fund rules relating to insurance premiums are similar to the trust fund provisions of the Act relating to funds in a construction project.

An insurance agent sold insurance to auto dealers. After paying commissions and settled any current claims under the policies, the insurance agent paid the balance of the premiums on a monthly basis to the appellant insurance companies.

In December 1986, the insurance agent started banking with Lloyds, using one bank account for all its transactions. The Bank was aware that insurance premiums were being deposited into that account. From June, 1987, the insurance agent no longer settled paid claims under the insurance policies, with the result that the amount of premium money being paid into its bank account increased significantly. Lloyds then received instructions from the insurance agent's parent company to transfer all funds in defendant's account to the parent company's account at the end of each business day. The transfer of funds between the accounts resulted in an overall reduction in the parent company's overdraft to Lloyds. After the insurance agent and its parent company ceased carrying on business, the appellant insurance companies brought an action against Lloyds for the outstanding insurance premiums. The Supreme Court of Canada re-instated the trial judgment holding Lloyd's liable to the insurance companies for breach of trust.

Section 124(1) of the Alberta *Insurance Act*, provides that an agent who receives any money as a premium for an insurance contract from the insured is deemed to hold the premium in trust for the insurer. The Court held that the arrangement between the parties met the three characteristics of a trust: certainty of intent, certainty of subject-matter, and certainty of object. The fact that funds in the insurance agency's account with Lloyd's were commingled with other funds did not undermine the relationship of trust between the parties. The insurance agent's actions in failing to remit to the appellants the insurance premiums collected on their behalf in July and August 1987 were clearly in breach of trust.

[18] *Citadel General Assurance Co. v. Lloyds Bank Canada*, [1997] 3 S.C.R. 805,

The Supreme Court considered three ways in which a stranger to a trust could be held liable for breach of trust: (i) a trustee *de son tort*; (ii) for "knowing assistance"; and (iii) for "knowing receipt."

The Court did not consider the first situation, for the Bank had never assumed the office or function of trustee. It also rejected the application of the second ground to the facts of this case – "knowing assistance." A stranger to a trust can be liable for breach of trust by knowingly assisting in a fraudulent and dishonest design on the part of the trustee: "it is clear that only actual knowledge, recklessness, or wilful blindness will render the [B]ank liable for participating in the breach of trust. Since the [B]ank had only constructive knowledge, it cannot be liable under the "knowing assistance" category of constructive trust."[19]

Lastly, the Supreme Court considered liability on the basis of "knowing receipt", which required that a stranger to the trust receive or apply trust property for its own use and benefit. By applying the deposit of insurance premiums as a set-off against the parent company's overdraft, the Bank received a benefit and thus received the trust funds for its own use and benefit.[20]

The second requirement for liability on the basis of "knowing receipt" related to the degree of knowledge required of the Bank in relation to the breach of trust. The Court held that there should be a lower threshold of knowledge required of the stranger to the trust. "More is expected of the recipient, who, unlike the accessory, is necessarily enriched at the plaintiff's expense. Because the recipient is held to this higher standard, constructive knowledge (knowledge of facts sufficient to put a reasonable person on notice or inquiry) will suffice as the basis for restitutionary liability."[21] Therefore, this lower threshold is sufficient to establish the "unjust" or "unjustified" nature of the recipient's enrichment, thereby entitling the plaintiff to an equitable remedy.

On the issue of knowledge, the Court concluded that it was clear from the trial judge's findings that the Bank was aware of the nature of the funds being deposited into, and transferred out of, the insurance agent's account. The Bank knew that the insurance agent's sole source of revenue was the sale of insurance policies and that premiums collected by the insurance agent were payable to the appellant insurance companies. In light of the Bank's knowledge of the nature of the fund, the daily emptying of insurance agent's account was in the trial judge's view "very suspicious." A reasonable person would have been put on inquiry as to the possible misapplication of the trust funds. The Bank should have inquired whether the use of the premiums to reduce the account overdrafts constituted a breach of trust. As a result, by failing to make the appropriate inquiries, the Bank had constructive knowledge of the insurance agent's breach of trust. Therefore, the Bank's enrichment was clearly unjust, rendering it liable to the appellants.[22]

We will now examine cases applying these principles under the trust fund provisions of the *Construction Lien Act*, or the comparable legislation in other provinces.

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[19] *Citadel*, at p.3

[20] *Ibid.*, at p.3

[21] *Ibid.*, at p.4

[22] *Ibid.*, at p.5. The Supreme Court of Canada also considered the tracing of trust funds in *Air Canada v. M & L Travel Ltd*, [1993] 3 S.C.R. 787 and *Gold v. Rosenberg*, [1997] 3 S.C.R. 767 (in which the issues were largely related to whether the conduct in issue was "knowing assistance"); and *B.M.P. Global Distribution Inc. v. Bank of Nova Scotia*, [2009] 1 S.C.R. 504 (in which the issues related to the recovery of monies paid under a mistake of fact).

In *Provincial Drywall Supply Ltd. v. Toronto-Dominion Bank et. al.*, 2001 MBCA 38, the Manitoba Court of Appeal was concerned with a claim by Provincial against The Toronto-Dominion Bank for breach of duties and obligations arising under *The Builders' Lien Act* (the **"BLA"**) of Manitoba.[23]

When dealing with the knowing receipt issue, the Court considered the *Citadel* principle, i.e., that constructive knowledge was sufficient in order to establish knowing receipt on behalf of the Bank: "At the very least, the Bank had constructive knowledge that Geon Interiors' deposits included an element of trust funds and that when applied to Geon Interiors' indebtedness to the Bank, a breach of the statutory trust imposed by the BLA was inevitable. Under the circumstances, the Bank was under a duty not to appropriate those trust funds in reduction of the Bank debt."[24]

Thus, constructive trust was found to be established by the operation of law. That is, the trust fund provisions of the BLA provided a necessary element in the application of the "knowing receipt" principle. This reasoning may be a powerful aid to claimants seeking equitable remedies against third parties who receive monies arising from construction projects.

The tracing issue was considered by the Court to the extent permitted by s. 8 of the BLA, which stated that "[n]o action to assert any claim to money constituting a trust under section 4 or 5 shall be commenced after the expiry of 180 days after the date upon which the person bringing the action first became aware of the breach of trust." The Court referred to the *Glenko Enterprises Ltd. v. Keller*,[25] where it was held that "in circumstances where the *in rem* tracing remedy might be available to a claimant, it must be acted upon within 180 days, after which the tracing remedy expires." Thus, the tracing was available to the claimant, as long as the time restrictions were met.

In *Iori v. Village Building Suppliers (1997) Ltd.*, 2007 ONCA 156, Ontario Court of Appeal considered two issues: (i) unjust enrichment; and (ii) constructive trust. Village supplied drywall to the drywall subcontractor on a construction project. Village agreed to discharge its lien in return for a mortgage on a property in the name of the wife of the owner of the drywall subcontractor. The wife then asserted that the mortgage was null and void against her, and the Court so found. Village then asserted a claim against the wife based upon unjust enrichment and constructive trust.

So far as constructive trust is concerned, the Court of Appeal confirmed that the wife, as a stranger to a trust, might be liable as a constructive trustee for breach of trust on the basis of knowing receipt of trust property. However, liability depended on Village proving that two requirements had been satisfied: (i) the wife received trust property; and (ii) she had knowledge of the breach of trust.

On the facts of the case, the Court of Appeal held that the wife did not have sufficient knowledge of the circumstances such that, she should have been on inquiry, as required by *Citadel* case. Moreover, the Court also found that the wife had never received trust property; that is, she had not received any of the monies paid by the contractor to the drywall subcontractor. As a result, the appeal was dismissed, for no constructive trust based on knowing receipt had arisen.

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[23] R.S.M. 1987, c. B91

[24] *Provincial Drywall*, at 33

[25] [2000] M.J. No. 444 (Q.L.) (C.A.)

In Glenko Enterprises Ltd. v. Keller, 2008 MBCA 24, the Manitoba Court of Appeal considered the issue of "knowing assistance" by the appellant in the breach of statutory trust under the *Manitoba Builders' Lien Act*. entered into a sub-contract with Glenko for the latter to provide gravel and concrete supplies for a project. Keller Ltd. stopped paying Glenko's invoices. Mr. Keller (sole shareholder) had guaranteed Keller Ltd's indebtedness to the Bank to a maximum of $550,000. The Bank withdrew its financial support from Keller Ltd. and refused to accept any further deposits.

The Manitoba Court of Appeal agreed with the trial judge's conclusion that Mr. Keller knowingly participated in a breach of trust. The basis of liability for "knowing assistance" required two main elements of proof: "the nature of the breach of trust, which must be fraudulent and dishonest, and the degree of knowledge required of the stranger."[26] Actual knowledge; reckless or wilful blindness will also suffice. Therefore, if the trust was imposed by statute, then he or she will be deemed to have known of it. Mr. Keller had put the trust funds at risk to the prejudice of Glenko's rights as beneficiary of the trust, and he knew that the risk was one which it had no right to take.[27]

The Court of Appeal also concluded that the claims for "knowing assistance" and "knowing receipt" were not barred by the 180 limitation period for bringing trust fund claims under the Manitoba Builders' Lien Act. That limitation period only applied to a claim to the funds themselves or tracing them, but not to claims for compensation for knowing assistance or knowing receipt.

While it is not a construction lien case, the decision of the British Columbia Supreme Court in *Peel Financial Holdings v. Western Delta Lands et al***.,** 2003 BCSC 1911 is a recent reminder of a fundamental principle relating to tracing trust funds. In addition to *Citadel* and *Gold v. Rosenberg*, the court considered the following statement of the House of Lords in *Foskett v. McKeown:*[28]

> "a beneficiary of a trust is entitled to a continuing beneficial interest not merely in the trust property but in its traceable proceeds also, and his interest binds every one who takes the property or its traceable proceeds except a bona fide purchaser for value without notice."

In dismissing a summary judgment motion to dismiss the action, the British Columbia court observed:

> "if [a] trust exists, then it is at least arguable that the various defendants either knew, or ought to have known of its existence, and if so, it is at least arguable that they each, in their various ways, acted in a manner inconsistent with that trust."

The *Citadel* decision was applied in a class action relating to trust funds arising from a construction project in *Tampa Hall Ltd. v. Canadian Imperial Bank of Commerce*, 1998 CanLII 14631. This was a motion for an order certifying a class action. The plaintiff sought to represent a class of all unpaid creditors who had supplied materials or services to the bankrupt

[26] *Glenko,* at 58*;* see also *Air Canada v. M & L Travel Ltd*., [1993] 3 S.C.R. 787

[27] *Glenko*, at 58-59

[28] [2001] 1 A.C. 102

contractor which were incorporated into improvements and were paid for by the recipient to the defendant bank.

The court referred to the *Citadel* and *Gold v. Rosenberg* decisions of the Supreme Court of Canada in order to draw a distinction between "knowing assistance" and "knowing receipt" cases: "'knowing assistance' cases – where the defendant has assisted in the breach of trust but not benefited from it, and 'knowing receipt' cases – where the defendant has received a benefit."[29] The court cited and confirmed *Citadel* principles. In "knowing assistance" cases, there is a higher threshold of knowledge required of the stranger to the trust. Constructive knowledge is excluded as the basis for liability in such cases. In "knowing receipt" cases, which are concerned with the receipt of trust property for one's own benefit, there should be a lower threshold of knowledge required of the stranger to the trust.

On this basis, the Court concluded that a cause of action in knowing receipt had been properly pleaded by the plaintiff. However, the Court concluded that, since the liability of the bank would depend on establishing the breach of the s. 8 trust and the constructive knowledge of the trust by the bank, in respect of each class member, the action did not raise common issues and it was not the preferable procedure for the claims to be asserted. Accordingly the action was not certified as a class action.

The decisions applying the principles in *Citadel General* show how powerful those principles are in relation to a trust fund claim under section 8 of the *Construction Lien Act*. In particular, the cause of action in "knowing receipt" has two advantages. First, because the trust is a statutory trust, it arises by force of law and no defendant can assert that he or she is unaware of the trust. Second, the Supreme Court has said that the "knowledge" test is a low one. Facts sufficient to put a reasonable person on inquiry will establish constructive knowledge for the purpose of "knowing receipt" even if they are insufficient to meet the higher test in "knowing assistance". When a bank or other party is dealing with a contractor and receives money from the contractor that it knows or ought to know come from a construction project, then a claim in knowing receipt will have a strong basis.

What is not clear is the boundary between the tracing remedy and "knowing receipt". The decisions in *Glenko* and *Provincial Drywall* draw a distinction between these two claims, since the limitation period for trust fund claims in Manitoba has been held to apply to the former and not to the latter. Yet, the elements of "knowing receipt" appear to be very close to those for tracing trust funds into the hands of another person.

5. Conclusion

The decisions in *Sunview Doors* and *Citadel General* provide new grounds for claimants to assert trust fund claims under section 8 of the *Construction Lien Act***.**

Sunview Doors enables suppliers to assert trust fund claims even if they cannot trace their supplies to a specific job site. If they can show that they supplied to the contractor and that the contractor was connected to the job site, then the onus will fall on the contractor to show that all the funds it received on the project were properly paid to persons involved in the project. In the absence of such proof, the supplier will not only be able to assert rights against the contractor but also against employees, officers and directors of the contractor and, potentially, to other persons who received those funds.

[29] *Tampa Hall*, at 27

Citadel General widens the avenue of recovery for trust funds against persons who have received money from person engaged in construction projects, based upon "knowing receipt" of those funds. The trust fund section in the Act creates a presumption of legal knowledge of the trust. The defendant will be liable for "knowing receipt" it is shown to have had constructive, not actual, knowledge of sufficient facts that would put a reasonable person on inquiry as to its receipt of trust funds in breach of the trust established under the Act. When third parties are dealing with contractors or others engaged in construction projects, it may take very little for that level of knowledge to be found.