

The Role of Theory (and Policy) in Commercial Law — Two Historical Examples

The Honourable Mr. Justice Bruce D. MACDONALD*

When this topic was initially chosen for discussion at this conference it included "policy" as well as "theory". I take those terms to be interchangeable.

The topic immediately brought to mind two developments in the field of commercial law which occurred during my early years at the bar. The first arose out of the attempt on the part of finance companies to insulate themselves from the equities arising under conditional sale and home improvement contracts by utilizing promissory notes, and the holder in due course protection afforded by the *Bills of Exchange Act*.¹

In British Columbia, as in other provinces, courts were struggling in the 1950's to find ways around the apparently unassailable position of finance companies which were suing on promissory notes discounted to them in situations where the underlying contract had not been performed. In some cases, the work required under a home improvement contract was only partially completed or improperly done. In others, goods purchased under a conditional sale agreement were defective or never delivered.

To deny recovery to the finance company in those situations, the court was forced to find some facts to support a conclusion that the holder of the note did not take it "in good faith". *Interior Finance v. Nichols*² is an example of a case where the court was successful in so finding. There, the finance company knew (indeed insisted) that the vendor of the goods, who was acting as agent for the owner thereof, pay a portion of its own indebtedness to the finance company out of the proceeds. The fact that the commission which the agent would earn on the sale was not covered in the evidence at trial allowed the appeal court to ignore the possibility that the amount to be diverted to the agent's account might have been quite proper. The determining, but underlying fact, was that the goods sold were unsatisfactory, and had been returned to the agent with its consent.

British Columbia courts were not always successful in finding excuses with which to insulate the innocent purchaser. In *Rand Investments v. Wallberg*³ a frustrated trial judge felt himself forced to give judgment to the finance company, as the holder in due course of a promissory note, despite the defenses which the purchaser would have had to an action by the seller under the contract between them. In the course of doing so,

* Supreme Court of British Columbia, Vancouver, British Columbia.

1. *Bills of Exchange Act*, S.C.B.C. 1979.
2. *Interior Finance v. Nichols* (1958), 26 W.W.R. 609 (B.C.C.A.).
3. *Rand Investments v. Wallberg* (1961), 34 W.W.R. 412 (B.C. County Ct.).

however, the trial judge made it clear that he regarded the law, as it then stood, to be highly unsatisfactory :

I do not think the present condition of the law does full justice, as there is no doubt whatsoever that the finance companies are parties to the sale of goods under conditional sale agreements and should be responsible for the acts of the selling company, who in too many cases, are without assets and completely unreliable and can only operate through being financed by the finance companies.

It was my involvement in practice with Rand Investments, the successful plaintiff in that 1961 decision, which made me conscious of the significant change in the law which occurred the following year. The effect of that change is evident from the failure of Rand Investments thereafter to recover in similar circumstances.

Credit for that change in the commercial law must go to the Ontario Court of Appeal. In *Federal Discount Corp. v. St. Pierre*⁴ an "intimate relationship" between a dealer and a finance company was held to deny the latter status as a holder in due course. The relationship and pre-arrangements between a dealer and a finance company "[...] may be so close [...] that, in effect, the finance company and the dealer can be considered as engaged in one business [...] with the result that the finance company [...] cannot avoid the defenses and equities available to the customer against the dealer [...]".

The courts in other provinces were quick to follow that lead. British Columbia was no exception, and Rand Investments soon experienced the result. In October of 1962, relying on *Federal Discount Corp. v. St. Pierre*, the Supreme Court of B.C. dismissed an action by Rand Investments on a promissory note where the underlying home improvement contract had been induced by fraud.

[...] such a close relationship existed between the dealer and the plaintiff finance company that they should be treated as one enterprise so that any defence (available) against the dealer would be equally available against the plaintiff.

The change was not a temporary one. Four years later in *Rand Investments v. Bertrand*⁵ a determined attack on the "close relationship" approach pioneered in *Federal Discount Corp. v. St. Pierre*⁶ was unsuccessful. Despite the "accepted custom" in retail instalment sales financing for finance companies to provide the forms, and despite the fact that Rand Investments had a similar association with some 27 other retail dealers and contractors which accounted for 60% of its business, the court deprived the finance company of the status of holder in due course and gave effect to the equities existing between the parties to the home improvement contract.

4. *Federal Discount Corp. v. St. Pierre* (1962), 32 D.L.R. (2d) 86.

5. *Rand Investments v. Bertrand* (1996), 58 D.L.R. (2d) 372 (B.C.S.C.).

6. *Supra* note 4.

By 1967, the Manitoba court was able to summarize the then current position in these statements :⁷

1. In all cases, where the good faith of the holder of a note is in issue, the question is one of fact, and wide latitude in the matter of evidence should be permitted.
2. A finance company cannot enjoy the privileged status of a holder in due course unless it can show that it remained at a minimum arm's length from the negotiations between vendor and purchaser.
3. In this case, the relationship between finance company and vendor was so close, and its participation so active, that its role approximated more closely to that of an original party than to that of a subsequent purchaser in good faith.

Whether you label it theory or policy, the concern of the courts for the plight of innocent purchasers, left without recourse against bankrupt or unscrupulous vendors and contractors, led to a significant development in this aspect of commercial law. The difficulty of proving a lack of good faith on the part of a finance company in a given case was overcome by the "close relationship" doctrine and a shifting of the burden of proof to the finance company.

The second example is the significant change in 1960 in the exposure of the banks to trust claims under provincial builders' lien legislation.

In a line of cases culminating in *Fonthill Lumber v. Bank of Montreal*,⁸ the position of a bank looking to the receivables of a contractor as security for advances had become almost untenable. Knowledge of the trust character of such receivables was imputed to the bank. Express statutory provisions granted priority to trust claimants over any general or specific assignments which the bank might hold. Almost any knowledge of unpaid trust claims was sufficient to create liability on the part of a bank. It was not even necessary that the bank have a personal interest in the matter or receive a personal benefit.

As a matter of policy, the courts reacted to what was rapidly becoming an untenable commercial situation. Contractors were finding it increasingly difficult to obtain financing for their operations from normal sources because of the risk to which a lender was exposed. The concept of the "ordinary course of banking business" was developed.

Only a year after the "high water mark" of *Fonthill Lumber v. Bank of Montreal*,⁹ a judge of the Ontario High Court reacted with two decisions, both reported at (1960) 24

7. See *Traders Finance v. Norray Distributing* (1967), 60 W.W.R. 129.

8. *Fonthill Lumber v. Bank of Montreal* (1959), 19 D.L.R. (2d) 618 (Ont. C.A.).

9. *Ibid.*

D.L.R. (2d) 460. Both *John M.M. Troup v. Royal Bank*¹⁰ and *Standard Electric v. Royal Bank*¹¹ dismissed trust claims against the bank on the ground that the trust proceeds were deposited with the bank by its customer (the contractor) in the ordinary course of business. Even though such deposits had the effect of reducing the contractor's overdraft with the bank, no liability arose in those circumstances. *Fonthill Lumber v. Bank of Montreal*¹² was distinguished on its facts (that is, knowledge on the part of the bank that a breach of trust had occurred).

In the second of his 1960 decisions,¹³ Mr. Justice Smily of the Ontario High Court put the matter this way :

If a bank is required to account for monies deposited in the account of [...] a builder [...] and thus known [...] to be [...] moneys from an owner [...] and that there may be suppliers [...] and subcontractors [...] who have not been paid [...] it would be impossible for a [...] builder to carry on his business [...] through the medium of a bank account as a bank could not afford to take the risks involved. This would make it almost impossible for a [...] builder to carry on business at all.

The theory or policy behind the approach of Smily, J. is not hard to discern.

That approach was quickly adopted across the country in all provinces where statutory trusts of building contract proceeds existed as a parallel remedy under construction lien legislation. Two early examples from British Columbia will serve. In *Canadian Pittsburgh Industries v. Bank of Nova Scotia*,¹⁴ the bank escaped liability despite having given the owner notice of a specific assignment and despite the bank being aware that there was probably one or more unpaid suppliers or subcontractors. Fortunately for the bank, the owner ignored the assignment and paid the contractor, who deposited the cheque in the ordinary way. The court found that the bank had no reason to believe that the contractor was in financial difficulties or that the holdback would be insufficient to pay the outstanding accounts. The bank was held to have received the monies in good faith and no breach of trust could be imputed to it.

In 1964, another B.C. Supreme Court decision (*Pilkington Glass v. C.I.B.C.*)¹⁵ followed both the *John M.M. Troup*¹⁶ and the *Canadian Pittsburgh Industries*¹⁷ cases. The action against the bank was dismissed on the ground that it had acted in good faith and in

10. *John M.M. Troup v. Royal Bank* (1960), 24 D.L.R. (2d) 460.

11. *Standard Electric v. Royal Bank* (1960), 24 D.L.R. (2d) 460.

12. *Supra* note 8.

13. *Supra* note 11.

14. *Canadian Pittsburgh Industries v. Bank of Nova Scotia* (1962), 37 D.L.R. (2d) 120 (B.C.S.C.).

15. *Pilkington Glass v. C.I.B.C.* (1964), 42 D.L.R. (2d) 504.

16. *Supra* note 10.

17. *Supra* note 14.

the ordinary course of business, being unaware of any actual or intended breach of trust. The contract payments deposited were not made as a result of the bank's assignment. The fact such payments were applied from time to time to reduce the contractor's overdraft did not create liability on the bank when it continued after each such reduction to extend further credit to the contractor.

The theory that the protection afforded to materialmen and subcontractors under the trust provisions in construction lien legislation must be balanced against the right of contractors and banks to deal with each other in the ordinary course of business finally prevailed. The courts finally applied the legislation in a manner which achieved that balance.

I have chosen two examples of the role of theory or policy in the development of the commercial law. There are many others in the past with more to come in the future. I leave it to my distinguished panelists to suggest some theories which will influence the future direction of the law pertaining to commercial disputes.

What is clear to me as a trial judge, in both listening to the arguments of counsel and in striving to achieve a result I consider fair in a given case, is that theory and policy will always have a major role to play in the development of commercial law.