

**GETTING PAID: HOLDBACKS AND OTHER
SELECTED TOPICS**

Getting Paid is something that is easier to say than it is to do. You want to recover as much of what is owed to you at the least net cost, in the shortest possible time. Not the least of the frustrations encountered in reaching this goal is the delay and expense involved in the litigation process. Even the relatively simple steps necessary to prosecute a lien claim from registration through to trial can be used by a skilled defence lawyer to defeat an otherwise legitimate claim. While it was once intended to be a summary remedy, it is now clear that a full range of interlocutory procedures are available in lien proceedings, such as motions for summary judgment, security for costs, third party procedure, examinations for discovery and other steps, notwithstanding the apparent proscription of s. 67(2) of Construction Lien Act, which states as follows:

“Interlocutory steps, other than those provided for in this Act shall not be taken without the consent of the Court obtained upon proof that the steps are necessary or would expedite the resolution of the issues in dispute”.

To the extent that there is any generally reliable advice for ensuring payment in a construction setting, it sounds like a counsel of perfection: bid reasonably; turn down jobs that cannot help but lose money; even if you need the volume; contract only with reputable parties; pay your own trades and suppliers religiously, out of your own pocket you must; and, last but not least, say a prayer or two when payment is due. In the real world, however, clients regularly underbid and take dubious contracts just to keep crews busy and put volume on the books for the bank. These companies are then motivated to try to “build” some degree of margin during the course of construction through alleged changes, extras and claims for delays, often on the slimmest of grounds and always driven by pure necessity. Who wins in this unhappy scenario? The lawyers and consultants, of course.

All of the good advice that is available on how to get paid is therefore entirely dependant on market forces. For example, only in a sellers market will contractors have the bargaining power necessary to negotiate favourable payment terms, but that is when they are least likely to need them; in a buyers market such as the one owners have enjoyed for the last five years the opposite is true, Contractors desperately need favourable contractual terms, but are least able to bargain for them.

With that serious qualification out of the way, we will look at public and private law frameworks for “getting paid”. We will touch briefly on the policy behind holdbacks and discuss the possibility of reform of the law in this area. We will also examine

payment clauses in the prevailing standard form contracts. There are issues enough here to fill a book, but the following selected topics will be discussed or referred to:

1. **PUBLIC LAW**

- 1.1 PPSA
- 1.2 Construction Lien Act
- 1.3 Proceeding Against the Crown Act
- 1.4 Financial Administration Act

2. **PRIVATE LAW**

- 2.1 Standard Payment Terms
- 2.2 "Pay When Paid" Clauses
- 2.3 Interest
- 2.4 Holdback Provisions
- 2.5 Bonds

In the oral presentation that accompanies this paper we will examine a variety of common excuses for non-payment, such as the "notice of trust claims" excuse and the "third party demand" excuse.

1. **PUBLIC LAW**

A number of statutory schemes have been designed to further the public policy of preventing unjust enrichment by helping suppliers of services and materials get paid. Leaving aside the federal *Bankruptcy Act*, R.S.C. 1985, c. B-3, as amended, which is a powerful and useful tool, even for unsecured creditors, and the federal *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-6, as amended, which are well beyond the scope of the present paper, the following Provincial legislation may be drawn to the reader's attention.

1.1 **Personal Property Security Act, R.S.O. 1990 c.P.10:**

Suppliers of services and materials in a construction setting often assume that all materials supplied become incorporated into the improvement and that the lien remedy is the only appropriate remedy. This is not always so. In fact, a survey of the case law in this area reveals that it may be better for certain suppliers of construction materials to retain title to unpaid goods, perfect their security interest by timely registration under the PPSA, and then enforce payment on default by repossession, free of holdback restrictions, trust fund complexities and the burdensome class action provisions of the Construction Lien Act. The difficulty is one of definition. Is a supplier of modular windows, for example, a material supplier under the Construction Lien Act or the supplier of a price of moveable property, or chattel, under the Personal Property Security Act? (answer: CLA). Is the supplier of an immense ton pulp and paper

machine, which he bolts onto a specifically poured, plumbed and wired foundation, a material supplier under the Construction Lien Act or a chattel supplier under the Personal Property Security Act? (answer: PPSA).

Some subcontractors supply labour under one purchase order or company name in some cases and materials under another so that they can lien for the labour and re-possess their materials without having one contract coloured by the other. This may help a plumber, electrician, or mechanical installer but is of little use to a mason or drywaller.

Suppliers and installers of stand-alone heating, ventilation and air conditioning units, component parts of manufacturing, processing or packaging equipment, items of interior decoration or recreational use such as pools, saunas or gymnasium equipment, safes or security systems, irrigation or drainage systems, portable or modular structures such as sheds, barns, garages, and even schoolrooms and trailers in some cases, as well as certain lifting, elevating and freight handling equipment contractors may be better off reserving title, registering under the PPSA and electing to repossess rather than sue for their price.

Steel fabricators have begun identifying individual fabricated steel components by serial number, and perfecting security interests in steel so marked, so that steel that has not yet been incorporated into the structure can be identified and repossessed immediately upon non-payment. Although such materials may have little intrinsic value, they are often desperately needed by the owner/contractor or bonding company and may be hard to

replace during certain phases of construction. This can be an excellent bargaining chip for an unpaid trade.

On sophisticated industrial projects contracts may involve key computer software components, intellectual property or training manuals which may not be lienable but which may constitute "personal property" and give effective bargaining control if withheld in the event of non-payment.

1.2 **Construction Lien Act, R.S.O. 1990, ch. C.30:**

The working premise of the Construction Lien Act is that no one should get the benefit of another's labour or material without paying for it. One of the fundamental methods by which this premise is expressed in the legislation is in the concept of "holdback" and liens or charges upon that holdback. The concept of "holdback" begins with a very simple proposition. The notional "profit" component of each person's contract is withheld from them by the payer, until all liens under that person have expired or otherwise resolved.

The Construction Lien Act then creates a "lien" which is a remedy *in rem* securing the value of the holdback in the land which has been improved or benefited by the work, or the cash that has been put in place of the land. In Ontario, and in certain other provinces, the protection of a statutory trust is added to insulate funds within a given construction project from outside claims.

Like many fine ideas, the simple idea of holdback has lost its innocence and has evolved into something quite complex and unaccountably difficult in practice.

The procedure for realizing a claim to holdback through a lien under the Construction Lien Act is anything but summary. In fact its only real advantage is that it imposes a form of case management which can speed things along if it is used properly, and, until recent proposed “reforms”, Toronto lien actions enjoyed their own *de facto* court under the Toronto lien masters.

In the years prior to 1983 the rights granted by the then Mechanics’ Lien Act had become subject to much abuse. Liens were commonly registered for not only what was owing, but the full remaining contract price, crippling many projects. The situation had become so unsatisfactory that the Province empanelled a group of highly qualified people, representing most aspects of lien practice as an Advisory Committee to the Attorney General of the Province to reform the then Mechanics’ Lien Act.

The Attorney General’s Advisory Committee specifically addressed the concerns of those who supplied services and materials. These suppliers wanted to get more money into their hands, faster and cheaper. Several substantive and procedural reforms were enacted to address these concerns. Most significantly, the Committee reached back one level further than had the Mechanic's Lien Act and granted these trades a special priority over building mortgages to the extent of any deficiency in holdbacks. Despite

representations from organizations representing certain of these financial institutions, these amendments, among others, were carried into force and imposed upon mortgagees a new set of obligations with respect to holdbacks and deficiencies in holdbacks.

Section 78(2) of the Construction Lien Act now provide as follows:

“(2) Where a mortgagee takes a mortgage with the intention to secure the financing of an improvement, the liens arising from the improvement have priority over that mortgage, and any mortgage taken out to repay that mortgage, to the extent of any deficiency in the holdbacks required to be retained by the owner under Part IV, irrespective of when that mortgage, or the mortgage taken out to repay it, is registered.”

We have used this section as an example because it best illustrates the balancing of interests in favour of trades and suppliers in the Construction Lien Act. The object of the committee was reform. The following explanation of the Committee’s proposal makes this clear:

“Clause by clause Analysis

Subsection 1 provides in effect that the lien has priority over all unregistered interests in the premises. No equivalent provision is

found in the Mechanics' Lien Act, although the effect of this provision is implicit in that Act.

Subsection 2 provides that a lien has priority over a building mortgage to the extent of any deficiency in the holdbacks that the owner is required to retain under Part V. This priority would apply to those mortgages which are taken by the mortgagee to secure the financing of the improvement. The priority applies irrespective of whether the mortgage was registered prior or subsequent to the first work being done on the improvement. In the opinion of the Committee, subsection 2 provides a reasonable balance between the interests of the mortgagees who finance the construction of improvements and the lien claimants who do the actual work on the improvement. It should be noted that building mortgagees enjoy the benefit of the lien claimants' work: as a result of the improvement, the mortgagee's interest will usually be secured against a property which has been enhanced in value. Therefore, it is only fair that the mortgagee's interest be partly subordinated to the liens of the suppliers to the improvement, to ensure that there will be money available to pay them for the work that they have done. Subsection 2 leaves mortgagees free to deal with the additional risks through ordinary commercial procedures, such as the adjustment of interest

rates or the obtaining of alternate forms of security, and thereby avoids additional administrative costs.

It should be noted that subsection 2 gives the lien claimants priority only where the mortgage is taken by the mortgagee to secure the financing of the improvement. Thus it is the intention of the mortgagee which is relevant in determining whether a mortgage is a building mortgage.

Subsection 3 and 4 are similar in effect to the existing law. They specify the relative priorities between the liens arising from an improvement and mortgages, conveyances and other agreements in respect of the owner's interest in the premises that are registered prior to the commencement of the improvement. These "prior" interests are generally accorded priority over the lien. However, under subsection 3 the priority of those interests is limited in the case of advances made prior to the commencement of the improvement of the actual value of the premises at the time when the making of the improvement commences. Where advances are made in respect of those interests after this date, they are entitled to priority in respect of those advances in accordance with much the same rules as apply under subsection 6, in respect to advances under subsequent interests.

Subsection 5 is proposed by the Committee to redress what it believes to be a major inequity in the law resulting from the decision of the Supreme Court of Canada in Dorbern Investments Ltd. v. Provincial Bank of Canada, a case which dealt with the priority between a subsequent collateral mortgage and the lien. Under the Mechanics' Lien Act, an advance made under a mortgage that is registered subsequent to the time when the work on an improvement commences, has priority over the liens arising from that improvement, unless there was a preserved lien against the premises at the time when the advance is made, or the mortgagee had received written notice of a lien before making the advance. In the case of a collateral mortgage, all "advances" on that mortgage may have been made long before the registration of the mortgage, as in Dorbern where the mortgage was given to secure past indebtedness. As a result, in the Dorbern case, the mortgagee was held to have priority over the lien claimants: the lien claimants' interest in the premises was totally subordinated to the interest of the mortgagee, even though the property had been free of this encumbrance at the time when the making of the improvement commenced.

While the Committee does not disagree with the Supreme Court's decision as an application of the existing law, in the opinion of the Committee, to permit a subsequent collateral mortgage to take full

priority over the liens is unjust. A subsequent collateral mortgage may provide no additional funds to enable the owner to pay for the work that has been done on his property. At the same time it reduces the value of the owner's interest in the premises, and thereby reduces the equity available to satisfy the lien claimants should the owner subsequently become insolvent. It should be noted that the value of the property will usually increase as a result of the improvement, and that the mortgagee will enjoy greater security than if the improvement had not been made. If there is a sale under the mortgage, the price received will reflect the improved value of the premises. Since the mortgagee will enjoy the benefit of the improvement, it is unfair for the lien claimants to suffer as a result of the reduction in the owner's equity. The liens should have priority to the extent of any deficiency in the holdback that the owner is required to retain. Providing the lien claimants with this priority protects their rights from total eradication by the registration of a subsequent collateral mortgage. At the same time, since the priority of the lien claimants is limited to the holdback which ought to be available to satisfy their lien claims, subsection 4 provides reasonable protection to mortgagees.

The Committee considered the question of whether the priority should apply only where the mortgagee has notice of the making of

the improvement. A majority of the Committee concluded that it should apply regardless of the knowledge of the mortgagee. The effect of a mortgage is always to decrease the owner's equity in the premises. The effect of the improvement will almost always be to enhance the value of the premises. As a person holding a security interest in the premises, the mortgagee will enjoy the benefits of this enhancement, irrespective of his knowledge of its making. No corresponding benefit results to lien claimants as a result of the mortgage. A mortgagee has the ability to determine whether an improvement is being made, should he so desire.

Subsection 6 has the same effect as subsection 15(1) of the Mechanics' Lien Act in that it gives liens priority over advances on a mortgage made after a lien is preserved or notice of lien is received by the person making the advance.”

The detailed operation of the Construction Lien Act holdback scheme will be dealt with by other speakers, and reference should be made to their papers for the exact workings of the holdback scheme. The general scheme is set out in Part IV of the Construction Lien Act and may be summarized as follows:

- (a) **Basic Holdback:** Under the former statute, this used to be 15% of the value of services or materials as they were supplied. Now it is 10% of the “price” of services

or materials as they are actually supplied. “Price”, on the other hand, means the contract or subcontract price agreed upon between the parties or, where no price is agreed upon (as, for example, in some cases of disputed extras or changes), the “actual value” of the services or materials. In effect, each person’s notional profit is withheld from them by the person with whom they contracted, for the benefit of the persons who actually provided the services and materials to earn the money. The sense of the section is explained in the words of the Advisory Committee:

“The percentage required to be retained by a person paying on a contract or subcontract has been reduced from 15 per cent to 10 per cent. This reduction of the holdback, proposed in the Discussion Draft, was adopted by the Committee. In the opinion of the majority of the Committee, this change is justified since the rate of 10 per cent more realistically reflects the current margin of profit within the construction industry. A reduced holdback will increase the cash flow within the construction pyramid. While the security available for lien claimants is reduced, the majority of the Committee decided that, on balance, the adverse effects are more than offset by the benefits. The Committee also proposes a number of provisions to minimize the adverse effects of the reduction of holdback, for example, increased priority for liens over mortgages and greater priority for workers’ benefits.”

Basic holdback provides the greatest level of security for lien claimants. It must be retained until all liens that may be claimed against it, have expired or otherwise provided for under the Act. An owner is personally liable to the lien claimants for the amount of this holdback. Because of new provisions to permit early release of holdback in some narrow instances (certification of completion of a subcontract, for example) a second “finishing” holdback was created which will be discussed below.

The “holdback” exists as an inchoate financial liability until consensual payment or order of the Court. Contrary to popular belief, there is no “pool” of money sitting in an account somewhere gathering interest, although this option was discussed by the Committee. And what if the holdback is not there? In such cases the priority provisions under section 78 and the trust provisions under Part II of the Act provide useful remedies. Harsher remedies were considered and rejected by the Committee:

“Section 24 of Discussion Draft (Deleted)”

Section 24 of the Discussion Draft established a joint trust account system as a method of securing the holdback. Under subsection 1, the owner was required to deposit the basic holdback into an interest-bearing joint trust account on any contract where the value of the services or materials to be supplied amounted to \$150,000 or more.

The Committee decided that the system set out in section 24 was too rigid to serve as the method of providing security. This decision was reached after considering the many briefs received from the public in response to the Discussion Paper. These briefs raised many possible problems with respect to the administration of a joint trust account, the calculation of interest, and the equitable distribution of the proceeds. Therefore, the Committee recommends that section 24, as proposed in the Discussion Draft, be deleted.

Various types of holdback security schemes, such as joint trust accounts, bonding, letters of credit, and an industry-financed insurance fund were evaluated by the Committee and found to be inadequate. Each of these systems would add significant costs to construction which would not be proportionate to the risks of default in retaining the holdback.

However, the Committee was of the opinion that there was a definite need for securing the holdback. Due to the current rates of interest on mortgages, an owner's equity in property can quickly disappear when a mortgage falls into arrears, leaving little to satisfy lien claims. It was agreed that a system providing for the priority of lien claims over building mortgages to the extent of the holdback would be the most effective, efficient and fair method of securing a holdback. Thus, the

Committee recommends the establishment of such a lien/mortgage priorities system the details of which may be found in Part XI of the Draft Act (Priorities). This recommendation has been embodied in proposed section 80. The details of this proposal may be found in the notes under that section.”

(b) **Finishing Holdback**: This holdback only applies to contracts that have been certified or declared to be substantially performed. This is a further holdback of 10% of the remaining price of services or materials, as they are actually supplied. As a result of the rules governing substantial performance, particularly section 2 of the Construction Lien Act, finishing holdback is usually thought of as 1% of the contract price, plus \$25,000. There is a special trust that applies to all unpaid monies as of the date of certification of substantial performance, including finishing holdback.

(c) **“Notice Holdback”**: This title has been placed in quotation marks because it is a concept not identified as such in the Construction Lien Act but, nevertheless, one that has become entrenched in practice as a statutory holdback. This “notice holdback” arises out of section 24 of the Construction Lien Act, as follows:

“24. (1) A payer may, without jeopardy, make payments on a contract or subcontract up to 90 per cent of the price of the services or materials that have been supplied under that contract or subcontract

unless, prior to making payment, the payer has received written notice of a lien.

(2) Where a payer has received written notice of a lien and has retained, in addition to the holdbacks required by this Part, an amount sufficient to satisfy the lien, the payer may, without jeopardy, make payment on a contract or subcontract up to 90 per cent of the price of the services and materials that have been supplied under that contract or subcontract, less the amount retained. R.S.O. 1990, c. C.30, s. 24.”

The intent of the Committee in recommending this section is set out in their 1982

Report as follows:

“Section 24

This proposed section is substantially similar to section 25 of the Discussion Draft which was, in turn, derived from subsection 12(7) of the Mechanics’ Lien Act. The purpose of the provision is to permit the flow of funds, other than the holdback, down the construction pyramid during the course of the project.

It establishes that the payer on a contract or a subcontract, may pay out money that is owing if no written notice of a lien has been received. Where written notice of a lien is received, the payer merely

retains an amount sufficient to satisfy that lien, and pays the balance of any money then payable.

Since the Committee has recommended the removal of the provisions in Part II of the Draft dealing with the notice of breach of trust, section 24 has been redrafted to reflect this change.”

The real question with respect to “notice holdback” relates to the issue of set-off.

Set-off is expressly prohibited by section 30 of the Act as follows:

“30. Where the contractor or a subcontractor defaults in the performance of a contract or subcontract, a holdback shall not be applied by any payer toward obtaining services or materials in substitution for those that were to have been supplied by the person in default, nor in payment or satisfaction of any claim against the person in default, until all liens that may be claimed against that holdback have expired as provided in Part V, or have been satisfied, discharged or provided for under section 44 (payment into court). R.S.O. 1990, c. C. 30, s. 30.”

The most prevalent view in practice is that sections 24 and 30 create a third category of holdback, against which no claims for completion costs, for example, may be set-off. The argument against this is that “holdback”, as it is used in the Act, and

therefore in section 30, is defined to mean the “10%” holdback in Part IV. Section 24(2) itself speaks of a retainage “in addition to the holdbacks required by this part”, which would support an argument that section 30 is not intended to prohibit a set-off in the case of so-called “notice holdbacks” as the “retainage” effected by section 24 is clearly “in addition to”, and therefore not one of the holdbacks referred to in section 30. The best advice is still to get written notice of your lien into everyone’s hands as soon as possible, subject, of course, to the strictures of section 35, and worry about set-off later.

- (c) **Interplay of CCDC2 - 1994 & Holdbacks:** GC 5.5.3 of CCDC 2 now includes a provision requiring the holdback to be placed into a bank account in the joint names of the owner and the contractor ten days prior to expiry of the holdback period. It will be interesting to watch the application of this clause in practice, as the exact extent of an owner's holdback has become the subject of some rather controversial recent decisions.

On the basis of the Divisional Court decision in Lansing Building Supply (Ontario) Ltd. v. Kemp¹ and the trial decision in Lindsay Brothers Construction Ltd. v. Halton Hills Development Corp.², the Courts have decided, that an owner is required to holdback only 10 per cent of the value of each contract that it has with a contractor,

¹ Lansing Building Supply (Ontario) Ltd. v. Kemp (1992), 4 C.L.R. (2d) 161 (Ont. Master); reversed, unreported, Justice Montgomery, March 22, 1993 (Ont.Div.Ct.).

² Lindsay Brothers Construction Ltd. v. Halton Hills Development Corp. (1992) 4 C.L.R. 168.

being the person contracting directly with the owner, and not 10 per cent of the total value of all contracts for the improvement. In each of these cases the owner had contracted with many contractors.

Justice Fortier in Lindsay noted that where an owner contracts directly with a contractor who in turn contracts with a subcontractor, the proper holdback, consistent with the scheme of the Act, is 10 per cent of the main contract. This is consistent with and applies the decision of Justice Austin, sitting in the Divisional Court in Forte Aluminum, where it was held that although section 22(1) of the Construction Lien Act could be interpreted as requiring an owner to hold back 10 per cent of the value of a particular subcontract and not 10 per cent of the value of the whole contract, this interpretation would involve a radical departure from what is understood to be the accepted practice in lien proceedings.³

The result is best understood by example. Imagine a \$100,000 improvement let as a single general contract with nine separate \$10,000 subcontracts. As the lien period expires 45 days following publication of the declaration of substantial performance, the owner should be holding basic holdback of \$9,700 (10% of \$100,000 - 3%) and each of the nine trades will be able to look to the whole \$9,700. If, for example, one of the trades fails, the claims under that trade are not likely to exceed that trade's price of \$10,000 and therefore the \$9,700 holdback would be ample security. Result, happiness.

³ Forte Aluminium Ltd. v. Frank Plastina Investments Ltd. (1989), 29 C.L.R. 167.

Imagine the same improvement let as ten separate "contracts" instead of one general contract with nine subtrades. Now each "contract" is substantially performed at \$9,700 (\$10,000 - 3%) and each basic holdback at that point is \$970. When one of these "contractors" fails, its \$10,000 or so of subtrades will now be looking at \$970 of holdback. Result, unhappiness and, perhaps, more defaults.

While the reasoning in the Lindsay case may be correct in terms of a literal interpretation of section 22(1), it may lead to a remarkable number of separate joint bank accounts on a literal application of CCDC GC 5.5.3.. It is worth examining this point further, to see what is really being achieved by this complex network of holdbacks and joint bank accounts.

Essentially, section 22(1) and the statutory definitions provide that each owner upon a contract between the owner and a person employed directly by the owner to supply services or materials to an improvement under which a lien may arise shall retain 10 per cent of the value of the services or material supplied under that contract, which means 10 per cent of the price of the services or materials as they are actually supplied under the contract.

Although, in both the Lindsay and Lansing the owner who had contracted directly with many contractors, the Act appears to have contemplated a more pyramidal contractual structure with an owner at the apex, a single general contractor

immediately below and numerous subcontractors and sub-subcontractors on the next levels. As was indicated by Justice Fortier in Lindsay, the definition of "holdback" itself does not make reference to an improvement. The definition of "holdback" refers to a "contract" which is defined as a contract between an owner and contractor and "contractor", in turn, is defined as a person contracting directly with the owner to supply services or materials to an "improvement". Therefore, the definition of holdback incorporates the concept of "improvement" only by reference to the defined terms "contract" and "contractor".

The policy that the holdback retained be calculated on an amount equal to the value of the "improvement" is also reflected in the Report of the Attorney General's Advisory Committee on the Draft Construction Lien Act. There the Committee stated that section 22 provides for two holdbacks:

“The first, created by subsection 1, requires the retention of 10 per cent of the price of the services or materials actually supplied from the commencement of the making of the improvement to the date certified as the date of substantial performance of the contract (where there is no certification, it requires retention of 10 per cent of the price of all services and materials supplied).”

It may be argued that while Lindsay may be an entirely correct application of the law to the facts the resulting effect on the law of holdbacks may be contrary to the

policy of the Act. By contracting directly with numerous trades, an owner is effectively limiting its liability, and that of its financial institution, to the trades as an overall group. This is indeed contrary to the policy of the Act and the risk spreading analysis undertaken by the Attorney General's Committee.

A second observation is the Act does not provide for situations where the owner is in default of payment. The limitation provisions in section 23 of the Act only contemplate situations where the contractor and subcontractor are the defaulting payers.

In M.W.M. Construction of Kitchener Ltd. v. Valley Ridge Inc.⁴ Justice West was called upon to determine the amount of the holdback for which the owner, Valley Ridge, and its mortgagee, were responsible. The owner and the general contractor were controlled by the same person. Most lien claimants had contracted with the general contractor while one claimant, a security firm, had contracted directly with the owner. Justice West acknowledged the trial level decisions in Lansing and Lindsay, however he did not have the benefit of the Divisional Court reversal in Lansing.

On the facts before him, Justice West held that the security firm was entitled to share in the holdback fund with the other lien claimants and was not restricted to a claim against the value of the holdback of its particular contract with the owner.

⁴ M.W.M. Construction of Kitchener Ltd. v. Valley Ridge Inc. (1993), 8 C.L.R. (2d) 25.

Justice West found that in the circumstances it would be "completely inequitable" to allow the mortgagee to limit its liability to the security firm. As the court found that the general contractor and the owner were controlled by the same person and that the services of the security firm benefited all the claimants as well as the mortgagee, Justice West concluded that "the interposing of a corporate body which is not dealing at arm's length with the owner should not be allowed to deflect or defeat the legitimate claim of the security firm to share in funds available to all lien claimants.

As the issue in the case was a priority over a mortgage to the extent of my deficiency in holdback, Justice West also found support for his conclusion on the basis of subsections 78(2) and 78(5) which give priority to "liens arising from the improvement" and not simply to liens arising under a "particular contract"⁵. The Divisional Court, however, disagreed with Justice West and in reversing him on this point held that the security firm was only entitled to a lien arising from its particular contract with the owner. The Divisional Court also held that piercing the corporate veil made no difference to the outcome of the case.

As the Lindsay, Lansing and M.W.M. Construction cases suggest a possible defect in the Act, amendments may be required to the Act to clearly delineate the owner's

⁵ M.W.M. Construction of Kitchener Ltd. v. Valley Ridge Inc., endorsement of the Divisional Court, released November 3, 1993.

holdback obligations. The area is now so complex that the whole idea of "holdback" might fairly be called into question.

In Alberta, a Task Force has been set up for some time to review the province's Builders' Lien Act⁶. Alberta's Task Force has recommended that the requirement of a statutory holdback be eliminated in favour of detailed trust provisions. Conceptually, the lien would still attach to the land and to any contractual holdbacks in the owner's hands, but not to any statutory holdback per se. The Task Force recommended eliminating the requirement of a statutory holdback as many subtrades were under a misunderstanding as to the degree of the protection and security that was afforded by the holdback provisions. The Task Force also thought that eliminating holdbacks would "provide greater assurance of payment by increasing cash flow". The recommendations of the Task Force have not yet been adopted.

The Alberta Task Force also noted that in most cases, there is no actual pool of money in existence to fund the holdbacks, in other words no fund of cash to be paid into any bank account in any name. The Task Force also found that in the majority of cases, the owner defers borrowing the amount of the holdback until after the lien period has expired. Usually in practice no amount retained as holdback from material suppliers thereby forcing the contractor and the subcontractor to finance the

⁶ Information for this section was obtained from "The Proposed Alberta Construction Payment Act and The Final Report of the Joint Government/Industry Task Force: An Initial Review", 38 C.L.R. 73, by Kerry Powell and in conversations with Mr. Powell.

difference in any event. The Task Force concluded that this "deficiency in cash flow is a serious problem and itself often leads to insolvencies and business failures, especially for those in the construction industry who have a low ratio of equity to receivables in their business". This warranted their recommendation eliminating the requirement of a statutory holdback.

The Ontario Attorney General's Advisory Committee has also noted that the holdback operates as an interest free loan used to finance the owner's project, a concern of the Alberta Task Force and reason identified by them for the elimination of statutory holdback. The Ontario Attorney General's Discussion Paper proposal of a joint trust account was not adopted by the Committee. The Ontario Attorney General's Advisory Committee also acknowledged that the holdback may result in an increase in the risks of an insolvency on the project, however in the opinion of the majority of the members of the Committee, now carried into law, a holdback reduced from 15 to 10 per cent was thought to provide adequate protection to the suppliers of an improvement, without creating a serious risk of insolvency.

A New Brunswick a Discussion Paper⁷ has sought to ascertain whether that Province's Mechanics' Lien Act should be repealed and, if not, what should be done about the holdback provisions. The New Brunswick Discussion Paper considered that the purpose of the holdback fund was to "protect the owner from people lower

⁷ Law Reform Branch Office of the Attorney General, Discussion Paper, The Mechanics' Lien Act: Time For Repeal?, July 1992.

down in the chain of contracts. It provides a fund out of which liens can be satisfied, at least partially, while not exposing the owner to the double jeopardy of paying both the contractor and the lienholder for the same work". This rationale can be contrasted with the Ontario position that "where the contractor defaults in the performance of the contract, the holdback may be the only money available to satisfy the lien claimants ... the reduction of holdback below 10% would reduce the protection afforded by the Act below an acceptable level".

The New Brunswick Discussion Paper also noted that the Mechanics' Lien Act provided four types of security, two of which are the charge on the holdback and the right to require an additional holdback. The Paper observed that their usefulness "is not apparent from the case-law". As an example the Discussion Paper used the case of R.A. Corbett & Co. Ltd. v. Phillips⁸ where a subcontractor abandoned a project at a time when the owner still retained more than \$47,000.00 in holdback, creditors of the subcontractor only had access to the holdback to the extent of \$2,640.00, this being the portion of the holdback attributable to the contract between the contractor and the subcontractor. The Discussion Paper concluded that the charge on the holdback was of little value since a subcontractor only has access to it to the extent that is attributable to its subcontract. The position in Ontario, as amended in 1990, is that an owner will only be liable for the lesser of the holdback the owner is required to retain or holdback required to be retained by a contractor from a subcontract. While the New Brunswick Discussion Paper identified this result as a

⁸ R.A. Corbett & Co. Ltd. v. Phillips (1973) 5 N.B.R. (2d) 499.

defect in the holdback provisions, the Government in Ontario has adopted a similar provision.

It is suggested that the time may have come to rethink the holdback provisions. Once the policy is clearly identified as to who is to be protected, to what extent and for what purpose, a proper scheme of holdbacks can be drafted.

- (d) **Trust Remedies:** The trust remedies of the Construction Lien Act are codified in Part II of the Construction Lien Act and are the subject of more detailed and thorough comment elsewhere in the conference materials.

These are essentially three “owner’s trusts”:

(a) s. 7(1): all money received by an owner;

(b) s. 7(2): all money certified for payment by an owner;

(c) s. 7(3): all money payable upon substantial performance, either in owner’s hands, or received thereafter.

There is a single “contractor’s trust”, expressed in s. 8(1) covering all amounts owing, whether or not due or payable and all amounts received by a contractor.

The committee considered a “notice trust” provision, similar to the “stay the hand of the pay master” case, Bre-Aar Excavating v. D’Angela Construction (Ontario Ltd. (1975), 8 O.R. (2d) 598, 21 C.B.R. (N.S.) 260, 56 D.L.R. (3d) 654 and rejected it in favour of clear language as to the proper objects of the trust.

There is a “vendor’s trust” in section 9, with respect to the net proceeds of sale of a premises. This can be an immensely valuable remedy in dealing with lots in a plan of subdivision.

There are generous set-off provisions in section 11 and section 12 permitting a trustee, for example, to use trust funds to repay a loan taken out and used for the payment of trades and suppliers. This is the subject of a case currently before the Ontario Court of Appeal. It seems to be the law that the onus is on the trustee to prove that all borrowed monies were used on the actual project from which the funds used to repay the loan were taken.

The key amendment, however, was to remove the limitation period and summary conviction offence sections and to substantiate for them a strongly worded provision extending liability for breach of trust to directors, officers, employees, agents, and persons having effective control of a corporation. Courts have applied these trust sections rigorously. As can be seen by a number of recent trial level decisions and the remedy is a powerful one. The Committee would be pleased. Their views in 1982 were as follows:

“Section 13

This new section was included in the Discussion Draft to prevent the use of a shall corporation as a device for defrauding creditors. The use of such corporations presents a problem in some segments of the construction industry. Section 13 allows the court to disregard the limited liability of a corporation, and to impose liability upon those who are actually responsible for a breach of trust. The words “assents to or acquiesces in” in subsection 1 are intended to convey that only those who had the power to prevent a breach of trust are to be found liable under this section.

The section replaces the penal provision of the Mechanics’ Lien Act, contained in subsection 3(7). This type of provision is unnecessary in light of section 296 of the Criminal Code which makes it an indictable offence, punishable by up to 14 years imprisonment, to convert trust funds with an intent to defraud. Where there is no intent to defraud, the civil liability for breach of trust should be sufficient to note that subsection 3(7) of the present Act has rarely been used, even though it has been in force for over 20 years.

Subsection 13(3) of the Discussion Draft adopted by reference the relevant provisions of the Negligent Act for the purposes of

determining degrees of fault and apportionment of liability in an action for breach of trust. The Committee decided that section 13 should be expanded to explicitly deal with all aspects of a breach of trust under the Draft Act, without reference to other legislation. In addition, the Committee was of the view that the adopted provisions of the Negligence Act were inappropriate.

Therefore, two new proposed subsections have been added to deal with liability for breach of trust and apportionment of compensation payable. Subsection 13(3) now expressly provides for the joint and several liability of persons found liable for a breach of trust. Subsection (4) then imposes an obligation on the parties to the breach to share equally the burden of compensation, unless the court considers some other apportionment more appropriate in the circumstances of the particular case.”

1.3 **Proceeding Against the Crown Act, R.S.O. 1990, ch. P.27:**

Although the lien statutes of many provinces, including Ontario, have been amended to include as an "owner" the Crown and Crown agencies to which the Crown Agency Act, R.S.O. 1990, C.48, applies, it had been held under the Ministry of Transportation and

Communication Creditors Payment Act, 1975 (Ont.) C.44, that a Plaintiff had no right to pursue a trust remedy under the Construction Lien Act once its rights under the Ministry of Transportation and Communication Creditors Payment Act had been exhausted. The Ministry of Transportation and Communication Creditors Payment Act has now been repealed and replaced by the Ministry of Transportation Act, R.S.O. 1990, ch. M-36.

As a result, the jurisdictional impediment to the power of the Courts to enforce statutory trusts against the Crown now appears to have been removed. This being so, the Proceedings Against the Crown Act, and the immunities granted by s. 2(2)(c), s.s.(1)(c) (duties attaching to ownership of property) and s. 5(3) (liability for acts of servants performing duties legally required), as well as the notice requirements of s. 7, must be reconsidered particularly as s. 19 of the Proceedings Against the Crown Act specifically bars the enforcement of any claim "in rem" against the Crown, which would appear to specifically include the usual in rem declaratory relief sought in a trust action. In the event of a conflict, the Proceedings Against the Crown Act is given precedence over any other Ontario Act. In short, despite the amendments enacted in the Ministry of Transportation Act, payment remedies against the Crown are still severely circumscribed even though, these days, they have emerged as one of the largest buyers of construction services and materials.

1.4 **Financial Administration Act, R.S.C., 1990 ch. C. F.12:**

Under the authority of the Financial Administration Act the federal government regulates contracts with the federal government and its agencies. These regulations are collected and published and readily available from the Queen's Printer as the "Treasury Board Manual". The policy objective of the federal government is stated in this manual to be "to acquire goods and services and to carry out construction in a manner that enhances access, competition and fairness and results in best value or, if appropriate, the optimal balance of overall benefits to the Crown and the Canadian people".

The expression of this policy objective in actual practice is interesting to observe. By way of example only, the reader is directed to the "Information and Administrative Management" component of the Treasury Board manual, and, particularly to s. 12.8, "Disputes", and to the negotiation, mediation and arbitration provisions set out therein, and also to Appendix "M", being a guideline for a construction claim mediation agreement. The federal government's own objective seems to be to remove its disputes from federally appointed judges in favour of alternative dispute resolution methods, consistent with current provincial initiatives in the same direction.

A particularly useful procedure payment procedure with respect to "public works", is the Contract Disputes Advisory Board ("CDAB"), created in 1987 pursuant to the prerogative powers of the Minister of Public Works Canada, as a board of the Minister and not of the Department, to provide an alternative to mediation and arbitration. It is meant to be used to settle disputes quickly. In other words, it is meant to achieve the

same purpose as Ontario's Construction Lien Act. A comparison between the two systems is enlightening.

The CDAB advises that their process has a "success ratio" of 95%. The authors doubt that the perceived "success ratio" in lien litigation is this high.

To initiate the CDAB process, the contractor sends a letter to the Minister requesting that a board be convened. The Board will then verify that negotiations between the Department and the contractor have been exhausted and that the parties have arrived at their final positions. The contractor will then receive a reply from the Minister advising that the Minister is prepared to convene the CDAB. If the Minister declines to convene a board, the contractor is then left to pursue its other options. CDAB proceedings are conducted "without prejudice", and are not legally binding and do not rule out future referral of the dispute to arbitration or litigation. The Board confines itself to issues of fact and does not deal with questions of law.

Along with the reply from the Minister, the contractor is sent an "Agreement to Convene", an example of which is annexed to this paper.

The Board is comprised of three people. The Minister uses a list of names which may be provided by the Arbitrators' Institute, listed by geographical area and experience in an area of construction, to prepare a shorter list of three individuals, one of which will be chosen as the neutral party. This neutral party is usually one with a good deal of

proven practical experience in the construction industry and is rarely, if ever, an academic, a professional mediator or other "expert" negotiator. The CDAB administrator sends this short list of three names to the contractor and the Department, who rank the names. The person with the highest ranking selected as the neutral Chairperson of the Board. This facet of the CDAB is crucial to getting the most use out of the CDAB.

The second member of the Board is nominated by the contractor as an advocate of the contractor's position. The third member is nominated by the Deputy Minister of Public Works. These two "advocates", who may be experts, consultants or lawyers, must have intimate factual knowledge of the contractor's claim. The contractor's advocate will serve no useful purpose to the contractor if he is not fully informed as to the project and the contractor's claims.

Six weeks prior to convening the CDAB, the contractor will forward five copies of its claim document, clearly defining the issues and describing the contractor's position with respect to the items of the claim. Two weeks prior to convening the CDAB, the Department will submit its rebuttal document.

Commonly, a CDAB hearing lasts for no more than three days. In fact, at the time of writing, only two hearings since the Board's creation have lasted four days. On a typical three day hearing, the contractor presents his claim on the first day and the Department presents its rebuttal on the second day. At the end of each presentation, the Contractor

and the Department are given time to challenge statements made by the other. The contractor and the Department are permitted to have their case presentations made by counsel if they so desire. Both parties are also permitted to have experts give evidence. The Board members are allowed to ask questions at any time during the presentation⁹.

On the third day, the contractor and the Department witnesses and the like are dismissed, leaving only the three Board members to carry on. It is on this day that the Board member selected by the contractor plays a vital role. This day has been described by participants as a day in which the two advocates on the Board "lobby" the Chairperson. They attempt to persuade the Chairperson to accept the position of the party that they represent¹⁰.

At the end of the third day the Board is adjourned. The Chairperson submits a confidential report to the Minister within two weeks from the last date of the hearing. The Minister reviews this report with his Department, obtains their position with respect to same and sends a letter to the contractor offering to settle the dispute. The Minister is not bound by the Chairperson's report and may reject its conclusions, in which case the Minister must inform the contractor and set out the reasons for the refusal. However, as of the date of this paper, the Minister has yet to reject a single report submitted by the

⁹ CDAB Conditions and Procedures.

¹⁰ Interview of Richard Beifuss, Director Claims Administration, Public Works Canada, January 30, 1993.

CDAB. If the Minister's offer is accepted, that is the end of the matter. If not, the parties can pursue other avenues of recovery.

If this procedure is compared to lien litigation at any point in the process, the comparison favours CDAB. One can only wonder at this stage if the 1994 amendments to ss. 58(1), (1.1), (1.2) and (1.3) of the Construction Lien Act permitting a reference to “a person agreed on by the parties” could refer to a “Chairperson” operating by the CDAB procedure whose report would then have the force of a judgment.

The reference procedure in the Construction Lien Act is not to be discounted. In fact, if used properly it has most of the advantages of case management and alternative dispute resolution, with few of the disadvantages. As we see it, the advantages of the Construction Lien Act references are these:

1. The lien Master is an expert neutral third party, with highly developed construction law expertise, paid for by the government;
2. No one is better qualified to ride herd on the lawyers in a case than a Master. Once a Master is seized of a reference, which is usually at the very beginning of a case, they never let go. This gives a strong incentive to lawyers to moderate their positions and prepare carefully on the merits;

3. The lien Master is adept at court procedures and can use them judiciously, to move determinative issues forward and leave incidental issues behind. It must be remembered that leave of the Court is required for most interlocutory matters;
4. Although bond claims cannot be brought in a lien action, they can be brought in a normal civil action and referred to the Master under r. 54.02. If bond claims are referred to a lien Master along with lien claims, all issues can be resolved in one case managed proceeding;
5. Although trust claims cannot be joined in a lien action (section 50(2)), they can be brought in a normal civil action and referred to the Master under r. 54.02.. In this way even officers, directors and persons in control can be brought into a reference;
6. The “place of hearing” rule for motions (rule 37.03) does not apply to references after an order is made fixing a trial date (which can be included usefully in the Order of Reference). This allows the Master to fully control procedure on a reference and to expedite resolution.
7. A Master on a reference does not make formal “orders”, he makes “directions”. These are effective as soon as the Master writes them in his “procedure book”. This saves time and assists in case management;

8. Lien Masters operate on a “fixed trial system”, with many pre-trial meetings. Once you start a reference, you know exactly when you will be heard and that you will be heard until you are done;

9. A Master is not restricted to factual matters, as is the Board members are in the CDAB process. A Master on a reference can punish for contempt, compel witnesses to attend and issue committal orders if necessary. This tends to keep people focussed on the business at hand;

10. You cannot appeal a Master’s report on a reference. You can bring a motion to oppose confirmation of the report on at least three days notice but a judge will only refuse confirmation if there has been an error in principle, an absence or excess of jurisdiction, or a patent misapprehension of the evidence and it is unjust, on all the evidence. In other words, although a Master’s report on a reference is not absolutely final, it may as well be.

2. **PRIVATE LAW**

Seemingly independently of the public law aspects of this subject of “getting paid”, the private law aspects have been changing as well. The Canadian Construction Documents Committee continues to endeavour to keep pace with legal developments by providing balanced and effective contractual provisions, leaving it to the parties themselves, for example, to decide just how much front end loading of a contract is a good thing.

2.1 **Standard Payment Terms**

At law, strictly speaking, the price of a contract is not due at all until it has been performed. In other words, in a construction setting, the first dollar would not become due until and unless the last work had been performed. While this is workable in other commercial contracts where there is an immediate exchange of goods and value, construction contracts are typically performed over months or even years and this general proposition of contract law has long been accepted as unworkable. In order to accommodate this, standard construction contracts make provision for periodic payments against earned progress according to a progress payment schedule usually negotiated during the optimistic days immediately after contract award.

There is a conflict inherent in this system. The payer wants to hang on to every cent until the last minute but not to bankrupt the payee and the payee wants to get as much money into its hands as fast as it can in the case of an honest contractor to finance subsequent performance, and in the case of a dishonest contractor, to withdraw from the company for some other pressing reason. The result is usually a form of agreed progress billing breakdown which becomes one of the Contract Documents. This document will be examined closely by the Surety company if a claim is made.

It is worth turning to the payment provisions of CCDC 2 *Stipulated Price Contract*¹¹, Article A-5, which provides as follows:

ARTICLE A-5 PAYMENT

5.1 Subject to Applicable legislation, subject to the provisions of the *Contract Documents*, and in accordance with legislation and statutory regulations respecting holdback percentages and, where such legislation or regulations do not exist or apply, subject to a holdback of _____percent (_____%), the *Owner* shall in Canadian funds:

5.1.1 make progress payments to the *Contractor* on account of the *Contract Price* when due in the amount certified by the *Consultant* together with such *Value Added Taxes* as may be applicable to such payment, and,

5.1.2 upon *Substantial Performance of the Work*, pay to the *Contractor* the unpaid balance of the holdback amount when due together with such *Value Added Taxes* as may be applicable to such payment, and

¹¹ CCDC 2-1994 *Stipulated Price Contract*; all references to this paper are to the new CCDC 2-1994 unless otherwise expressly stated.

5.1.3 upon the issuance of the final certificate for payment, pay to the *Contractor* the unpaid balance of the *Contract Price* when due together with such *Value Added Taxes* as may be applicable to such payment.

Part 5 of the CCDC 2 provides for the actual mechanism for payment to the contractor:

GC 5.1 FINANCING INFORMATION REQUIRED OF THE OWNER

5.1.1. The *Owner* shall, at the request of the *Contractor*, prior to execution of the Agreement, and/or promptly from time to time thereafter, furnish to the *Contractor* reasonable evidence that financial arrangements have been made to fulfil the *Owner's* obligations under the *Contract*.

5.1.2. The *Owner* shall notify the *Contractor* in writing of any material change in the *Owner's* financial arrangements during the performance of the *Contract*.

GC 5.2 APPLICATIONS FOR PROGRESS PAYMENT

5.2.1 Applications for payment on account as provided in Article A-5 of the Agreement - PAYMENT may be made monthly as the *Work* progresses.

- 5.2.2 Applications for payment shall be dated the last day of the agreed monthly payment period and the amount claimed shall be for the value, proportionate to the amount of the *Contract*, of work performed and *Products* delivered to the *Place of Work* at that date.
- 5.2.3 The *Contractor* shall submit to the *Consultant*, at least 14 days before the first application for payment, a schedule of values for the parts of the *Work*, aggregating the total amount of the *Contract Price*, so as to facilitate evaluation of applications for payment.
- 5.2.4 The schedule of values shall be made out in such form and supported by such evidence as the *Consultant* may reasonably direct and when accepted by the *Consultant*, shall be used as the basis for applications for payment, unless it is found to be in error.
- 5.2.5 The *Contractor* shall include a statement based on the schedule of values with each application for payment.
- 5.2.6 Claims for *Products* delivered to the *Place of the Work* but not yet incorporated into the *Work* shall be supported by such evidence as the *Consultant* may reasonably require to establish the value and delivery of the *Products*.

General Condition 5.2 requires the contractor to submit an application for payment on the last day of the agreed monthly period. The application for payment is for the value of the work performed and products delivered to the site as of the last day of the agreed monthly period. The wording of GC 5.2 is substantively the same as is the old CCDC 2 and, accordingly, case law decided under the old CCDC 2 may remain applicable.

General Condition 5.3 provides for progress payments. The progress payment provisions in GC 5.3 are substantially the same as the old CCDC 2.

GC 5.3 PROGRESS PAYMENT

5.3.1 The *Consultant* will issue to the *Owner*, no later than 10 days after the receipt of an application for payment from the *Contractor* submitted in accordance with GC 5.2 - APPLICATIONS FOR PROGRESS PAYMENT, a certificate for payment in the amount applied for or in such other amount as the *Consultant* determines to be properly due. If the *Consultant* amends the application, the *Consultant* will promptly notify the *Contractor* in writing giving reasons for the amendment.

5.3.2 The *Owner* shall make payment to the *Contractor* on account as provided in Article A-5 of the Agreement - PAYMENT no later than 5 days after the date of a certificate for payment issued by the *Consultant*.

Standard form subcontracts, being CCA S-1 (Short Form Subcontract) and CCA L-1 (Long Form Subcontract), contain their own payment code and some interesting anomalies. The common features of these two forms of subcontract are as follows, bearing in mind that at the time of writing a significantly improved CCDC S-1 is being promulgated by the Committee:

- (a) **Progress Payments on Account of the Subcontract Price:** (CCA S-1), Article 4.1(a); CCA L-1, Article IV (a)(i), are subject to the decision of "the certifier" in the case of CCA S-1 and the "Consultant" in the Long Form Subcontract (CCA L-1); and,

- (b) **Payment of Holdback on a Stated Date:** The Short Form Subcontract CCA S-1, Article 4.1 (b) provides that holdback is to be paid on the day following substantial performance, the expiration of all relevant lien rights, there having been "no claim for lien asserted relating to the subcontract work...which continues to inhibit the payment to the subcontractor", and the provision of a statutory declaration as to payment in full of all accounts, save and except for holdback. In the case of CCA L-1, similar terms are found at Article IV (a)(ii) and IV (c), however it is interesting to note that while both the CCA S-1 and CCA L-1 refer to holdback being paid after substantial performance, CCA S-1 refers to the additional requirement that the time for a "lien to be asserted" has

expired, whereas CCA L-1 does not refer specifically to liens, but rather to "claims against the work".

The use of the word "asserted" in CCA S-1 may require that the lien be more than merely "in existence". A lien comes into "existence" at the moment work, services or materials are supplied to a premises. This is provided by ss. 14 and 15 of the Construction Lien Act, and is a definition supported by case law considering those sections.

For a "claim for lien" to be "asserted" something by way of notice or preservation is required. The provisions of CCA L-1, on the other hand, are open to abuse as it would be easy for a contractor to identify "claims against the work" claiming through or under a subcontractor and thereby avoid paying holdback to that subcontractor, whereas the requirement that a "claim for lien" be "asserted" in CCA S-1 is capable of objective verification. This is often a very real problem for a contractor with the trades of an insolvent or bankrupt subcontractor. These "claimants" are usually small in number and amount and are inclined to give notices of trust claim as opposed to incurring the expense of preserving a claim for lien.

Declaratory relief may be available in such circumstances under the Construction Lien Act. This will be addressed in another conference paper dealing with interlocutory motions in lien proceedings.

If by "asserted" the standard form contract language means "written notice of a lien", the reader is referred to "Progress Payment and "Written Notice of a Lien", by Harvey Kirsh, published in Carswell's Construction Law Reports at 8 C.L.R. (2d) 86. There various of Mr. Kirsh's colleagues discuss whether registration of a lien under the Ontario Land Titles Act or Registry Act constitutes "written notice of a lien" within the meaning of s. 24 of the Construction Lien Act.

With respect to the common condition in both forms of subcontract that a statutory declaration as to the payment of trades be provided as part of holdback release, the utility of such declarations is open to serious question, particularly in light of the little known 1983 trial decision in E. Bondy Excavating & Trucking Ltd. v. Victoria Insurance Company of Canada.¹²

In this case the plaintiff subcontractor had completed its subcontract work, requisitioned final payment and swore a statutory declaration stating, correctly, that \$128,456.70 remained owing to it from the general contractor. The general contractor advised the plaintiff that a statutory declaration sworn in this form would prevent release of the holdback by the owner, at least, to the extent of the Plaintiff's claim. At the general contractor's specific request, therefore, the plaintiff provided a second statutory declaration, this time falsely declaring that it had been paid in full. The general contractor gave the plaintiff a cheque in the amount of \$128,456.70 in exchange for this

¹² E. Bondy Excavating & Trucking Ltd. v. Victoria Insurance Company of Canada [1983] I.L.R. 1-1654; a copy is appended to this paper.

statutory declaration. The Plaintiff was told not to present the cheque until the contractor had received and deposited the holdback into account. Needless to say, the holdback never reached the account. The holdback was released to an officer of the general contractor who temporarily absconded overseas with the funds.

The subcontractor, chagrined at the failure of its first scheme, made a claim and brought action for the payment of money against the general contractor's labour and material payment bond surety. The surety's defence was that the plaintiff's conduct in swearing a false statutory declaration, knowing it to be false at the time and intending it to be relied upon, was fraudulent and that this very conduct which had created the shortfall, of which the plaintiff complained.

The trial judge would have no part of it. The Court found, remarkably in my respectful view, that there was no fraudulent conduct on the part of the plaintiff in signing and swearing a false statutory declaration in the circumstances of the case. The Court took judicial notice of a "practice in the trade" that a subcontractor could not actually be paid in full until after the release of the holdback, which release would not occur until a statutory declaration was provided. Reasoning that this was a type of "Catch-22", in the sense that you could not truthfully swear it until you were paid and you could not get paid until you swore it, the Court found:

The evidence confirms ... that it is not at all unusual or to be expected that a declaration will be taken acknowledging payment in full when that

has not in fact occurred. The reasonable inference from his evidence is that in practice in most cases there can be no final payment until the holdback money is released...that a subtrade will only get paid in full after the holdback monies are released and that such will not occur until the subtrade makes available a sworn declaration or signed acknowledgement that payment has been made in full.

The Court did indicate that this industry practice is to be used only to facilitate the process of the release of holdback monies and the statutory declaration is to be treated as being effective only as of the moment of the release.

In view of the Bondy decision, the requirement of a statutory declaration as a condition of final payment of holdback adds nothing to the process and protects no one except, perhaps, if it is used to clarify the division of work between labour and material supply to assist in determining the necessity of a Certificate of Clearance under the Worker's Compensation Act upon each payment, or, at least, upon final payment. A statutory declaration may also give some comfort to a payer regarding the existence of its payee's unpaid trust beneficiaries. Apart from this, the requirement for a statutory declaration as a condition of payment of holdback is now an anachronism and should be deleted consensually at the time of execution of the contract or, ideally, from the standard form subcontracts themselves. It seems odd that forms of documentation which retain some legal meaning or merit, such as Workers' Compensation Board releases, progressive releases of the contractor and its surety, and assignments of relevant third party

warranties into joint names, are nowhere provided for in the payment provisions of standard subcontract documents or made condition of payment.

The mechanism triggering payment in the case of each of the standard form subcontracts is identical. Subject to pending amendments in the new CCA S-1, this mechanism is found in Article 4.2 of CCA S-1 and Article IV (b) of the CCA L-1. The language is permissive. It states that approved sums "become due and payable". It does not say, as it might if it was meant to be mandatory, "shall be paid without deduction or set off". Article 4.2 of CCA S-1 is set out below:

4.2 The subcontractor shall submit to the contractor for his approval before the first application for payment, a schedule of values of the various parts of the work, aggregating the total amount of the subcontract price and divided so as to facilitate evaluation of application for payment.

The subcontractor shall make applications for payment together with supporting statutory declarations and/or other documents when required by this agreement on or before the __ day of each month (herein called "the submission date") to the contractor for approval and due processing covering the value of the products delivered at the site and the work performed by the subcontractor proportionate to the subcontract price up to the ____ day of the month, whereupon payment to the subcontractor by the contractor in the amount of __ percent of the certified sum shall

become due and payable not more than thirty (30) days after the submission date or ten (10) days after certification, whichever is the later. Where the contractor or certifier makes any changes to the amount of the applications for payment as submitted by the subcontractor, the subcontractor shall be so notified promptly in writing. The subcontractor shall be given the opportunity to defend his submission without delay, (emphasis added).

Article IV (b) provides as follows:

- (b) The Subcontractor shall make applications for payment together with supporting Statutory Declarations and/or other documents when required by the Contract Documents on or before the ___ day of each month (herein called the Submission Date) to the Contractor for approval and due processing covering the value of the products delivered at the site and the work performed by the Subcontractor proportionate to the Subcontract Price up to the __ day of the month, whereupon payment to the Subcontractor by the Contractor in the amount of ___ per cent shall become due and payable not more than thirty (30) days after the Submission Date or ten (10) days after certification whichever is the later. Where the Contractor or the Consultant makes any changes to the amount of the applications for payment as submitted by the Subcontractor, the Subcontractor shall be so notified promptly in writing

by the Contractor of changes and given the opportunity to defend his submission without delay. (emphasis added).

2.2 "Pay When Paid" Clauses

Simply stated, "pay when paid" clauses provide that a payer is not obligated to pay a given trade until that payer has actually received payment for the same work.

Such provisions are enforceable. Courts have explained away the harsh results caused by "pay when paid" clauses by stating that they are merely asked to interpret a clause in a contract to which parties of equal bargaining position have agreed not to remake such an agreement. With respect, this is usually a non sequitur. I have yet to read a report of such a case where it appears that any direct evidence as to equality of bargaining power is referred to, or where such evidence was led.

Furthermore, such provisions are found in construction contracts which, by virtue of s. 5(1) Construction Lien Act, "deemed to be amended in so far as is necessary to be in conformity with this Act". In other words, Courts are enforcing a contractual provision on the basis of a bargain made by parties of equal bargaining power when the legislature has expressed a policy in s. 5(1) of the Construction Lien Act to amend construction contracts, presumably because of the likelihood of onerous waivers of remedies arising out of inequality of bargaining power. Construction contracts, like insurance contracts, have been singled out as being contracts requiring statutory amendment in order to

prevent unequal bargains. Literal interpretation does not, therefore, seem to be an appropriate way of analyzing competing interests in a construction setting. A purposive test would be more appropriate in achieving this object.

The majority of the Ontario Court of Appeal upheld a variation of a "pay when paid" clause in Timbro Developments Ltd. v. Grimsby Diesel Motors Inc.¹³. The clause was found in the purchase orders of the contractor and provided as follows:

Payments will be made not more than thirty (30) days after the submission date or ten (10) days after certification or when we have been paid by the owner, whichever is later...

The Court of Appeal held that the clause clearly specified a "condition" governing the contractor's legal entitlement to payment and did not merely deal with the timing of such payment. The minority attempted to construe its way out of the obviously harsh result by interpreting the clause as relating merely to "timing" of payments due under the contract and not as fixing the subcontractor with all of the risk of non-payment to the contractor. In both the majority and minority decisions, the Court relied on their own interpretation of the parties' intentions, rather than entering into a purposive analysis of the competing interests of the parties such as their reliance, restitution and expectation interests.

¹³ Timbro Developments Ltd. v. Grimsby Diesel Motors Inc. (1988), 32 C.L.R. 32 (Ont. C.A.); leave to appeal to S.C.C. dismissed (1989), 99 N.R. 400.

While Timbro suggests that a "pay when paid" clause will be upheld in Ontario, it must be pointed out that the only legal issue before the Court of Appeal was whether or not the clause created a true condition precedent to payment, being merely the in personam aspect of the lien action and not whether or not the clause barred a lien claim, which is the *in rem* aspect of the lien action. The trial judge in Timbro had ordered a sale in default of payment by the owner and had found that the lien claimants had valid and subsisting liens against the estate of the owner, thereby declaring their rights in rem. In other words, the "pay when paid" clause only blocked the personal judgment in Timbro, not the lien judgment.

Therefore even though a subcontractor may be faced with a "pay when paid" clause in its subcontract, the timely preservation and perfection of its lien rights may still be vital to its interest in getting paid. Subcontractors should press forward with their liens right through to sale of the land notwithstanding the existence of a "pay when paid" clause in their subcontracts. The relative bargaining positions of the parties may shift in favour of a subcontractor if such steps are taken.

It is worth commenting here that any agreement that a "pay when paid" clause bars the regular enforcement of the lien remedy, in rem, as opposed to the personal judgement in personam, would be met by s. 4 of the Act:

An agreement by any person who supplies services or materials to an improvement that this Act does not apply to the person or that the remedies provided by it are not available for the benefit of the person is void.

It has also been suggested, but not to our knowledge argued even in the Timbro case, that the provision of s. 5(1) of the Act requiring a judge or master to "try the action...and all questions that arise therein or that are necessary to be tried in order to completely dispose of the action and to adjust the rights and liabilities of the persons appearing before it..." may also require a judge or master to adjudicate the in personam issues as well, even in the face of a "pay when paid" clause, applying Timbro only to suspend enforcement of the resulting judgment until the judgment debtor receives funds. In this regard, the mandatory language "shall try the action" should be contrasted with the permissive language "may award any lien claimant a personal judgment", as used in s. 63 of the Act. A clause in a contract or subcontract that purported to render this jurisdiction unavailable to a lien claimant would appear to be void by virtue of s. 4 of the Act.

The position in Ontario may be contrasted with the American position as stated, for example, in Thos. J. Dyer Co. v. Bishop International Engineering Co.¹⁴. This provision in the subcontract stated that "no part of [the payment] shall be due until five (5) days after Owner shall have paid Contractor therefor". The Court used reasoning similar to

¹⁴ Thos. J. Dyer Co. v. Bishop International Engineering Co., 303 F. 2nd 655 (1962).

that of the minority in Timbro and spoke in terms of a doctrine of "reasonable time" which permitted them to interpret the clause not as a true condition precedent to payment, but rather as a clause which postponed payment, after work was completed, for a "reasonable time" during which the contractor was to secure payment from the owner. In a thorough analysis of this issue, Harold Murphy has argued in his article "Pay When Paid Clauses" that the Court has imposed an equitable doctrine of "reasonable time" to avoid harsh results. He comments that U.S. courts have recently extended the "reasonable time" doctrine to a degree apparently not envisioned by the Dyer case.¹⁵ It appears that the floodgates may have been opened as a result of the Court's attempt to relieve against the harsh application of "pay when paid" clauses.

In this province, the Ontario General Contractors' Association has expressed views at different times both for and against such claims. The Association's position on such clauses has been expressed as follows:

..., it is untenable for a general contractor to assume the entire financial burden for improvements to the owner's project when the owner delays or fails to pay. The general contractor should not have to bear the collective losses of all the subcontractors in addition to his own direct loss. In such a case the financial

¹⁵ Harold J, Murphy, "Pay When Paid Clauses in Construction Subcontracts: Conditions Precedent or Terms of Payment", 47 C.L.R. 288.

risk should be shared by the general contractor and the subcontractors alike, in proportion to their involvement in the project.¹⁶

This language expresses the concept of risk sharing as if each construction project was some kind of de facto partnership or joint-venture among the various levels of contractors. Justice Finlayson has stated that subcontractors are not co-adventurers or partners in the construction contract in his Timbro dissent, and that once a subcontractor has done its work, as had been found by the trial judge in Timbro, that particular subcontractor should be entitled to be paid for the work, even if this puts the contractor at risk.

The Ontario General Contractors' Association has sought to make certain that the clause is construed on a "condition" and not as a "timing" provision by changing a "pay when paid" to a "pay if paid" clause as follows:

The contractor shall pay the subcontractor provided that, as a condition precedent, the contractor has been paid the certificate in which such amount has been included by the owner.

This further refinement makes subtrade payments entirely conditional on the good will of persons over whom they have no control, as it is the general contractor who will decide when and what to put into an application for payment and it is a payment certifier

¹⁶ John Westeinde, Construction Law Letter, vol. 4 July/August 1988, no. 6.

hired and paid for by the owner who will decide what items on the certificate will be approved for payment.

It is not unknown for a developer to set up one company to own the land and another to act as general contractor. By the simple expedient of a "pay when paid" clause, such a developer could maintain a discretionary control over all contract funds. An unscrupulous or "one-shot" developer could use such a scheme to starve out his trades, sending their money directly to its "bottom line". Presumably such a fact situation would provoke a different "construction" of the wording of the payment clause. A purposive analysis, on the other hand, would give such a scheme no hope or promise of succeeding.

Subcontractors have tendered to view this proposal on over-reaching and argue that such a provision will enable a contractor to refuse payment to a subcontractor simply because the owner has refused to make payment as a result of some minor disagreement between them, which may be unrelated to the work performed by the subcontractor seeking payment. They have also noted that a subcontractor may never get paid, not only as a result of the owner's insolvency, but where the owner makes a claim against the contractor for breach of contract or negligence.¹⁷

Take the example of a subcontractor hired to provide excavating services. The subcontractor remains unpaid as a result of a "pay when paid" clause, and possesses a

¹⁷ Paul Sandori, Construction Law Letter, vol. 5 Nov./Dec. 1988, no.2.

sheltered lien for this work. In a separate action the engineers and the contractor dispute their relative negligence arising out of the collapse of part of the improvement. The contractor, relying on its "pay when paid" clause, refuses to make payment to the subcontractor in the lien action because of the collateral issues in the negligence action. The negligence action between the owners, the engineers and the contractor will likely take years to resolve, while the subcontractor languishes unpaid. This exemplifies the unfairness inherent in these clauses because it visits the burden of the unresolved action upon persons who are not even parties.

A "pay when paid" clause was considered in Kor-Ban Inc. v. Pigott Construction Limited et al.¹⁸ The issue in Kor-Ban was not clouded by Construction Lien Act considerations as Kor-Ban's lien had allegedly expired before it was preserved and no evidence was led at trial to prove a lien for completion work. The clause considered in Kor-Ban was section 12 of a standard form of subcontract employed by the general contractor which provided, inter alia, as follows:

Payment to be made as follows:

Ninety (90%) of the value of complete work done by the subcontractor
... provided the amounts of such payments are certified by the Architect
..., and five (5) days after payment of such amount has been received by
the Contractor from the Owner.

¹⁸ Kor-Ban Inc. v. Pigott Construction Limited (1993), 11 C.L.R. (2d) 160 (Ont.Gen.Div.).

The balance of the Contract Price will be paid in accordance with the Construction Lien Act 1983 and ten (10) days after payment of such amount has been received by the Contractor from the Owner ...

The trial judge in Kor-Ban followed the Court of Appeal in Timbro and held that section 12 specified a condition governing the subcontractor's legal entitlement to payment and not merely the time of payment. The trial judge went on to state that she was:

satisfied that the Court of Appeal in Timbro accepted that notwithstanding that the subcontractors were not entitled to receive payment from the owner, the subcontractors were entitled to pursue their lien rights.

Relying on the principle that the contractor is not entitled to use ambiguities in its own draftsmanship to its own advantage, the Court then considered whether or not there was any act or default of the general contractor that would disentitle it from relying on section 12. The Court found that the general contractor had a duty to act promptly and to obtain the architect's valuations within a reasonable period of time in respect of the change orders and that the general contractor had not complied with this duty.

The Court then enumerated four circumstances in which the general contractor could not rely on the "pay when paid" clause in the subcontract, and which would form the

basis to an exception to the "pay when paid" clause. Only two of these four circumstances are of general application:

- 1) where no change order was issued by reason of the general contractor's failure to obtain the architect's valuations of the changes; and,
- 2) where the change was within the scope the general contractor's work but not within the scope of the relevant subcontractor's work.

The Ontario General Contractors' Association has tried to alleviate subcontractor's fears by indicating that they were mistaken if they thought the clause meant they would not get paid in every case where the contractor did not get paid. They have described a situation in which a contractor had no right to withhold payment, such as where the owner withheld payment due to deficient work, which deficiency was not the responsibility of the subcontractor seeking payment, and contrasted this with a situation in which the reason for non-payment is the bankruptcy of the owner, in which case, the Association contends the subcontractor should have "just as big a problem as the general".¹⁹

The ideas that there are equitable exceptions to "pay when paid" clauses, and that in some cases a subcontractor will be paid even if the contractor has not been paid appears to be at odds with the Association's previously stated view that as the owner, not the general contractor, finances the project, the general contractor should not become the

¹⁹ Paul Sandori, op. cit.

owner's financier in any circumstances, and, since it is the owner's project, and since it alone benefits by the subcontractor's work, the general contractor should never be forced to pay for this work in lieu of the owner.²⁰

In day to day practice in this area, it is clear that whatever the Ontario General Contractors Association may say, a contractor who has not been paid by an owner and who has such a provision in its contract with its subcontractors will rely on it whenever it is beneficial to do so. In our view, only subcontractors who hang on to some real bargaining power to the very end of their subcontract have any chance of forcing a general contractor to back down from such a clause.

When this paper was first presented²¹, we speculated as to what effect a "pay when paid" clause would have where the subcontractor then made a claim upon a labour and material payment bond. We speculated that the subcontractor would argue that in the context of a bond claim, the "pay when paid" clause should be interpreted as payment within a reasonable period of time. The surety on the other hand would argue that since the bond provides for payment to the subcontractor as provided for in its contract with the general contractor (principal), and as the action on the bond is for sums "justly due" which provision is for the benefit of the surety, the bond would incorporate the subcontract payment language and make the liability of the surety exactly co-extensive with that of the principal.

²⁰ John Westeinde, op. cit.

²¹ Construction Superconference, October 1993, Toronto, Ontario.

In the recent case of Arnoldin Construction Forms Ltd. v. Alta Surety Co.²², the court dealt squarely with this issue and these arguments. Arnoldin had entered into a subcontract for the supply of concrete form work and placing with the general contractor Gem Construction Specialists Limited. Arnoldin had entered into a contract with the owner by leasehold KMI. During the course of construction, Gem did not receive payment from KMI and Gem was unable to pay its subtrades. Construction on the project ceased on or about December 20, 1990.

Arnoldin had entered into Gem's standard form subcontract which provided, in part, as follows:

[Before the last day of each month, the Subcontractor shall requisition from the Contractor the value of the Work performed to date less holdback and previous payments.] The balance of the amount of the requisition as approved by the Contractor shall be due to the Subcontractor on or about one day after receipt by the Contractor of payment from the owners.

The subcontract also provided that:

²² Arnoldin Construction Forms Ltd. v. Alta Surety Co. (1994), 13 C.L.R. (2d) 307 (N.S.S.C.).

...Final payment shall be made on acceptance of the work by the Contractor, Architects and/or Engineers, and Owners, and within 30 days after payment has been received by the Contractor.

The labour and material payment bond issued by Alta Surety provided, in part, as in most standard form payment bonds, that:

The Principal and Surety, hereby jointly and severally agree with the Obligee, as Trustee that every Claimant who has not been paid as provided for under the terms of his contract, with the Principal, before the expiration of a period of 90 days after the date on which the last of such Claimant's work or labour was done or performed or materials were furnished by such Claimant, may as a beneficiary of the trust herein provided for, sue on this bond, prosecute the suit to final judgment for such a sum or sums as may be justly due to such Claimant under the terms of his contract with the Principal and have execution thereon.

[emphasis added in original]

The trial judge held that Arnoldin did not have a claim against Gem under the subcontract because Gem was not paid by KMI. Arnoldin, therefore, did not have a claim against Alta Surety under the payment bond. Many American authorities were cited and the Court found that as the cases can go either way in supporting the position of Arnoldin or Alta Surety, they were not of any great assistance.

The Arnoldin Construction was successfully appealed to the Nova Scotia Court of Appeal and from there to the Supreme Court of Canada where leave to appeal was refused.²³ Justice Hallett writing for the Nova Scotia Court of Appeal stated that since the final progress billing showed Arnoldin's work was 100% complete, the Court was only dealing with the final payment provision of the subcontract.

The Court of Appeal found that much clearer language would be required to impart the intention that payment of the subcontractor was conditional upon payment being received by the contractor from the owner. The court of Appeal held that the provision only delineated the time when payment was to be made and not a condition precedent.

The Court of Appeal then noted that "the contra proferentum doctrine of interpretation is only to be employed as a last resort for removing a doubt as to the meaning of the contract in issue" and held that the application of the doctrine dictates an interpretation of the payment provisions that favoured Arnoldin Construction.²⁴

The decision of the Nova Scotia Court of Appeal is not conclusive as to the effect a "pay when paid" clause upon a labour and material payment bond claim. The decision is founded on its specific facts and the possible interpretations of the specific subcontractual provision then under consideration. Justice Hallett stated that:

²³ Arnoldin Construction & Forms Ltd. v. Alta Surety Co. (1995), 19 C.L.R. (2d) 1 (N.S.C.A.); (1995), 22 C.L.R. 131 (S.C.C.) leave to appeal dismissed.

Appropriate words would have been that the balance claimed by the subcontractor for the completion of the work pursuant to the terms of the subcontract would only be paid “if” the owner paid the contractor. The word “if” is defined in the Oxford Dictionary as meaning “on the condition or suggestion that”. To impose on a subcontractor a term that payment was conditional on the contractor receiving payment from the owner would require the clear language of the nature I have identified.²⁵

As a word of caution, we should be mindful of the prevailing judicial mood and therefore consider the case of Crompton v. Norman Hill Realty Inc.²⁶ an action dealing with commissions on real estate sales, Justice Rosenberg in dealing with a form of “pay when paid” clause made the following general observation:

In any event, cases in construction law relating to the contractor and subcontractor hold that even if there is a “pay when paid” clause in the subcontractor’s contract with the contractor, the subcontractor is entitled to be paid for his work even if the contractor is not paid. The “pay when paid” clause only entitled the contractor to a reasonable time to be paid.

Justice Rosenberg cited the Arnoldin Construction case to support his comments made in obiter, however notwithstanding Timbro Developments and Kor-Ban, Ontario Courts may be tending towards a policy that all “pay when paid” clauses are not conditions

²⁴ Arnoldin, at p. 13 (N.S.C.A.)

²⁵ Arnoldin, at p. 11 (N.S.C.A.).

precedent to payment but rather delineate the timing of the payment. In a recent Manitoba case, Winfield Construction Co. v. B.A. Robinson Co. [1996] 4 W.W.R. 305, 134 D.L.R. (4th) 99, the Manitoba Court of Appeal has given a similarly restrictive treatment to a purported “pay when paid” clause, when it was raised to limit the amount “payable” as defined by section 55 of the Manitoba Builder’s Lien Act, R.S.M. 1987, c. B.91.

This problem is exacerbated in the case of an under-financed, or, worse, dishonest owner. There has been much discussion from time to time about requiring contract security by an owner to ensure that the owner has the means at hand at all times to pay for the work that is being done.

The requirement of contract security by an owner may raise as many issues as it resolves. Should the owner be required to provide commercially sensitive information which it has undertaken to keep confidential in order to obtain financing. When should the financial information be made available? What power should there be to go behind the mere statement to facts? These questions may spawn more and much money may change hands enforcing and resisting such requirements before there would be certainty in the industry.

Prospectus requirements in the securities industry or for persons who finance construction by means of writs in limited partnership are mandatory and rigidly

²⁶ Crompton v. Norman Hill Realty Inc., [1995] O.J. No. 3407

enforced. In the author's view, it would require a similar scheme backed up by summary quasi-criminal enforcement provisions to give the requirement for financial disclosure any real meaning. A prospectus requirement on a large project would not seem particularly onerous in this context, each trade being, in essence, a secured investor to the extent of the unpaid value of goods, services and material provided on credit. This can and does often run into the many millions of dollars.

The history of the proposal for owner's security is long and controversial. An earlier draft of CCDC GC 5 had included a provision that "until such reasonable evidence is furnished, the Contractor is not required to execute the Agreement or to commence the work". It has been argued that this wording is internally inconsistent as the contractor is not bound by this contractual term until such time as the contract is signed, however for GC 5 to be effective, it must form part of a binding contract. It was therefore recommended that the phrase "to execute the agreement or" be deleted and this suggestion was carried forward into the revised GC 5.

The Committee of Canadian Architectural Councils responded to the proposal by observing that there is no mechanism for settling a dispute under this provision. The Committee believed that the issue of the owner's contract security should be settled before the contract is awarded and executed. Accordingly the Committee suggested that the language in the AIA Bidding Instructions should be used or, alternatively, that the execution of the agreement by the contractor signifies the contractor's acceptance of the evidence of the owner's financial arrangements. The Committee also believed that the

information should be included in the Information to Bidders and that by submitting a bid, the contractor should be treated as accepting the owner's financial circumstances.

The CCDC 2 Stipulated Price Contract has been revised to include financial disclosure by the owner to the contractor. The addition to the CCDC 2, which finally received Committee approval, is as follows:

**GC 5.1 FINANCING INFORMATION REQUIRED OF THE
OWNER**

5.1.1 The *Owner* shall, at the request of the *Contractor*, prior to execution of the Agreement, and/or promptly from time to time thereafter, furnish to the *Contractor* reasonable evidence that financial arrangements have been made to fulfil the *Owner's* obligations under the *Contract*.

5.1.2 The *Owner* shall notify the *Contractor* in writing of any material change in the *Owner's* financial arrangements during the performance of the *Contract*.

This provision entitles the successful bidder/contractor to receive from the owner, prior to execution of the contract, reasonable evidence that financial arrangements are in place which will permit honest owners to fulfil their obligations under the head contract.

While this may be the spirit of the clause, default is always possible on both sides. It may be argued that a contractor who fails to request the information prior to execution of the contract has waived its rights to such information or, for that matter, any subsequent change in the owner's financial arrangements. A permissive arrangement has therefore been adopted instead of any affirmative duty on the part of the owner to make disclosure at the outset or upon any material changes, or to account for such monies as if the information provided had been true and accurate.

No one yet knows what will be deemed to be "reasonable evidence" of the owner's financial arrangements. Appended to these notes is the Project Financial Information form. Along with requiring the disclosure of the name of the institution providing the loan, the type, amount and terms of the loan, the Project Financial Information form requires the owner to provide one of the following:

- Construction Loan Agreement;
- Lender's "Set-Aside" Letter acknowledging the amount of loan proceeds to be applied to draw for the construction contract;
- a bank letter evidencing financial arrangements made to fulfil the Owner's obligation under the Contract;
- Owner's Audited Financial Statement; and,
- Other evidence of the source of funding.

Presumably "reasonable evidence" will include any of the enumerated documents. However, to what extent and what type of evidence will be deemed reasonable where the owner chooses to provide "other evidence", is not clear.

It should be noted that the language used in GC 5.1.1 tracks the language used in AIA Document A201 (1987). The AIA clause notes that "unless such reasonable evidence were furnished on request prior to the execution of the Agreement, the prospective contractor would not be required to execute the Agreement or to commence the Work". The American case law interpreting this AIA provision will be useful in interpreting GC 5.1, specifically in determining what constitutes "reasonable evidence".

What will the recipient of such disclosure do with it? Depending on the prevailing market conditions for the contractor's services it will likely either ignore it, misconstrue it, or, most likely, defer to a professional for an opinion of some kind. It is not hard to imagine a negligence action against a professional from whom such an opinion was sought following the failure of the project. As a result, GC 5.1 may have the unexpected effect of shifting construction losses to the errors and omissions insurance industry. As construction industry losses tend to be large and difficult to quantify precisely, the measure of damages in such actions may prove an equally difficult task.

In order to circumscribe the scope of potential liability arising from negligence in the issuance of such information, the CCDC 2 is further revised to expressly state that the Consultant shall not be required to make any findings or interpretation in respect of the reasonableness of the financial information provided.²⁷ CCDC 2 provides an alternative

²⁷ GC 2.2.6 and GC 2.2.7 expressly excludes the consultant from the interpretation of the requirement of "reasonable evidence".

scheme in the event that the Consultant has no authority to make a decision under the contract. These procedures are set out in paragraphs 8.1.3 and 8.2.3 to 8.2.8.

GC 8.1.3 provides that if a dispute is not resolved promptly, the Consultant shall give instructions for the proper performance of the work and to prevent delays pending resolution of the dispute. A contractor may therefore be required to commence construction and may not terminate the contract simply because it believes that "reasonable evidence" has not been furnished by the owner. In fact, GC 7.2.3, subparagraph 4, expressly excludes the right of the contractor to stop the work or terminate the contract because the owner has failed to comply with GC 5.1. Failing a prompt resolution of this issue, the CCDC 2 provides for "without prejudice" negotiations, a form of mediation and finally a reference of the dispute to arbitration or to the Courts. Effectively, therefore, a contractor may be compelled to complete a contract even though the financial disclosure intended by GC 5.1 has not been forthcoming.

Another issue that may arise, but which does not appear to have been considered, is the effect of GC 5.1 on the trust provisions of the Construction Lien Act. Section 7 of the Act provides:

All amounts received by an owner, other than the Crown or a municipality, that are to be used in the financing of the improvement, including any amount that is to be used in the payment of the purchase

price of the land and the payment of prior encumbrances, constitute, subject to the payment of the purchase price of the land and prior encumbrances, a trust fund for the benefit of the contractor.

In Andrea Schmidt Construction Ltd v. Glatt et al.²⁸, decided under the Ontario Mechanics' Lien Act, the court drafted with a statutory trust provision that "all sums received by an owner..." constituted a trust fund for the benefit of certain enumerated individuals. Justice Saunders held that the words "all monies received by an owner for the benefit of the contractor" applied to all monies "receivable" by the owner, even though those funds were not then to be found in the hands of the owner, but diverted in the meanwhile to other purposes. The Andrea Schmidt case is said to establish a principle of constructive receipt which has helped to render the trust remedy effective in some cases. The Andrea Schmidt reasoning appears to have been followed in the more recent case of G.C. McDonald Supply Ltd. v. Preston Heights Estates Ltd.²⁹. Where Justice West held that the mortgagee who deducted a portion of the mortgage advance to apply toward unpaid interest owing on mortgages on other properties had thereby breached its statutory trust to the Contractor.

In both Andrea Schmidt and G.C. McDonald Supply the mortgage had been given to facilitate the construction of an improvement and the concept of constructive receipt

²⁸ Andrea Schmidt Construction Ltd. v. Glatt et al. (1980), 25 O.R. (2d) 567; appeal dismissed (1980), 28 O.R. (2d) 672 (Ont. C.A.).

²⁹ G.C. McDonald Supply Ltd. v. Preston Heights Estates Ltd. (1992), 1 C.L.R. (2d) 157.

was applied. Under the new CCDC 2, GC 5.1, the Project Financial Information form requires an owner to identify the sources of funding for the project including the type, amount and terms of the loan and would appear to represent, reliably, that there is a certain earmarked sum available from the assets of the financial institution to be used to finance the improvement. This sum may, at the moment of identification in the Project Financial Information form, constitute a trust fund for the benefit of the contractor on the theory of constructive receipt. On a sophisticated financing, the identification of syndication arrangements or even government "matching" funds on non-profit housing projects, for example, may give rise to far reaching trust obligations, effectively "locking-in" funds to the purpose of the trust and making it difficult, if not impossible, to revoke their allocation to a particular project and apply them elsewhere, even where it is a condition of the financing that has not been met. the reader will recall that by virtue of s. 5 of the Act every contract or subcontract "related to an improvement" is deemed to be amended insofar as is necessary to be "in conformity" with the Act. True, the definition of "contract" is limited, but it does not take much creativity to think of an argument, based on the policy of the new CCDC 2 itself, to broaden such a definition, using the constructive trust decision of Andrea Schmidt and G.C. McDonald Supply.

Furthermore, a contractor may be entitled to rely on subrule 45.02 of the Ontario Rules of Civil Procedure to argue that the funds identified in the form are a "specific fund" which is reasonably identifiable and earmarked for a pending action or other proceeding.

This theory of constructive receipt as it relates to the disclosure of financial information, will now have to be read in accordance with recent amendments to the Bank Act.³⁰

Subsection 437(3) of the Bank Act provides as follows:

A bank is not bound to see to the execution of any trust, whether express or arising by operation of law, to which any deposit made under the authority of this Act is subject.

A broad interpretation of this section might exclude trusts which arise both by operation of the Construction Lien Act and those constructive trusts created by common law. The trust in the Andrea Schmidt case was found in the Mechanic's Lien Act, and the Court employed a theory of "constructive receipt". However, if a bank is not required to see to the execution of such a trust and even though the funds held by the bank and identified for the construction of the project, the theory of "constructive receipt" may no longer be available to the contractor to obtain access to such funds, even where their existence is known. This, in the writer's view, excludes the most common situation in practice in which the trust remedy may have real and effective application.

In the appeal decision in Arthur Anderson Inc. v. Toronto-Dominion Bank³¹, the majority of the Court of Appeal has now suggested that subsection 437(3) of the Bank Act [formerly s.206 of the Bank Act] does not represent protection to a bank in all

³⁰ Bank Act, R.S.C. 1985, B-1.01.

³¹ Arthur Anderson Inc. v. Toronto-Dominion Bank (1994), 13 C.L.R. (2d) 185 (Ont.C.A.).

circumstances where a breach of trust is alleged. A duty may be imposed on the bank where there are sufficient facts and circumstances known to the bank which indicate that there is a good possibility of trust beneficiaries being unpaid in the normal course of business thereby imposing on the bank a "duty to enquire". Accordingly, it may yet be asserted by a bank that the mere identification of the source of funds for a construction project, by means of the GC 5.1 Project Financial Information form, may not impress those funds with a trust unless and until sufficient collateral facts are made known to the bank to indicate that there is a good possibility that the contractor and its subcontractor may be left unpaid. On the facts of the Arthur Anderson case, mere knowledge that the owner was involved in a construction project was not sufficient to impose the duty to enquire upon the bank.

One might therefore ask if it would not be more effective to require service of a Project Financial Information form upon the owner's and contractor's banks, prior to work commencing, so that there is no doubt about the nature and extent of the bank's trust obligations.

2.3 **Claim for Interest**

All standard form construction contracts include a provision for the payment of interest on all balances outstanding.

Subparagraph 5.3 of Article A-5 of the CCDC 2 provides as follows:

5.3 INTEREST

5.3.1 Should either party fail to make payments as they become due under the terms of the *Contract* or in an award by arbitration or court, interest at _____ percent (_____%) per annum above the bank rate on such unpaid amounts shall also become due and payable until payment. Such interest shall be compounded on a monthly basis. The bank rate shall be compounded on a monthly basis. The bank rate shall be the rate established by the Bank of Canada as the minimum rate at which the Bank of Canada makes short term advances to the chartered banks.

5.3.2 Interest shall apply at the rate and in the manner prescribed by paragraph 5.3.1 of this Article on the amount of any claim settled pursuant to Part 8 of the General Conditions - DISPUTE RESOLUTION from the date the amount would have been due and payable under the *Contract*, had it not been in dispute, until the date it is paid.

Subparagraph 5.3.1 has also been amended to provide for an award of interest to the owner at the rate set out in the subparagraph. The former CCDC 2 made the owner liable to pay interest, but did not specifically entitle an owner to receive interest.

The former CCDC 2 did not include "above the bank rate" or a definition of the bank rate, however it should be noted that the Bank of Canada rate fluctuates on a weekly basis. Subparagraph 5.3.1 fails to account for this or to provide for the use of an average rate. Where a rate is used that fluctuates weekly and compounds monthly, it may be difficult to state the rate as an annualized rate in a contract with any real precision and this, in turn, has very real consequences with respect to enforceability.

The interest provisions in the standard form subcontracts contain a similar anomaly in Article 4.3 of CCA S-1 and Article IV (e) of CCA L-1. Each of these clauses provides that "such interest shall be calculated and added to any unpaid accounts monthly". This clause in each standard form subcontract would appear to offend the Interest Act, R.S.C 1985 Ch. I-15, s. 4 as amended, insofar as the interest is stated to be compounded but no effective annualized rate is set out. The result would seem to be that a subcontractor using standard form CCA documents is entitled to interest only at the rate of 5% per annum.³² Where a contract does require interest to be paid on any outstanding amounts, the Courts will give effect to that term if the interest rate is expressed per annum. In Dadcon Construction Ltd. v. 725 Coronation Boulevard Ltd.³³, Justice Sills found that the court's general jurisdiction to award prejudgment interest under section 128 (1) of the Courts of Justice Act was specifically excluded by section 128(4)(g) where interest

³² In this regard, see for example Banerjee v. Spilchen (1985), 42 Sask. R. 162 (Sask. C.A.), where the contract provided for interest at the rate of 3 per cent per month yet failed to state the yearly interest rate as required by the Interest Act. The court limited interest on the plaintiff's claim to 5 per cent per annum.

³³ Dadcon Construction Ltd. v. 725 Coronation Boulevard Ltd. (1993), 8 C.L.R. (2d) 65.

is payable by a right other than s. 128(1), and therefore the per annum rate expressed in the contract applied.

The Dadcon case is also significant for Justice Sills held that prejudgment interest would be calculated from the date that the payment became due, as found in the language of the contract irrespective of any counterclaim for damages. Justice Sills found that payments became due at the time the amount was certified by the consultant and the fact that a counterclaim may be claimed makes no difference as to when payments became due under the contract.

Even though the standard form contract and subcontracts provide for interest, it should be noted that section 14(2) of the Construction Lien Act provides that:

no person is entitled to a lien for any interest on the amount owed to the person in respect of the services or materials that have been supplied by the person, but nothing in this subsection affects any right that the person may otherwise have to recover that interest.

The Act is explicit and the Courts have consistently upheld this provision. A claim for lien cannot include a claim for interest.

However, consider the case where an invoice for the supply of materials provides such terms as "net 20 days", and net higher amounts for each ten day period after the first twenty. There is nothing on the face of the invoice to suggest that the abatement over

time of the discounted price of the materials is interest. Should the supplier be entitled to a claim for lien in the amount at "net twenty days" or a subsequent higher amount, which may be stated on the invoice as "over ninety days"? The supplier is not claiming a lien for interest per se, yet a claim for lien for the higher amount may effectively amount to and be deemed to be a claim for interest.

The Act entitles a supplier of materials to a lien for the price of the materials. Section 1 defines "price" as that which is agreed upon between the parties or where no specific price is agreed upon, then the actual value of the materials supplied. If a discount is given that abates over time it may be argued that this is the price that the parties have agreed upon and not interest as such.

A similar situation arose in Granville Constructors Ltd. v. Somerset Place Developments of Georgetown Ltd.³⁴. The defendant sought to vacate the claim for lien of the plaintiff upon the payment into Court of a "reasonable amount" under s. 44(2). The plaintiff's lien claim was for the amount of \$1,708,411.89 which included the sum of \$437,098.00, representing a share of the savings that the plaintiff claimed it would be entitled to pursuant to the contract if the contract was completed under a certain cost. Justice Speyer held that this amount is not a lienable amount and should be deducted from the claim for lien. This amount was found not to be calculated from the price of materials and services but was rather found upon the savings to the owner which may or

³⁴ Granville Constructors Ltd. v. Somerset Place Developments of Georgetown Ltd. (1990), 43 C.L.R. 36.

may not occur. This makes sense because the value of the land is, by definition, not enhanced by the value of the "savings".

2.4 Holdback Provisions

The CCDC 2 has been amended to allow for the release of holdback upon substantial performance of a designated portion of the project. GC 5.4.1 provides that:

5.4 SUBSTANTIAL PERFORMANCE OF THE WORK

5.4.1 When the *Contractor* considers that the *Work* is substantially performed, or if permitted by the lien legislation applicable to the *Place of the Work* a designated portion thereof which the *Owner* agrees to accept separately is substantially performed, the *Contractor* shall prepare and submit to the *Consultant* a comprehensive list of items to be completed or corrected and apply for a review by the *Consultant* to establish *Substantial Performance of the Work* or substantial performance of the designated portion of the *Work*. Failure to include an item on the list does not alter the responsibility of the *Contractor* to complete the *Contract*.

Basically, GC 5.4.1 entitles a contractor to apply for substantial performance and release of the holdback to that extent where the owner agrees to accept a designated portion of the project is substantially completed.

Section 2(1) of the Act sets out the definition for substantial performance being:

Section 2(1) For the purposes of this Act, a contract is substantially performed,

- (a) when the improvement to be made under that contract of a substantial part thereof is ready for use or is being used for the purposes intended; and

- (b) when the improvement to be made under that contract is capable of completion or, where there is a known defect, correction, at a cost of not more than,
 - (i) 3 per cent of the first \$500,000 of the contract price,
 - (ii) 2 per cent of the next \$500,000 of the contract price, and
 - (iii) 1 per cent of the balance of the contract price.

This definition affords no discretion and is capable of being precisely determined on the basis of the value of deficiencies in relation to the contract price.

Section 2(2) goes on to provide:

- 2(2) For the purposes of this Act, where the improvement or a substantial part thereof is ready for use or is being used for the purposes intended and the remainder of the improvement cannot be completed expeditiously for reasons beyond the control of the

contractor or, where the owner and the contractor agree not to complete the improvement expeditiously, the price of the services or materials remaining to be supplied and required to complete the improvement shall be deducted from the contract price in determining substantial performance.

This subsection refers to two situations in which the contract price can be reduced when applying the definition of substantial performance, one where the contract cannot be completed for reasons beyond the contractor's control and another more consensual arrangement. The situation envisaged by the CCDC 2 article 5.4.1. where the owner agrees that a designated portion of the work is substantially complete, is not specifically provided for by subsection 2(2) of the Act. By agreeing to accept separately a designated portion of the work the owner and the contractor are not, it would seem, agreeing "not to complete the improvement expeditiously". Until the Act catches up with the amendment to CCDC 2, the contractor may not be able to take advantage of GC 5.4.1.

Another complexity brought about by this amendment may relate to the applicability of standard OAA Takeover Guidelines following upon substantial performance or completion of a designated portion of the improvement, but that is beyond the scope of this paper.

In Bob Dionisi & Sons Ltd. v. F.J. Davey Home for the Aged (Algoma)³⁵, decided prior to the final draft of the CCDC 2, the owner and operator of a home for the aged entered into a "staged" contract for the construction of a new wing and renovations to three existing wings of an existing home. This "staged" contract provided firstly for the construction of the new wing, then patients in the existing wings would be moved to the new wing, followed by renovations to two of the existing wings, moving patients out of the other existing wing and then renovating it, a common enough form of contract in these cases. Although it was one contract, it was clearly set out to be a "staged" contract and one that could be broken down into designated portions.

The new wing was completed and occupied. The parties agreed that the remaining renovation work could not be expeditiously completed. The contractor then applied for and received the holdback in respect of the construction of the new wing. The Court held that this release of holdback complied with S.2 of the Act.

In the meantime, renovations proceeded on two of the three wings. When this phase was completed, the contractor applied for a certificate of substantial performance and release of holdback in respect of phase two. Renovations continued in respect to the third wing and final phase of the project. The contractor ran into financial difficulties and the bonding company was called upon to complete the contract.

³⁵ Bob Dionisi & Sons Ltd. v. F.J. Davey Home for the Aged (Algoma) (1992), 3 C.L.R. (2d) 162 (Ont.Ct.Gen.Div.)

In respect of the release of holdback after phase two, the Court queried whether Section 2 of the Act "contemplated a second or indeed a greater number of uses of the section to provide succeeding releases from the holdback amount, and more generally, whether there was one improvement or three improvements".

The Court found that the definition of improvement in the Act is not restricted to only one improvement to one piece of land. However, the Court also found that the renovations to the three wings was not a "substantial portion" of the total contract. The Court then found that there could not be more than one improvement since all the wings were attached and because the construction of the new wing and the renovations were all included in one "staged" contract.

The Court held that the release of holdback, after the completion of phase two, did not comply with section 2 of the Act. By extension, therefore, GC 5.4.1 may not be of any use to a contractor as the release of holdback in respect of a designated portion of the work may leave an owner liable for that holdback. The F.J. Davey Homes case suggests that unless there is more than one discrete building or maybe the contract can be divided into substantial parts, a contractor may not be able to take advantage of the early release of holdback in respect of a designated portion of the work.

Bob Dionisi & Sons Ltd. must now be considered in light of the Divisional Court decision in Soo Mill & Lumber Company Limited v. J.J.'s Hospitality Limited.³⁶ It is

³⁶ Soo Mill & Lumber Company Limited v. J.J.'s Hospitality Limited (1996), 30 O.R. (3d)

apparent from this decision of the Divisional Court that a contract can relate to more than one improvement. While this decision may be used by contractors to obtain holdback before overall substantial completion, it leaves subcontractors in a precarious situation because they may not know at the time of contract when the holdback will be paid out nor the extent of the owner's holdback liability. In October of 1996, the Ontario Court of Appeal dismissed an appeal from the Divisional Court recognizing that section 2(2) of the Construction Lien Act, R.S.O. 1990, c. C.30, is a difficult provision to interpret.

2.5 Bonds

Perhaps the single most significant private law remedy for non-payment on substantial or public projects is the surety bond. This is, again, an area that will be covered in great detail by other speakers and in other papers.

The bonding industry accounts for a good deal of the risk shifting that goes on in the private sector. Since 1981, courts had been moving towards a position of almost strict liability against compensated payment bond sureties, relieving from egregious non-compliance with formal requirements and limitation defences. Most recently, however, there seems to be a shift back toward a more reasoned theory of liability, imposing upon surety and claimant a more balanced list of responsibilities.

The keys to payment from a bonding company in the writer's view, are as follows:

1. Demand a copy of the labour and material payment bond under section 39 of the Construction Lien Act;
2. Give notice early and after and in strict accordance with the form of bond you are dealing with;
3. Organize all claim and supporting documents, clearly index them, and produce them to the surety or its adjuster on demand and as often as demanded;
4. Cooperate fully with the surety's adjuster in all matters;
5. Commence action upon denial of claim or within the limitation period of the bond, whichever is soonest;
6. Move for judgment as and when settlement discussions breakdown.

3. CONCLUSION:

As you can see, there are a wide variety of remedies and procedures available to ensure payment, not the least of which is the holdback regime in Ontario. The real skill is to know how to combine and exercise these remedies and procedures in a way that settles cases quickly, efficiently and with maximum recovery.

**GETTING PAID: HOLDBACKS AND OTHER
SELECTED TOPICS**

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