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Many in the Design Build Industry, as well as other sectors of the construction industry, are cognizant of the importance of receiving all their money owed to them from their projects and contract agreements. In this regard, a member of our Risk Management Committee has provided the following article with respect to current issues / challenges arising from funds being held in holdback accounts.

The Risk Management Committee of the Canadian Design Build Institute will continue to circulate articles of this nature to members as they become available. We trust this will be found to be of interest and beneficial to the members.

HANDS OFF MY HOLDBACK

by Paul Stocco Partner, Brownlee LLP

Article prepared with the assistance of Kristjana Kellgren, Associate, Brownlee LLP.

These are turbulent times for the construction industry. While there are signs of a modest economic recovery, there are also many warning signs about how fragile the recovery really is. Some of the foremost concerns of the industry are the availability of credit and maintaining a positive cash flow. If contractors are experiencing difficulties in operating their businesses, this has an impact on the industry as a whole—work on projects can start to slow down, contractual defaults can increase, and the spectre of contractor insolvency looms. Another development often seen in times of economic slowdown is the increased activity of the Canada Revenue Agency (“CRA”). This increased activity often arises due to the failure to remit source deductions. As a consequence, payors in the construction pyramid often receive Requests to Pay (“RTP”) from the CRA. This presents a challenge to many payors because they may not know how to address the competing claims to the funds held by them for the construction project. In particular, a payor may not know who has a priority claim to holdback funds in its possession—the CRA or others. The decision in the case of ***PCL Constructors Westcoast Inc. v. Norex Civil Contractors Inc.*** sheds some light on this issue.

In the case of ***PCL Constructors Westcoast Inc. v. Norex Civil Contractors Inc.***, the British Columbia Supreme Court considered three applications involving claims by the CRA to the holdback funds retained by three general contractors pursuant to the requirements of the British Columbia *Builders’ Lien Act* (“BLA”). In each case, a general contractor had entered into a subcontract with a subcontractor who subsequently breached its subcontract. In each case, the general contractor was required to hire a replacement subcontractor to complete the work at a greater cost. In each case, the general contractor also retained a holdback fund, as permitted by section 4 of the *BLA* (similar to section 18 of Alberta’s *Builders’ Lien Act*), from progress payments due to the subcontractor. In each case, each subcontractor had failed to remit employment insurance and Canada pension plan remittances to CRA. As a result, CRA had issued a RTP to the general contractors.



In each of the three applications before the court, the general contractors argued that there were no monies owing to the defaulting subcontractors. Therefore, CRA could not claim the holdback funds held on account of the subcontracts because these funds never became payable to, or the property of, the subcontractors. In response, CRA argued that a deemed trust arose, in respect of the holdback funds, under section 227 of the *Income Tax Act* (“*ITA*”) and that this deemed trust in favour of CRA took priority over other interests and claims to the holdback funds. CRA also argued that it had a beneficial ownership interest in the holdback funds pursuant to section 224(1.2) of the *ITA*.

In its consideration of the issues, the Court noted that the holdback fund has multiple purposes. The holdback fund is not a simple trust in favour of subcontractors and their sub-subcontractors and suppliers. Rather, the holdback fund is designed to limit the liability of a general contractor to a subcontractor and to the sub-subcontractors and suppliers of the subcontractor. In addition, the holdback fund is a fund in which subcontractors, and their sub-subcontractors and suppliers, have an interest. The Court noted that a subcontractor’s entitlement to the holdback fund is conditional on a number of factors: a subcontractor must prove that money is actually owed to it under the subcontract; a subcontractor must prove that the project has been completed and that the holdback retention period has expired; and, perhaps most importantly, a subcontractor must prove that no lien claims of sub-subcontractors or suppliers have been registered and that there are no competing claims to the holdback funds. If all of these conditions are met, the subcontractor will establish a prima face right to the holdback funds in the hands of the general contractor subject to the claim of setoff by the general contractor (possibly for costs to complete). When setoff is claimed by a general contractor, this means that a general contractor is asserting the right to use the holdback funds to pay some of the expenses that it has incurred as a result of the subcontractor’s contractual defaults and breaches.

The Court held that neither section 227 nor section 224(1.2) of the *ITA* operated to automatically entitle CRA to the holdback funds. In order to establish any such right to the funds, CRA had to first prove that there were monies actually owed by the general contractor to the subcontractor. The Court stated that “it does not logically follow that because [CRA on behalf of] Her Majesty takes beneficial ownership of the subcontractor’s right to the fund, that this right automatically becomes more than it was in the subcontractor’s hands”. In other words, even though CRA delivered a RTP to the general contractor, this gave CRA no greater claim to the holdback than the subcontractor would have had at the time of delivery of the RTP.

The Court held that where a general contractor proves its setoff claim against the subcontractor, CRA has no claim against the holdback fund unless that holdback fund exceeds the amount of the general contractor’s setoff claim. The Court directed that if CRA wished to pursue its claim to the holdback funds, it would have to, in effect, step into the shoes of the subcontractor and litigate the general contractors’ entitlement to set off costs to complete against the holdback funds.

While this case involved the competing claims of a general contractor and CRA to holdback funds, the principles of this case equally apply to all payors in the construction pyramid who maintain a holdback by virtue of provincial builders’ lien legislation. Therefore, if a payor receives a RTP from CRA in respect of a tax debtor, a payor should seek legal advice before paying over the holdback funds to CRA. If there are no monies due and owing to the tax debtor by the payor, or if a payor maintains a holdback fund in respect of the tax debtor while also asserting a right of setoff against those funds, it may be possible for the payor to prevent CRA from getting its hands on the holdback.



Paul V. Stocco is a partner and the head of the Construction Law Team for the Alberta based law firm of Brownlee LLP. Paul's practice involves providing advice to his clients on issues relating to all aspects of construction contracts including design-build and P3s, and construction procurements involving tenders and RFPs. Paul also represents clients involved in construction litigation at all levels of Courts. Paul is the editor of Brownlee LLP's **Constructive Thinking** newsletter and is a member of the Law Society of Alberta and the Law Society of Upper Canada (Ontario). The Construction Law Team at Brownlee LLP practices in conjunction with a number of lawyers at the firm whose practice includes Municipal Litigation and Corporate Commercial Litigation.

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