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Issues with Annual Holdback Release and Lien Expiry on P3 Projects and Beyond

The pending amendments to the *Construction Act* (the "*Act*") include a new requirement for the annual release of holdback, without the right to set off against holdback. However, while implementing a number of significant changes to the Act, the Legislature elected not to close an identified gap in the *Act* related to Public Private Partnership ("P3") projects. As a result of this failure to close the identified gap, a significant issue is created in the context of mandatory annual holdback released on P3 projects in Ontario.

One issue is that the "owner", for the purposes of the annual release of holdback, will be the provincial Crown (or one of its agents or crown corporations). On a P3 project, the provincial Crown will have little or no holdback to release each year. This might have the effect of denying subcontractors meaningful annual holdback release on P3 projects – but a related concern is that there is a significant lack of clarity as to whether the amendments require full annual release of accrued holdback by a contractor even if only some holdback is released by an owner. In our view, this issue requires clarification in the statute prior to the amendments coming into force.

Other potential issues with the amendments bear scrutiny even outside of the context of P3 projects:

(a) the amendments providing for annual lien expiry are likely to prompt a significant increase in the number of liens, as contractors and subcontractors will need to lien annually in respect of delay claims; and
(b) the amendments significantly increase the importance of proper invoices and adjudications, as these will be used to determine the amount of holdback releasable, which in turn increases the likelihood of adjudicative disputes in the course of projects.

The Unique Nature of P3s and the Definition of "Owner" Under the *Act*

A P3 project is a project where a special purpose entity ("Project Co") undertakes to finance construction of the project. Project Co in turn contracts the design and construction work to a contractor (the "Construction Contractor").

The *Act* defines an owner as a person with an interest in the premises who makes a request for the improvement. On a provincial transit project, that describes the Crown agency requesting the work (such as Metrolinx or Infrastructure Ontario). Project Co is not an "owner" under that definition.

This definition fits uneasily with the reality of a P3 project, in which Project Co, as the entity arranging for most of the payment utilizing funds borrowed by Project Co from its lenders, acts as a *de facto* owner. The Construction Contractor, in turn, acts as a contractor, with subcontractors below. While the provincial Crown may make some progress payments during construction, most of the amounts invoiced by the Construction Contractor are paid by Project Co.

Recognizing the unique nature of P3 projects, the prior amendments to the *Act* introduced Section 1.1 of the *Act* in order to deem Project Co to be an owner for the purpose of specific sections of the *Act* identified in Section 1.1(5). These specific sections, however, do not include the prompt payment provisions, the adjudication provisions, or section 26 which is being amended to require mandatory annual holdback release. (Section 1.1(3) does provide that the basic 10% holdback under Section 22 is to be determined based upon the contract between Project Co and the Construction Contractor and not as between the "owner" and Project Co.)

As Section 1.1(5) fails to deem Project Co as the "owner" for the purposes of the prompt payment provisions, and since all prompt payment obligations are triggered by a proper invoice being given to an "owner", invoices by the Construction Contractor to Project Co will not be a proper invoice, prompt payment will not apply either to the Construction Contractor's rights or any subcontractors of any tier, and there is no ability to adjudicate.

Missed Opportunity to Correct the Gap

This issue was discussed in an article from October 2023[1], was raised during Duncan Glaholt's consultative process, and considered in Duncan Glaholt's Final Report issued in parallel with the legislative changes to the *Act*.

Although the issue was flagged and, in the authors' opinion, a simple solution to the issue was available, Duncan Glaholt's Final Report did not recommend a change to the *Act* or its regulations to address the issue.

As a result, the problem with prompt payment under the *Act* on P3 projects remains, and now, with the pending amendments to the holdback provisions of the *Act*, more issues are created.

Resulting Issues with Mandatory Annual Release of Holdback on P3s

The amendments to the Act provide for a entirely new scheme of mandatory holdback release, without the ability of any party to set off claims against the holdback:

- Section 26 of the Act is to be amended to require the owner to:
    - (a) publish a notice of annual release of holdback within 14 days of each anniversary of a contract being entered into, prescribing the amount the owner intends to pay; and
    - (b) to pay such holdback no later than 14 days after the expiry of the lien period under Section 31(2).
- Section 26 requires the contractor to make payment of "*all of the accrued holdback in respect of the services or materials supplied by the subcontractor during the year*" 14 days after receiving payment of holdback from the owner.
- Section 31(2) will provide that liens arising from the supply of services or materials to an improvement "*that are included in a notice of annual release of holdback*" expire 60 days after publication of such notice.

[1] John Margie & Jay Nathwani, "Prompt payment on P3 projects: a gap in the Construction Act", (2023) https://margiestrub.com/prompt-payment-on-p3-projects-a-gap-in-the-construction-act/

But on a P3 project, relatively little holdback is retained by the "owner", the provincial Crown. As a result, the provincial Crown will have relatively little holdback to release to Project Co (to then be paid down the chain). Curiously, the deeming provisions of Section 1.1 provide that holdback for the purposes of section 22 is to be determined based upon the contract between Project Co and the Contractor, which will be a much greater amount of holdback than actually held by the provincial Crown (the balance of such holdback being held by Project Co's lenders).

Accordingly, the provincial Crown has an obligation to release the holdback accrued under subsection 22(1) on an annual basis when, in reality, the provincial Crown will not actually have the full amount of the subsection 22(1) holdback.

There is also a lack of clarity created by the *Act*'s amended language as to whether contractors have an independent obligation to release holdback irrespective of whether the owner releases holdback in full. The amended language of section 26 provides:

> **Payment by owner**
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> (4) Not later than 14 days after the expiry of the lien period under subsection 31 (2), **the owner shall make payment to the contractor of all of the accrued holdback** in respect of services or materials supplied by the contractor during the year immediately preceding the anniversary, unless a lien has been preserved or perfected in respect of the contract....
>
> **Payment by contractor**
>
> (5) Not later than 14 days **after receiving payment of a holdback** under subsection (4), the contractor shall make payment to a subcontractor of **all of the accrued holdback** in respect of the services or materials supplied by the subcontractor during the year described in that subsection, unless a lien has been preserved or perfected in respect of the subcontract and the circumstances set out in clause (4) (a) or (b) apply in respect of the lien.
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> [Emphasis added.]

There are two ways to read these related provisions: either as a pay-when-paid, or as creating independent holdback release obligations on the contractor.

One reading of section 26(5) is that Project Co, as a "contractor" for the purposes of section 26, will have no independent obligation to release holdback to the design-builder, until "after receiving payment" from the owner. In other words, if the holdback is not received, it does not need to be paid.

But the language of section 26(4) requires the owner to make payment of "all of the accrued holdback" from the previous year. Section 26(5) requires only that the contractor receive "payment of **a** holdback" before its obligation to "make payment to a subcontractor of **all of the accrued** holdback" is triggered. What is "a" holdback and what do these provisions mean? Does the contractor have to make payment of *all* accrued holdback if it receives *any* holdback from the owner? Or does it have to release only the holdback actually paid by the owner? Notably, the amendments provide for no ability of the contractor give a notice of non-payment to a subcontractor if an owner releases only some of the accrued holdback – so what is the

legislature's intention here? These provisions are enormously important to contractors' cash flow, and it is unfortunate that there was no opportunity to consider them in detail before they were enacted.

This is a point that affects both P3 and non-P3 projects alike, but in the P3 context, the *Act's* amendments could be read as either (a) resulting in little or no holdback release in years where the provincial Crown has little or no holdback to release; or (b) requiring Project Co to release all accrued holdback on an annual basis even if it has not received payment from the provincial Crown or Project Co's lenders.

The former interpretation results in differential treatment of subcontractors acting on P3 projects. The latter has significant implications for Project Co and the lenders on existing P3 projects.

Expiry of Subcontractor Lien Rights Irrespective of Holdback Release

A significant related concern is that the amendments to the *Act* provide for the expiry of all lien rights on an annual basis. The amendments properly ensure that annual holdback release is required after the expiration of liens (consistent with prior holdback release language of the *Act*) such that a payor is not in jeopardy. Accordingly, the new Section 31(2) provides for the annual expiry of lien rights for work performed in the year in question, 60 days after the publication of the notice of annual release of holdback.

Critically, neither the payment of the holdback, nor the amount of the holdback paid, have any implication upon the expiration in the new Section 31(2). Accordingly, a contractor's and a subcontractor's lien rights will expire irrespective of whether they will receive the full amount of the holdback then retained by their client. While this issue is also applicable to non-P3 projects, as discussed above, on a P3 project, where most of the invoices never go to the "owner", there will be a major disconnect between the amount of holdback being released by the "owner" and the amounts of holdback owing to the contractors and subcontractors down the pyramid.

Concerningly, as the new Section 31(2) provides for the expiration of all liens in that prior period. Accordingly, where there are issues, disputes, or claims, on an ongoing project, claimants will now be forced to preserve liens annually to avoid losing their lien rights in respect of such issues, disputes, or claims. Worse, as the project will be ongoing, a party's lien rights in respect of properly performed work not yet due and payable as of the date of expiration of lien rights under Section 31(2) will similarly expire. Although this last issue is resolvable by the proper application of the prompt payment provisions and associated adjudication provisions, as discussed above, these provisions are largely inapplicable to P3 projects (an issue that can easily be resolved by the Legislature).

Unfortunately, the only way for subcontractors to continue to maintain the security of lien rights in those circumstances will be to preserve their lien rights. On some of the large transit P3 projects currently underway, such as the Ontario Line, that could mean literally hundreds of liens every year, simply to preserve rights in respect of amounts that, at the end of the day, may not even be in dispute.

Not only will this likely result in many liens that could be avoided, but the *Act* also requires actions to be set down for trial within 2 years of their commencement. As a result, on long projects (which many P3s tend to be), a party will likely be required to move its lien action through the court process and set it down for trial while the project remains ongoing. This adds additional expense, complication, and uncertainty to the litigation process and will further bog down our already strained court system.

Proper Invoices, Adjudication, and Annual Holdback Release

In his Final Report, Duncan Glaholt explains that in his view any issues as to the amount payable – and by consequence the proper amount of holdback – should be determined at time a proper invoice is given:

> The correct time under the Act to withhold payment for claims and deficiencies is at the time of receipt of a proper invoice, which triggers the parties' rights to access adjudication and fair determination of any payment issues. Section 27.1 is not intended to allow an owner a second chance to raise payment issues.

With the greatest of respect, in our view Section 27.1 was designed precisely to permit an owner to wait to raise a payment issue or claim until the end of a project and prior to holdback release. There are good commercial reasons for parties to wish to see if payment issues can be worked out over the course of a project without the need for disputes over every invoice. Perhaps a delay can be mitigated so that claim is unnecessary, or a deficiency resolved in time.

However, mandatory annual holdback release without setoff raises the stakes for each proper invoice. Rather than having a pool of holdback available to set off against (if appropriate) at the end of a long project, an owner will see holdback dissipated annually and without the right to exercise any set-off. This means that the owner must instead set off against the amounts claimed in proper invoices, and, in order to avoid mandatory payment of holdback in respect of contract amounts which are not owing, those setoff (or other) claims will need to be raised immediately. It is not clear how holdback release will be affected by adjudications over proper invoices that may be ongoing at the time that annual holdback release comes due.

Further, in the context of P3 projects, Duncan Glaholt's suggestion that the proper amount of holdback will be determined through the proper invoice, prompt payment, and adjudication process, simply falls short due to the limited applicability of those provisions in the context of P3 projects.

The effect of these amendments, therefore, is likely to be a significant increase in claims by owners earlier than they otherwise would have been made or where such claims could be resolved without intervention.

Possible Solutions

The issues described above are unlikely not the intention of Duncan Glaholt's recommendations, but it may well be their effect. In the view of the authors, it is essential that some changes be made to resolve these issues prior to annual holdback release coming into force on P3 projects.

Some of these potentially serious issues could have been, and still could be, addressed with some minor changes to the *Act,* including a change to section 1.1(5) to provide that Project Co is deemed to be the owner for the purposes of Part I.1 (Prompt Payment) and sections 26 and 27 (dealing with holdback release). An obligation upon a lender to release holdback annually would also be beneficial.

Section 26 should also be amended to clarify the consequences to a contractor in the event that an owner releases some but not all of the accrued holdback. In short, it should be made clear that it is not be up to a contractor to cash-flow holdback release that has been improperly withheld.

Takeaway regarding consultation process

While there are many positive changes forthcoming, the problems identified above regarding P3 projects are, in our view, inadvertent. Although there was a significant consultation process prior to the issuance of Duncan Glaholt's report, it seems that this most consequential recommendation – mandatory annual holdback release without the right of set-off – was not presented to stakeholders for comment.

In addition, the draft legislation was introduced as a schedule to the provincial budget on the same day that Duncan Glaholt's Final Report was released. Consequently, industry stakeholders had no time to consider and comment on the most important change to the *Act* since the introduction of prompt payment.

The Legislature should consider seeking industry feedback through the consultation process, not only on the concepts, but on the actual proposed legislative changes. This would enable issues such as these to be raised during the drafting process, prior to being included in proposed legislation.

While annual holdback release appears to be inevitable, we strongly recommend that the Legislature engage in a further consultation process to address issues such as those referenced above, before any changes come into force.

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