

“pay me now, or pay me later” – the risks of poor payment and accounting practices

Developers and others with payment obligations in the construction pyramid (payors) can better manage their risk and exposure by ensuring that their payment and accounting practices are well-managed and clear – particularly given the Ontario Court of Appeal’s recent decision in *Colautti Construction Ltd v Ashcroft Development Inc.*¹ As *Colautti* confirms, payors must clearly allocate their payments to particular invoices or debts. Failing to do so may in certain circumstances allow those entitled to payment (payees) to apply received payments to other outstanding accounts – even where such accounts are due on other contracts or where the accounts have been outstanding past the two-year limitation period in which a claim for payment could be made. *Colautti* also cautions that payors who commingle project monies received with other funds, may be found to have breached their trust obligations owed to their payees under the *Construction Lien Act*.²

facts

Ashcroft Development Inc. (the “Developer”) contracted with Colautti Construction Ltd. (the “Contractor”) in 1997 to provide construction services for two major real estate projects in Ottawa (the “Projects”). The Contractor provided its services to the Developer under a series of written contracts and through various development phases. Initially, the Developer paid the Contractor with cheques that had counterfoils identifying the specific invoices to which the payments were to be assigned. The Contractor allocated these payments accordingly. In mid-1999, however, the Developer changed its payment practice and sent the Contractor seven advance payment cheques (the “Advances”) that contained brief, cryptic counterfoil notations. Six of the seven cheques

¹ 2011 ONCA 359 (“*Colautti*”).

² RSO 1990, c C 30 (the “*Act*”).

included the label, "Advance," and one of the seven cheques referred to a particular contract. However, none of the Advances identified the specific invoices to which they were to be applied.

The Developer specifically directed the first of the seven Advances to old debt from other contracts. The Contractor repeatedly requested allocation instructions for the remaining Advances from the Developer. The Developer did not respond. The Contractor accordingly allocated the Advances to debt that had been outstanding for more than two years in relation to other contracts with the Developer. The Contractor informed the Developer of these allocations and received no response.

The Developer did not maintain separate trust accounts for the Projects. Instead, the Developer kept only a single general account in which all funds received were comingled. Accounting and banking records were poorly kept, if at all.

Eventually, the Contractor claimed against the Developer for unpaid services respecting the Projects. In response, the Developer claimed that the Contractor had been overpaid and challenged the Contractor's allocation of payments.

The trial judge found that the Contractor was entitled to allocate the Advances as it did. It was also found that the Developer breached its trust obligations owed to the Contractor under the *Act* – the Developer owed the Contractor monies and did not have a proper accounting system for funds received and to be paid out in relation to the Projects. The Developer appealed.

Ontario Court of Appeal decision

The Ontario Court of Appeal dismissed the Developer's appeal. In doing so, the Court confirmed that where a payee asks its payor how payments are to be allocated and receives no response, the payee may apply such payments to outstanding accounts from other contracts. The Court noted that this circumstance is an exception to the general principle that payments made on a particular contract are to be applied to debts arising from that contract. In this case, the Developer's counterfoil notations were found to be insufficient to constitute an allocation.

The Court rejected the Developer's argument that the Contractor was prohibited from applying the Advances to debts outside the contracts at hand as doing so would have the Contractor breach its own statutory trust obligations owed to its subcontractor payees. Under the *Act*, project monies received by payors in the

construction pyramid are held in trust for the benefit of their payees “down the chain”. This statutory trust applies as between each payor/payee relationship in the construction pyramid. Project monies include funds received in payment for performed services or provided materials and building financing. Diverting such funds away from payees who have performed services or provided materials on the project constitutes a breach of trust. The *Act* empowers payees with significant remedies in response to such breaches, including an ability to “pierce the corporate veil” and pursue directors and others personally for the diversion of funds.

The Court held, however, that the *Act*'s trust provisions are only for the benefit of payees as against payors – not the reverse as the Developer's argument entailed. Only those down the chain in the construction pyramid can avail themselves to the *Act*'s trust provisions as against those up the chain.

The Court also rejected the Developer's argument that the Contractor was prohibited from applying the Advances to debts that remained outstanding past the expiry of the two-year limitation period in which the Contractor could have claimed against the Developer for the debt. As the Court put it, “a limitation period bars the remedy, not the right.”

The Developer was, moreover, found to have breached its trust obligations under the *Act* as it owed the Contractor monies and had failed to implement a “proper system... to receive, monitor and disburse the trust funds.” The Court identified the foregoing finding as “inevitable” in the circumstances as the Developer,

- comingled financing received for each of the Projects in a single general account;
- made payments respecting numerous projects from the general account; and
- failed to produce detailed accounting and banking records.

conclusion

Colautti serves as an important reminder that payors in the construction industry can significantly limit their risk and exposure by,

- maintaining separate accounts for each project;
- keeping detailed accounting and banking records; and
- making clear payment allocations.

Perhaps equally as important, those who effectively manage their businesses in this way may also gain significant legal remedies and financial advantages against others who fail to do so.

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a cautionary note

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