

# COMPETING CLAIMS FOR CONSTRUCTION HOLDBACK – WHOSE MONEY IS IT, ANYWAY?

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In a recent decision of Fregeau J. of the Ontario Superior Court of Justice in *Northwest Angle 33 First Nation v Razar Contracting Services Ltd.* [1], the court reviewed the applicability of the *Construction Act* trust provisions to a dispute over holdback amounts in connection with a project on federal lands, as well as a claim by the Canada Revenue Agency to a priority over same. [2]

The decision illustrates the importance of a careful analysis of the applicable contract provisions and the law in determining entitlements that, at first blush, may appear uncontroversial.

## FACTS

Northwest Angle 33 First Nation contracted with Razar Contracting Services Ltd. in February 2020 for the construction of a water system for its residents. The First Nation and Razar agreed that the First Nation was entitled to retain a holdback of 10% for the benefit of subcontractors and suppliers to Razar plus an additional maintenance holdback of 3% from progress payments otherwise payable to Razar.

In May 2022, the First Nation took the balance of the work out of Razar's hands and engaged other forces to complete. Under the contract, this extinguished Razar's right to any further payments. The total holdback amount retained from progress payments at that point was \$1,204,516.55.

The First Nation brought an application under rule 43 of the Rules of Civil Procedure seeking an interpleader order to pay the holdback into court. The First Nation wished to establish a process for the orderly and equitable distribution of the holdback among the numerous subcontractors and suppliers who had gone unpaid, as well as the CRA, with claims exceeding \$2 million in amount.

Pro-Gen (Thunder Bay) Inc., a subcontractor of Razar, had obtained a default judgment against Razar and had issued garnishment. The CRA had also issued a Requirement to Pay seeking payment owing by Razar for unremitted payroll source deductions. Both Pro-Gen and the CRA opposed the interpleader application on the basis that each was entitled to be paid in priority to the other claimants to the fund.

## ARGUMENTS OF PRO-GEN AND THE CRA

Pro-Gen argued that s. 8 of the *Construction Act* [3] did not apply to the First Nation. He took the position that the imposition of a trust under the *Construction Act* was the equivalent of seizing “the personal property of an Indian or a band situated on a reserve” which is prohibited by s. 89 (1) of the *Indian Act*. Pro-Gen argued that the holdback was not a trust fund but rather an amount payable to Razar pursuant to the contract, thereby permitting Pro-Gen to realize upon its judgment obtained against Razar in priority to other potential claimants to the fund whose rights had not crystallized by judgment.

The CRA argued that source withholding amounts were deemed to be held in trust for the Crown pursuant to s. 227(4) of the *Income Tax Act* (Canada) (“*ITA*”). It also argued that under s. 227 (4.1) of the *ITA*, the Crown now beneficially owned the holdback to the extent of CRA's claim as the source withholding amounts had not been paid. Accordingly, its position was that s. 227 of the *ITA* gave the CRA priority over the holdback.

The other subcontractors and suppliers disagreed with both Pro-Gen and the CRA, submitting that the positions of each were improperly premised on the holdback being characterized as the property of Razar.

## **DECISION OF THE COURT – THREE PRINCIPLES FROM NORTHWEST**

### **1. The legal characterization of funds retained under a construction contract will determine the right to priority over it in the case of a dispute**

The court began its analysis by examining whether the holdback was indeed the property of Razar or a debt payable to it. If not, the priority claims of Pro-Gen and the CRA would fail. [4] To determine whether this was the case, the court closely examined the contract between the First Nation and Razar in assessing the intent of the parties. [5]

The contract stipulated that as a pre-condition to the holdback being payable to Razar, the project must be substantially complete. Substantial completion had not occurred. Further, the contract provided that if the project was taken out of Razar's hands, its right to payment from the holdback would be extinguished. In May 2022, the project was taken out of Razar's hands. The court determined that given the plain words of the contract, the parties never intended that the holdback be the property of, or a debt payable to Razar under these circumstances. [6]

Following *Northwest*, parties to a construction contract would be well advised to turn their minds to the contract's characterization of statutory and contractual holdbacks, as that characterization may determine which party has a property interest in the funds.

### **2. The *Construction Act* may impose a trust on funds connected to projects on federal lands, including First Nations land**

The court held that the holdback is properly a trust fund for the benefit of unpaid subcontractors and suppliers under s. 8 of the *Construction Act*, and rejected the argument that s. 8 does not apply to the project because it was located on federal lands reserved for First Nations.

Despite the *Construction Act* being provincial legislation, the court held that it is still of general application, and thus applicable to First Nations under s. 88 of the *Indian Act* which provides “...all laws of general application from time to time in force in any province are applicable to and in respect of Indians in the province...”. [7] Justice Fregeau also looked to prior jurisprudence to uphold the principle that a trust claim may be advanced in relation to an improvement that is on federal lands, including First Nations land. [8]

The court also rejected Pro-Gen's argument that the imposition of a trust on the holdback under the *Construction Act* is inconsistent with s. 89(1) of the *Indian Act* as it amounts to a seizure of property of an “Indian or band”. Since the First Nation expressly disclaimed an interest in the holdback, it could not be “seized” as the First Nation's property. Additionally, the court again referred to the intention of the parties under the contract, which was to establish the holdback for the benefit of the unpaid subcontractors and suppliers of Razar – there was never an intention for the holdback to be attributable to the First Nation. [9]

### **3. The CRA does not have priority or a trust in respect of funds in a construction project unless those funds are the property of the CRA's debtor**

The court also rejected the CRA's argument, finding that the holdback cannot be characterized as the property of Razar or a debt payable to it. The court found that the deemed trust only gives the CRA a beneficial right to the funds that the contractor (Razar) actually holds, and not funds over which the contractor has no claim. [10] Accordingly, the deemed trust under the *ITA* could not apply to give the CRA priority.

This conclusion was further supported by the fact that pursuant to the terms of the contract, the First Nation had exercised its right to take the work out of Razar's hands, which extinguished any right Razar had to the holdback.

In the end, the court granted the interpleader order, and permitted the First Nation to deposit the holdback with the court. The relative entitlements of the various claimants to the fund are being determined among them in a summary proceeding to follow.

#### **KEY TAKEAWAYS:**

Key takeaways for the construction industry include these:

- i. A trust claim under the *Construction Act* may be advanced in connection with an improvement on federal or First Nations lands by subcontractors and suppliers;

- ii. The intention of the parties to the contract, and the characterization of holdbacks or other funds, is critical and may be determinative of who has priority or an interest in those funds;
- iii. If an owner disclaims an interest in funds held back, those funds may not be properly characterized as the property of the owner, thereby immunizing the owner from disputes among other claimants to the fund; and
- iv. The CRA's entitlement to statutorily or contractually retained funds only applies if the funds can be characterized as the property of the CRA's debtor or a debt payable to it.

[1] 2023 ONSC 1233 [*Northwest*].

[2] The Construction & Infrastructure team at McMillan LLP acted as counsel to the applicant, Northwest Angle 33 First Nation.

[3] Section 8 of the *Construction Act* provides that payments owing to a contractor or subcontractor, or received by a contractor or subcontractor, on account of an improvement under a construction contract, constitute a trust fund for the benefit of subcontractors and suppliers who are owed money.

[4] *Northwest* at para 65.

[5] *Northwest* at para 66.

[6] *Northwest* at paras 70-72.

[7] *Northwest* at para 74.

[8] *Northwest* at para 74.

[9] *Northwest* at para 76.

[10] *Northwest* at paras 86-88.

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### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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