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# The Need for Prompt Payment Legislation in the Construction Industry



April 2013



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# Executive Summary

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This report describes the need for a *Prompt Payment Act* in Ontario to establish minimum norms for payment schedules in the construction industry. The report recommends a statutory model for prompt payment that is based on other jurisdictions and on **a consensus agreement between the National Trade Contractors Coalition of Canada and the Ontario General Contractors Association.**

**Late payment practices are an important issue for the Ontario construction industry. These practices have negative consequences for the construction industry and for the broader economy, including:**

- **reduced employment in the construction industry,**
- **less investment in apprenticeship,**
- **greater use of ‘independent operators’,**
- **less investment in machinery and equipment and hence lower productivity,**
- **higher construction costs because of the need to factor in late payment risk,**
- **smaller bidding pools because payment risk forces contractors to limit the amount of work they take on, and**
- **an erosion of the principle of a level playing field by rewarding those contractors that delay payments without justification while penalizing those contractors who are forced to cope with late payments.**

Late payment is a problem in every industry. However, **the unique structure of the construction industry amplifies the consequences of late payment.** The construction industry is distinct from other industries because of its complex system of contracting and sub-contracting. The system maximizes the benefits of specialization. However, to function, the system of contracting and sub-contracting requires that cash flows through many levels of a pyramid structure. An interruption in the payment flow anywhere in the construction pyramid has a cascading effect down the rest of the contracting and sub-contracting chain.

**The heart of the problem is not outright default on payment, but late payment.** Outright default is rare and can be addressed by the lien system. However, there is no effective remedy to late payments. As a result, late payment practices have increased and so also, as a consequence, has late payment risk.

Imbalances in bargaining have led to the widespread use of contingent payment clauses in contracts which allow a party to delay payment to another party when payment to the first party has been delayed. In most circumstances

there is **no interest paid on the delayed payment**. In many cases, a contractor is obliged to continue work even when payment has been delayed. **Contingent payment clauses invite abuse**. Often a contractor whose payment is delayed has no means to verify that a payment delay higher up the construction pyramid was the cause of the delay.

In the current system, there are incentives to improperly delay payments. A party that delays payment reduces its need for bank financing and conserves its working capital. There are no costs borne by the party that delays payment. The costs are borne entirely by the party whose payment is delayed unless that party can further off-load the payment risk to another party. Like all games of musical chairs, however, there is always one player that loses - the party that has no capacity to off-load payment risk onto someone else.

There are both fairness reasons and sound economic reasons to enact minimum payment norms in the construction industry.

1. **Employment in the construction industry is lower** because Contractors must limit their payroll commitments to reflect the amount of payment risk that they can afford to take on.
2. There is **less investment in apprentices**. The logic of the apprenticeship system is that an employer recoups its investment in the latter stage of an apprenticeship. However, that requires a long-term commitment to increase payroll. Payment risk discourages long-term payroll commitments and by doing so discourages investment in apprenticeships. This has a broader economic impact because the construction industry accounts for roughly 40% of all apprenticeship.
3. There is **greater use of ‘independent operators’** (*i.e.*, individuals working as sub-contractors) in place of hourly-paid workers. This reduces exposure to payroll risk, but also eliminates deductions at source. This, in turn, significantly increases the opportunity for **tax evasion and complicates the collection of WSIB contributions**.
4. There is **less investment in new machinery and equipment**. Faced with the risk of late or uncertain payment, contractors curtail the overhead risk that comes with leasing or purchasing new machinery and equipment. The effect is to **reduce productivity growth**.
5. **Construction costs are higher because contractors must factor into their bids the financing costs associated with the risk of late payment**. Owner-developers in both the public and private sector must pay this risk premium even when they adhere to prompt payment norms. The opportunistic behaviour of the minority drives up costs across the board.
6. **Construction costs are also higher because bidding pools are smaller**. Payment risk limits the amount of work that contractors can take on. As a result, bidding pools are often reduced.

7. **Late payment practices erode the level playing field.** Those that maintain honourable practices are put at a disadvantage compared to those who ‘game the system’.

**‘Lean times’ amplify the adverse effects of late payment practices.** In ‘lean times’, banks are more stringent in their credit requirements, especially for the small and medium-sized businesses that are predominant in the construction industry. The result is that many construction contractors need *more* cash to support their credit lines at precisely the same time when those higher up on the ladder often have the greatest incentive to slow down the flow of funds. Those contractors that cannot marshal additional, internal cash resources have no choice but to cut back on the amount of work they undertake. In some circumstances, payment delays can trigger a demand for more security on existing demand loans. If this security cannot be provided, a contractor may be forced into insolvency. The overall result is that, **in ‘lean times’, late payment practices increase job losses in the construction industry.**

**The majority of U.S. states, the European Union, the United Kingdom, Ireland, Australia and New Zealand have enacted prompt payment legislation to counter late payment practices. Ontario must do the same.**

**The National Trade Contractors Coalition of Canada and the Ontario General Contractors Association have come together in support of prompt payment legislation in Ontario.** Enacting such legislation will benefit all stakeholders in Ontario’s construction industry, including both public and private sector Owner/Developers, General Contractors, Trade Contractors, Suppliers of Professional Services, and Suppliers of Building Materials and Equipment.

The *status quo* is not working. It is time for government to fix the problem.

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# 1. Introduction



This study describes the late payment problem in the construction industry and its broader consequences for the economy. The *Prompt Payment Act* recommended in this report is supported by both the National Trade Contractors Coalition of Canada (Ontario) and the Ontario General Contractors Association.

The report shows that the complex system of contracting and sub-contracting, which is so central to the construction industry, magnifies the consequences of late payments by freezing cash-flow across an entire construction project. The report shows that the broader effects of late payments are:

1. reduced employment in the construction industry,
2. fewer apprenticeships,
3. an increase in the number of ‘independent operators’ and a commensurate increase in the risk of under-registration with the workers’ compensation system and under-reporting of taxable income,
4. lower productivity in the construction industry as a result of less investment in machinery and equipment,
5. higher construction costs to reflect late payment risks,
6. a reduction in the number of contractors bidding on work, and
7. an erosion of the level playing field which is the foundation of an efficient and competitive industry.

Under the proposed *Prompt Payment Act*, any party in a construction project that owes a payment to another party would be required to make that payment promptly, if it has received payment. If a payer is in default, the payee would be entitled to due process, which includes proper notifications, right to cease work and to pursue remedy. Interest would be payable on late payments. The proposed *Prompt Payment Act* mirrors the approach taken in a large majority of U.S. states, the European Union, The United Kingdom and Australia.

Chapter Two of this report describes the system of contracting and sub-contracting in the construction industry. It is this system that causes a late payment by one party to cascade and multiply. The late payment problem is especially serious in the construction industry because many contractors are dependent on the cash-flow from a single project to support their business operations. Payment delays can be a problem in any sector of the economy. However, the system of contracting and sub-contracting amplifies the consequences of late payment in the construction industry.

Chapter Three describes the contractual provisions that facilitate late payment. These contractual provisions that are typically captioned as ‘pay-when-paid’ and ‘pay-if-paid’ clauses. Chapter Three also reviews the provisions of the standard agreements that are recommended by the industry, but which are not mandatory.

Chapter Four describes how the risk of late and uncertain payment leads to negative consequences for the construction industry and for the economy as a whole.

Chapter Five reviews the statutory approaches that have been adopted in most other jurisdictions, notably the United States, the U.K., Ireland, Australia, New Zealand and the European Union.

Chapter Six describes how the proposed *Prompt Payment Act* would operate.

Chapter Seven summarizes the case for making prompt payment legislation part of Ontario's economic recovery strategy.

Appendix A lists associations which have endorsed the adoption of Prompt Payment legislation in Ontario.

Appendix B sets out a proposed *Prompt Payment Act*. Appendices C and D provide explanatory commentary on the proposed *Prompt Payment Act*. Appendix E reproduces an article from the Daily Commercial News reporting on the joint agreement on prompt payment legislation between the National Trade Contractors Coalition of Canada (Ontario) and the Ontario General Contractors Association.

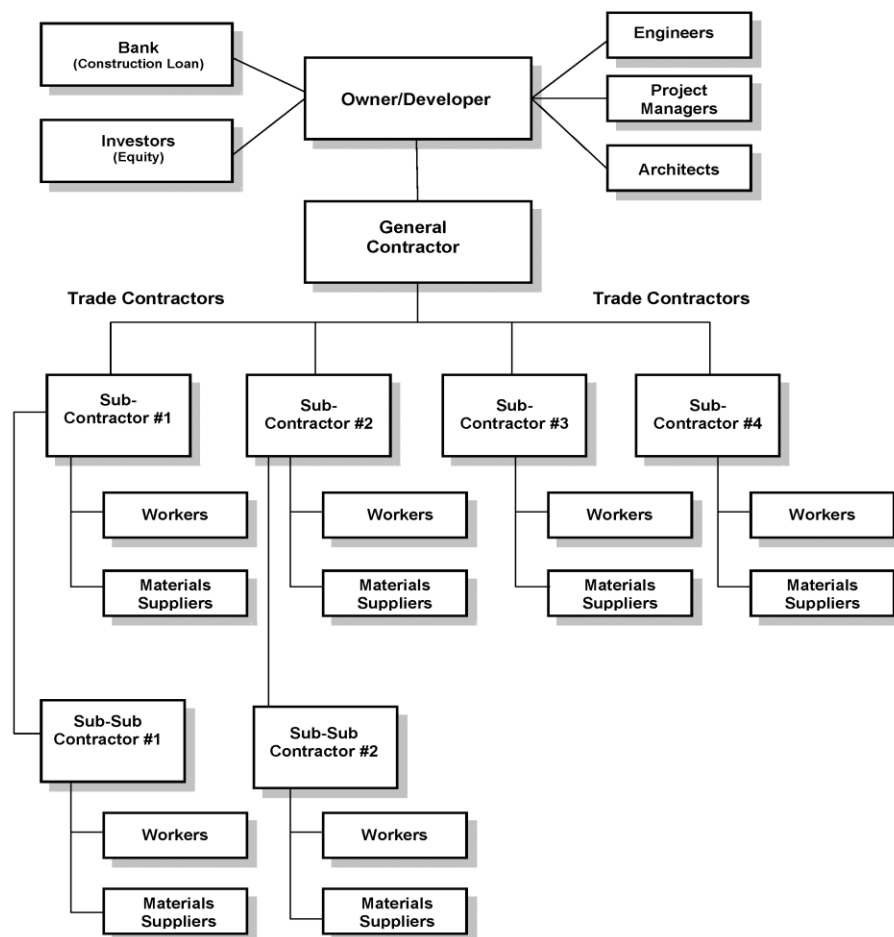
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## 2. The Construction Industry is Distinct

### *The Construction Pyramid:*

The complex structure of contracting and sub-contracting sets the construction industry apart from other industries. In the construction industry, the supply chain is a pyramid. Figure No. 1 illustrates the construction supply chain on a large building project.

Figure No. 1  
Construction Industry Supply Chain  
on a Large Building Project



- At the top of the pyramid sits the Owner-Developer. In the private sector, a project is financed by a combination of investor equity and a construction loan provided by a bank. In the public sector, government may provide all of the financing or may structure the project



as a public-private partnership which could entail different models of private sector involvement in financing.

- Based on the drawings and technical specifications developed for the Owner-Developer by architects and engineers, the Owner-Developer selects a General Contractor to build the project. For most projects this is a fixed price arrangement, although, in some projects, the General Contractor will operate only as a construction manager on a percentage basis.
- The Owner-Developer may use an architect to manage the project or may engage a specialized project manager. Some Owner-Developers undertake their own construction management.
- The General Contractor enters into sub-contracts with Trade Contractors for the various segments of the construction project, *e.g.*, excavation, structural work, cladding, fenestration, electrical work, mechanical and HVAC work, interior finishing, *etc.* Each of these Trade Contractors (who are Sub-Contractors to the General Contractor) employs workers directly. Usually these Trade Contractors also purchase the materials required for their segment of the construction project. Typically, the Trade Contractors bid for work on a fixed-price basis.
- The pyramid can have a number of levels when Sub-Contractors further sub-contract to other Trade Contractors who become Sub-Sub-Contractors and so forth down the pyramid.

Trade Contractors perform the greatest proportion of the construction work on large projects.<sup>1</sup> In the U.S., it is estimated that, on large projects of the type illustrated in Figure No.1, Trade Contractors perform 80-90% of the direct construction work.<sup>2</sup> More than half of all Trade Contractors employ fewer than 20 employees.<sup>3</sup> On most large projects, Trade Contractors either sub-contract from a General Contractor or sub-sub-contract from another Trade Contractor. As with all small and medium-sized businesses, access to bank credit is limited and dependence on cash-flow is high.

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<sup>1</sup> Historically, a large proportion of the construction work force was directly employed by General Contractors. After 1970, sub-contracting took on greater importance as General Contractors focussed on their role as construction managers. The shift of construction employment to Trade Contractors was not unique to Canada. A study by the International Labour Office (ILO) found that this employment shift was evident in virtually every developed economy. International Labour Office (ILO), "The Construction Industry in the Twenty-First Century", (Geneva 2001).

<sup>2</sup> Hinze, J. and A. Tracey, "The Contractor-Subcontractor Relationship – the Subcontractor's View", (1994) 120(2) *Journal of Construction Engineering and Management* p 274. Similar estimates for the U.S. are offered in Bartholomew, S., *Construction Contracting: Business and Legal Principles*, Prentice Hall, 1998. Bartholomew estimates that sub-contractors perform 50% of the work on civil projects and 75% to 100% on a typical private [building] construction project. A 1991 study by the Australian Industry Commission arrived at a similar estimate for Australia. Refer to: Australian Government Publishing Service, *Construction Costs of Major Projects*, Report No. 8, Industry Commission, (March 11, 1991) p 23

<sup>3</sup> Statistics Canada, CANSIM, Table 282-0076

### *The Payment System in Construction:*

In the construction industry, funds flow from the Owner-Developer to the General Contractor and thence to the various Sub-Contractors and Sub-Sub-Contractors, based on satisfactory progress. Satisfactory progress (or completion) is confirmed by a payment certifier, who is usually, but not always, the architect retained by the Owner-Developer. Some Owner-Developers may also engage a Project Manager who will also play a role in authorizing or making payments.

The difficulty with the payment system is that it is highly vulnerable to freeze-ups. When any party in the payment structure withholds or delays payment, their action freezes the flow of funds to all levels of the pyramid that are subordinate to them. Thus, sub-contractors and sub-sub-contractors are subjected to unexpected payment delays, even though their work was wholly satisfactory. In most cases, no interest is paid on the delayed payments. To compound the problem, in many cases, trade contractors are contractually obliged to continue working, even when the payments owed to them have been delayed. One prominent law firm in Canada advises contractors to: “say a prayer or two when payment is due.”<sup>4</sup>

The payment system is vulnerable to interruption from several causes:

- A dispute between an Owner-Developer and a General Contractor can interrupt payments to *all* Sub-Contractors, even when the dispute pertains to the performance of only one Sub-Contractor. Infrastructure Ontario (IO), to its credit, does not allow this to happen. IO only withholds payment for the portion of the work where there is a deficiency. Some Owner-Developers, however, use the pretext of *any* unsatisfactory work to halt an entire payment that is due to a General Contractor who may then be forced to suspend payments to *all* Sub-Contractors.
- A dispute between a General Contractor and a Sub-Contractor can interrupt the flow of payments to *all* of the Sub-Sub-Contractors who are further down the supply chain. Some General Contractors limit the payment delay to the portion of the work that is deficient. However, others withhold the entire payment. Similarly, further down the construction pyramid, a dispute between a Sub-Contractor and a Sub-Sub-Contractor can affect other Sub-Sub-Contractors who are not party to the original dispute, but depend on that cash-flow to finance their work.<sup>5</sup>
- An Owner-Developer may delay payment to a General Contractor for reasons that are unrelated to construction performance. This can occur if there are issues between the

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<sup>4</sup> Glaholt, Duncan W. and John Margie, “Getting Paid: Holdbacks and Other Selected Topics”, paper presented to Canadian Institute, 6<sup>th</sup> Annual Construction Superconference (1997, Toronto), p 2 <http://www.glaholt.com/publications/conferenceprs.html> Accessed January 31, 2010.

<sup>5</sup> The ‘collateral damage’ problem is described in a white paper published by Lowe’s, a large U.S.-based retailer of building supplies. The Lowe’s paper comments that, “even if the sub-contractor does an excellent job, a conflict elsewhere on the project might cause the client to withhold payments. If there is a pay-when-paid clause, none of the subs will receive payment until that conflict is resolved.” The Lowe’s paper cites one industry expert as saying, “that [dispute] can go on for months and there’s nothing the subcontractor can do about it.” Lowe’s Commercial Services, “A Closer Look: Why Pay-When-Paid Clauses are a Bad Idea” (February 2011) p 2

Owner-Developer and the provider of construction financing or if the Owner-Developer has other demands on its capital.

- Third party payment certifiers can also delay payments.
- Any contractor may delay a payment because it requires short-term funds for other purposes. To justify this delay, a delinquent payer may allege that it did not receive the payment it expected, thereby purporting to contractually justify its own delay in payment.

Those contractors who are furthest down the pyramid are at the greatest risk because there are more parties through whom the funds must flow and therefore more potential causes of payment delay.<sup>6</sup>

#### *The Liquidity Vice:*

The risk that payments will be delayed puts Contractors in a liquidity vice. On one side of the ledger are Contractor's revenues which are subject to unpredictable delays. On the other side of the ledger are Contractor's costs. These fall due monthly for payments to the Canada Revenue Agency and the workers' compensation system, weekly, in the case of wages, and immediately, or within a short order, for payment to the suppliers of equipment and materials. (While some equipment and materials suppliers can oblige immediate or prompt payment, many smaller suppliers are at risk of delayed payment in much the same manner as Contractors.) Both the Canada Revenue Agency and the Workplace Safety and Insurance Board believe in (and enforce) prompt payment.

#### *Late Payment Risk is Distinct from Default Risk:*

The issue that is at the heart of the payment problem in the construction industry is *late* payments, not default of payment. Payment default is another risk altogether. The lien system and the related hold-backs provide a measure of security against the risk of payment default.<sup>7</sup> Liens, however, are cumbersome, costly and time-

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<sup>6</sup> Thermal Contractors, for example, are typically Sub-Sub-Contractors to Mechanical Contractors who are sometimes a Sub-Sub-Contractor to an HVAC Contractor. The Thermal Insulation Association of Canada estimates that its members often wait 120 days or longer to receive payment when the contractual norm is supposed to be 15-30 days. Thermal Insulation Association of Canada, *TIAC Times*, Spring 2011 [http://tiactimes.com/magazine/article/Promoting\\_Prompt\\_Payment.html](http://tiactimes.com/magazine/article/Promoting_Prompt_Payment.html)

<sup>7</sup> A lien against a property arises automatically whenever construction work is performed. However, a construction contractor must take steps to 'preserve' and 'perfect' the lien. Within a period of time specified by statute after a project has been completed, an unpaid contractor files a lien claim against the property. This claim is registered at the title office. A lien claim can be filed electronically with payment of a modest fee. The lien claim is limited to the amount of the unpaid contractual obligation and does not confer any right to interest or damage. Once a lien has been 'preserved' in this manner, a lien claimant has one year to enforce the lien claim through court action. The presence of a lien claim can impair the sale or transfer of a property or the use of the property as security for debt. If the owner or any other party wishes to remove the lien, then he or she must settle with the claimant or post alternative security until the court action is heard.

consuming to enforce.<sup>8</sup> Consequently, liens have little practical relevance to the problem of *delayed* payments. If every payment delay were to result in a lien, the construction system would be mired in lien litigation. Owner-Developers could find their asset encumbered by liens precisely when they need a lien-free asset for other business purposes. As one scholarly review observed, “The central problem with the builders’ lien stems from the fact that it is slow and unwieldy. *In an industry that depends on speedy payments in order for parties to remain solvent, the delays that arise in the lien procedure are argued by some to have the potential to bring down whole construction projects.*”<sup>9</sup>

Late payment risk is different from default risk. There is remedy in the lien system for default. There is no effective remedy for late payment.

#### *Imbalance in the System:*

There is a bias in the construction industry’s payment system that tilts the system towards unpredictable payment delays. In describing the U.S. system, prior to the adoption of Prompt Payment legislation, one commentator noted that “each entity into whose hands the funds pass may be tempted to convert the funds to its own purposes, at least temporarily, if not permanently.”<sup>10</sup> The current system rewards those who delay payment by providing them with interest-free cash-flow, while imposing a cash-flow risk on those whose payment is delayed. Those who engage in opportunistic payment delays thereby secure a competitive advantage over who honour their payment obligations promptly. *Instead of a level playing field, the result is a system which confers advantage on those who operate opportunistically while at the same time introducing additional financial risks in the construction industry and the negative economic consequences associated with those additional risks.*

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<sup>8</sup> Master Carol A. Albert of the Superior Court of Justice commented: “Mention ‘construction lien’ and most lawyers cringe. They complain that it is too complicated.” Master Carol A. Albert of the Superior Court of Justice reviewing the 3<sup>rd</sup> edition of one of the standard legal commentaries – Kirsh and Alter, *A Guide to Construction Liens in Ontario*. September 28 2001, available at: [www.cccl.org/articles/Book.review.Kirsh.3rd.ed.CL%20in%20Ont.Sept.2011.pdf](http://www.cccl.org/articles/Book.review.Kirsh.3rd.ed.CL%20in%20Ont.Sept.2011.pdf)

<sup>9</sup> Baas, Susan Catherine, “Protecting New Zealand Construction Subcontractors” (November 2001), thesis submitted in partial fulfilment of the requirements for the degree of Master of Laws in the Faculty of Graduate Studies, University of British Columbia, pp 48-49 [Emphasis added.]

<sup>10</sup> Clarke C. Johnson and Jerome W. Zimmer, “The Case for Prompt Payment Legislation for Private Construction Projects,” *Michigan Real Property Review*, Vol. 22, No. 2 p 103.

Also referring to conditions in the United States, a writer for the *Engineering News Record* commented that:

“The [construction] industry is in fact notorious for its pay practices. *It is chock full of nonpayers, partial payers and slow payers.* Most are caught in an involuntary role, affected more by the actions of others. But there are also firms that use such tactics deliberately to their own benefit and to the detriment of the industry. The end result usually is a contractor ‘robbing’ assets from one project to pay for another with pay problems. *This is a recipe for disaster.*” Payment Risks”, *Engineering News Record*, 114 239 (7) (18 August 1997). Emphasis added.

### 3. Contingent Payment Clauses

#### *Contingent Payment Clauses:*

Contingent payment clauses are provisions of construction contracts that allow for payment to be delayed notwithstanding that the construction work was performed satisfactorily. In some cases, a contractor who is not paid is allowed to suspend work. In other cases, work must be continued at least for a period of time, even though payment is in arrears. Some contingent payment clauses provide for interest on delayed payments. However, the majority of contingent payment provisions do not require interest to be paid.

Once in place, at any level in the construction pyramid, the usual contracting practice is to require similar provisions in contracts further down the pyramid. Thus, if the contract between an Owner-Developer and a General Contractor contains a contingent payment clause, the General Contractor will require similar provisions in its contracts with Sub-Contractors. These Sub-Contractors, in turn, will require contingent payment provisions in their contracts with Sub-Sub-Contractors and so on down the construction pyramid. The lowest party in the pyramid, however, has no ability to off-load payment risk onto another party.

Some commentary - notably in the United States - distinguishes between two types of contingent payment provisions - 'pay-if-paid' and 'pay-when-paid' clauses. Canadian commentary sometimes recognizes this distinction. At other times, Canadian commentary conflates the two types of clauses treating them as effectively one and the same.

#### *Standard Contracts and Company-Specific Contracts:*

Standard contracts are contract templates that were developed and continue to be maintained by multi-party industry organizations. Standard contracts represent a broad industry consensus on what constitutes fair contracting practices.

There are two sources of standard industry contracts. The first are the standard contracts developed by the Canadian Construction Documents Committee (CCDC). CCDC standard contracts pertain to the contract between an Owner-Developer and a construction contractor who is directly engaged by an Owner-Developer. This is usually, though not always, a General Contractor. The second source of standard contracts is the Canadian Construction Association (CCA). CCA standard contracts apply to the relationship between a General Contractor and Sub-Contractor or between a Sub-Contractor and a Sub-Sub-Contractor.

Standard contracts have two compelling advantages. The first is that they reflect a broad agreement on what constitutes a fair balance between the interests of contracting parties. The second is that standard contracts use clear terminology that is widely understood in the construction industry. For both reasons, projects that are governed by standard contracts typically involve a much lower risk of litigation over the meaning of contractual obligations.

Company-specific contracts are contracts developed by an individual company and which are typically required of all parties who enter into a contract for the performance of construction work. Company-specific contracts diverge from standard contracts in two ways. In the first place, these types of contracts confer greater rights on the company which is the proponent of the contract. And second, company-specific contracts may use terminology or legal constructions which are less clear in their meaning than standard contracts. Company-specific contracts often involve a greater risk of litigation as well as conferring less rights or greater obligations on the subordinate party. *The difference between standard industry contracts and company-specific contracts is important to understanding the late payment problem in the construction industry.*

#### *Canadian Construction Documents Committee (CCDC):*

The CCDC was established in 1974 by the Canadian Construction Industry Consultative Committee.<sup>11</sup> The CCDC comprises two representatives from private sector Owner/Developers and two representatives from public sector Owner/Developers. In addition, the CCDC has representatives from each of the Association of Consulting Engineering Companies of Canada (ACEC), the Royal Architectural Institute of Canada (RAIC), Construction Specifications Canada (CSC), and the Canadian Construction Association (CCA). There is also participation from the construction law section of the Canadian Bar Association.<sup>12</sup> *The Ontario government should note that Infrastructure Ontario participates on the CCDC.*

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<sup>11</sup> The constituent members of the Canadian Construction Industry Consultative Committee are: the Association of Consulting Engineering Companies of Canada, the Royal Architectural Institute of Canada, the Canadian Construction Association, and Construction Specifications Canada.

<sup>12</sup> The current members of the CCDC are:

**Owner Representatives:**

Bruce Cleaver  
Royal Bank of Canada

Melinda Nycholat  
Defence Construction Canada

Mark Mulholland  
BLJC

Jocelyne Newton  
Infrastructure Ontario

**Consulting Engineering Companies:**

Sylvia Jungkind  
Focus Corporation

Kevin Murphy  
CBCL Limited Consulting Engineers

**Canadian Construction Association:**

Terry Brown  
STBR Consulting Ltd

Hugh Loughborough  
Aecon Industrial Group

Serge Massicotte  
Massicotte Construction Ltd.

Louis Fontaine  
BPR Construction Inc.

**Construction Specifications Canada:**

Gary Hartman  
Contraspec Ltd

Walter Strachan  
CBCL Limited Consulting Engineers

The CCDC proceeds on a consensus basis after extensive consultation. Hence, CCDC standard agreement forms are often referred to as consensus documents. CCDC-2 is the most commonly used standard agreement between Owner-Developers and General Contractors.

*Canadian Construction Association (CCA) Standard Contracts:*

The CCA draws its membership from most segments of the construction industry. The CCA has developed standard agreements for work sub-contracted by General Contractors and Trade Contractors and for work that is further sub-sub-contracted. The current standard agreement is CCA 1 – 2008. These documents may be used for any construction project, but must bear the CCA’s copyright seal.

*Contingent Payment Clauses - ‘Pay-If-Paid’:*

A ‘pay-if-paid’ clause is a contractual provision that makes one party’s duty to pay another party for work undertaken dependent on the first party receiving payments which are owed to it. In contract law this is known as a ‘condition precedent’. If a contract includes a clearly written ‘pay-if-paid’ provision, then, in principle, the first party has no obligation towards the second party unless and until the first party is paid. A ‘pay-if-paid’ clause is (or seeks to be) an absolute flowing through of payment risk from one party to another party.

An example of a ‘pay-if-paid’ clause is a provision such as: “payments will be made not more than thirty (30) days after the submission date or ten (10) days after the certification *or when we have been paid by the owner, whichever is the later.*” This contract provision was the focus of a dispute addressed by the Ontario Court of Appeal in *Timbro Developments Ltd. v. Grimsby Diesel Motors Inc.* The Court of Appeal held that this clause set out a clearly worded ‘condition precedent’, namely that payment to the Sub-Contractor only became due after the

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payment had been made to the prime Contractor by the Owner-Developer. The Court of Appeal stated that, “under the clause, the subcontractor clearly assumes the risk of non-payment by the owner to the contractor.”<sup>13</sup> Alberta courts have taken a similar view of these contract provisions.

Courts in some Canadian jurisdictions have not followed the strict application of contract language in the manner of the Ontario and Alberta courts. In 1995, Nova Scotia’s highest court considered a case of non-payment that was based on the following language: “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 by the owners...* 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.*”<sup>14</sup> Although this contract language is similar to the provision in the *Timbro* case, the Nova Scotia court did not uphold the strict conditionality, ruling instead that late payment (or non-payment) by the Owner to the General Contractor conferred only a right to delay payment to the Sub-Contractor, not an unambiguous removal of obligation to pay unless the Owner paid. The Nova Scotia court stated:

“... in order for a general contractor to impose a term on a subcontractor pursuant to a standard form of contract, that payment for its work is conditionally on the contractor being paid by the owner, the contract would require much clearer language than contained in the subcontract between Gem and the appellant. An intention so important cannot be buried in obscure language that would not alert the subcontractor that payment for the subcontract work was conditional on the owner paying the contractor.”<sup>15</sup>

The courts in Prince Edward Island, Manitoba, British Columbia and Saskatchewan have followed the Nova Scotia court in holding that a clause must be clear and unambiguous to fully shift payment risk onto the shoulders of a Sub-Contractor.<sup>16</sup>

In light of the different approaches taken by Canadian courts, some General Contractors that use company-specific contracts have re-drafted those contracts to unambiguously make payment to Sub-Contractors dependent on prior payment from the Owner-Developer being received by the General Contractor. The following are two examples of sub-contract agreements currently or recently used by General Contractors operating in Ontario. These contracts were found on the web. The highlighted portion of the clauses seeks to make the full transfer of payment risk to the Sub-Contractor clear and unambiguous:

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<sup>13</sup> *Timbro Developments Ltd. v. Grimsby Diesel Motors Inc* (1988) 32 C.L.R. 32 (Ont. C.A.) p 33

<sup>14</sup> *Arnoldin Construction & Forms Ltd. v. Alta Surety Co.* (1995), 19 C.L.R. 2d 1 (N.S.C.A.), rev’g (1994), 13 2d 307 (N.S.S.C.). [Emphasis added]

<sup>15</sup> *ibid.* at p 10

<sup>16</sup> Miller Thomson LLP, “Alberta Construction Industry Communiqué: Pay When Paid Clauses” February 2006. See also the discussion in Continuing Legal Education Society of British Columbia, “Construction Law – 2004 Update – Subcontract Issues”, prepared by Brian M. Samuels of Samuels & Co., Vancouver



“Article 19. The Subcontractor shall make application for payment for work performed by the Subcontractor in the month, together with a supporting statutory declaration, current Workplace Safety & Insurance Board Clearance Certificate and other documents when required by the Subcontract Agreement, on or before the 25th day of each month to the Contractor for approval, whereupon payment to the Subcontractor by the Contractor in the amount of ninety percent of the certified sum shall become due and payable on or about the 30th day of the month following or fifteen days after certification, whichever is the later, **providing that, as a condition precedent, the Contractor has been paid by the Owner** the certificate in which said amount has been included. The balance of ten percent will be paid forty-six (46) days after final acceptance and certification by the Architect/Engineer/Owner/Owner’s Consultants of the work. All payments will be made in Canadian funds and will be payable at par in Toronto, Ontario.”

“7.3.5 ...**The Subcontractor hereby acknowledges that it relies on its own evaluation of the credit worthiness of the Owner, and not the credit worthiness of the Contractor**, with respect to payment for the Subcontract Work, and **expressly assumes the risk of non-payment by the Owner thereof, for any reason including, without limitation, insolvency of the Owner.**”

The central difficulty with a ‘pay-if-paid’ clause is that a Sub-Contractor’s right to be paid is dependent on the credit-worthiness of the Owner-Developer. However, the Sub-Contractor is not a party to the contractual relationship between the Owner-Developer and the General Contractor and does not have any right to require demonstration of credit worthiness. The legal principle of ‘privity of contract’ explicitly denies any status to a party that is not a signatory to a contract. For Sub-Contractors, a ‘pay-if-paid’ risk is effectively a ‘blind risk’ that must be undertaken to get work.

#### *Contingent Payment Clauses - ‘Pay-When-Paid’:*

‘Pay-when-paid’ clauses allow a party to delay payment to another party when payment to the first party is delayed. A ‘pay-when-paid’ clause does not fully shift the risk of non-payment to the second party. That is to say, the first party remains obliged to pay the second party, even if the first party never receives payment. The following clauses are taken from two sub-contract agreements that are currently in use and which were found on the web. Both clauses illustrate the General Contractor’s right to delay payment *for a period of time* in the event that prior payment is not received from the Owner-Developer:

Example No. 1:

“4(d): Notwithstanding paragraphs (b) and (c) above [which set out payment obligations of the Contractor to the Sub-Contractor], **if the Owner fails to make payment to the Contractor when due in accordance with the terms of the Prime Contract, the associated payment to the Subcontractor will become due sixty (60) days after payment was due to the Contractor from the Owner.**”

Example No. 2:

“4.6: **In the event the Owner is in default of its payment obligations under the Prime Contract for a period of 90 days** from the time prescribed in the Prime Contract for payment of any progress draw or draws, holdback amounts or final payment amount, **the Contractor shall make the applicable payment to the Subcontractor within the 7 days following such 90 day period...**”

The clause in Example No. 1 allows for a payment delay of 60 days beyond the agreed schedule, while the clause in Example No. 2 allows for a 90-day delay.

Most contracts that contain ‘pay-when-paid’ clauses do not contain any provisions that require a statutory declaration that payment has not been received. As a result, most Sub-Contractors have no basis on which to dispute a payment delay that is founded on a ‘pay-when-paid’ clause.

#### *Incorporation of ‘Pay-If-Paid’ or ‘Pay-When-Paid’ by Reference:*

Some construction contracts create (or purport to create) an implicit right to delay payment even though there is no explicit language along the lines described above. This implicit right arises (or is claimed to arise) when a contract incorporates the terms of a superior contract by reference. For example, a contract between an Owner-Developer and a General Contractor may allow for payment delays in certain circumstances. The right to delay payment may be incorporated *by reference* into the contracts between the General Contractor and Sub-Contractors, and so on down the pyramid. The legal standing of ‘pay-when-paid’ clauses that are incorporated by reference, rather than being set out explicitly, is uncertain. However, the practice of incorporation by reference adds to the perception of payment risk and therefore further motivates the risk management behaviour described in the previous chapter.

#### *Contingent Payment Clauses reflect an Imbalance of Power*

The prevalence of contingent payment clauses reflects the imbalance of power that is inherent in the construction industry. There is first an imbalance of bargaining power between most Owner-Developers and the General Contractors. This arises from the fact that there are likely to be a number of General Contractors competing for the opportunity to undertake the construction project and therefore willing to accept terms that imply a degree of

payment risk. This imbalance of power is then replicated all the way down the construction pyramid. There are almost always a large number of Trade Contractors bidding to do work that is put out to tender by a much smaller number of General Contractors.<sup>17</sup> If a Contractor refuses to accept a contingent payment clause, the work will likely be awarded to another bidder and that Contractor risks being struck from future invitations to bid.

#### *Abuse of Contingent Payment Clauses:*

In principle, the delays allowed by contingent payment clauses are only contractually permitted if payment is delayed by a party higher up on the construction pyramid. The problem is that, under the common law principle of ‘privity of contract’, the parties lower down on the pyramid are not party to the contractual relationships higher up on the pyramid. This causes two problems.

The first problem arising from the ‘privity’ principle is that a party lower down on the pyramid does not have the legal capacity to sue the party higher up on the pyramid who is causing the payment delay. For example, a Sub-Contractor to a General Contractor cannot sue an Owner-Developer. Nor can a Sub-Sub-Contractor sue a General Contractor. It might be expected that the party higher up on the pyramid would pursue payment rights under its contract. Indeed, this is often what transpires. However, in some cases a party that is higher up on the pyramid may have business reasons not to pursue payment aggressively, especially if that party has been able to off-load payment risk onto the parties lower down on the pyramid.

The second problem arising from the ‘privity’ principle is that a Contractor may justify a payment delay on the grounds that it has not received payment, when payment, in fact, has been received. In some circumstances, the party whose payment has been delayed can verify whether the payment was or was not received by the party that is delaying payment. In many cases, however, the party whose payment has been delayed has no legal means to determine whether the payment delay is actually justified.

#### *Lack of Compensation for Delayed Payment:*

If delayed payment were compensated by interest payments, the incentive to delay payment would be significantly reduced. Indeed, *the validity of interest compensation for delayed payment is explicitly recognized in the Canadian Construction Association’s standard agreement CCA-1*.<sup>18</sup> However, many parties either use their own company-specific subcontract agreements which do not contain such provisions or delete these provisions from the CCA’s standard agreement. None of the four company-specific sub-contract agreements cited earlier in this chapter provide for interest on late payments. As a practical matter, therefore, *interest is rarely paid on delayed payments, even though the validity of such compensation is officially recognized by the Canadian Construction Association*.

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<sup>17</sup> Gruneber, S. L. and G.J. Ive, *The Economics of the Modern Construction Firm*, (London, England: MacMillan Press Ltd.), 2000

<sup>18</sup> Refer to sec. 6.3.4 and 6.5 of *Stipulated Price Subcontract, CCA 1- 2008*, copyright Canadian Construction Association

The absence of a duty to pay interest on late payments has an important negative consequence. *The absence of interest charges encourages late payments by making them costless to the party that delays the payment.*

*The Need for a Level Playing Field:*

There has been an increase in the presence of non-Canadian General Contractors entering the Ontario construction market. From the perspective of Owner-Developers, including governments, this is a positive development as it increases the competitiveness of the construction industry. Increased competitiveness, however, will make it even more difficult to rein in late payment practices, especially if companies from outside Canada regard late payment as a business norm. It is imperative, therefore, that the government establish a level playing field by legislating minimum payment norms that will apply to all parties in the construction pyramid.

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## 4. Economic Consequences

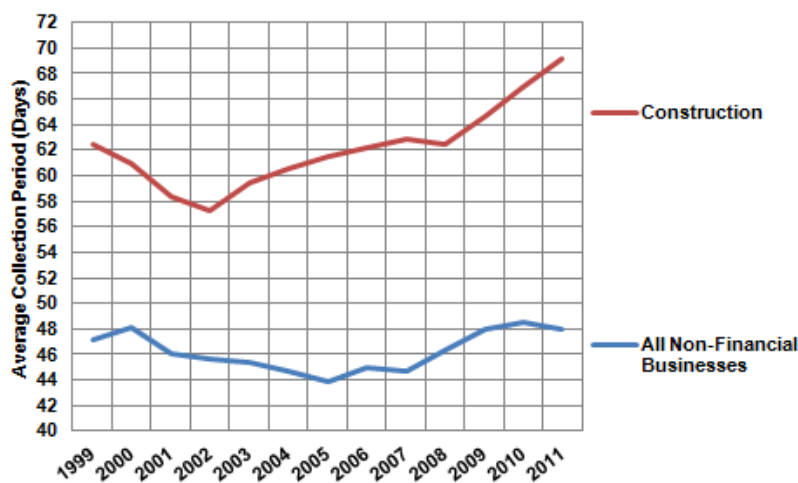
In the construction industry, payment risk is both real and greater than it need be. Payment risk causes construction businesses to operate in ways that have negative consequences for the economy. These broader economic consequences of payment risk include: diminished employment, fewer apprenticeships, lower productivity as a result of reduced investment in machinery and equipment, and higher construction costs owing to risk factors being incorporated into bid prices.

### *Limits on Contractors' Capacity to Carry Payment Risk:*

The ability of Contractors to take on the risk of late payments is constrained by two factors. The first is their working capital. The second is their access to bank credit. All construction companies, but especially smaller companies, encounter difficulty increasing their lines of credit when payments owed to them are delayed. Alternatively, the terms on which credit may be offered will be a deterrent. Consequently the amount of working capital, relative to the size of payroll and obligations to suppliers, is the most important determinant of a construction company's capacity to take on any additional risk of late payment.

The average collection period is a proxy for the impact of payment delays on cash-flow. Figure No. 2 shows that, in the construction industry, the 'average collection period' for receivables has increased in the last decade. This contrasts with the trend for non-financial businesses as a whole.

Figure No. 2  
Average Collection Period (Days) for Receivables:  
Construction Industry compared to All Non-Financial Businesses, 1999-2011 (Canada)  
Based on Statistics Canada, CANSIM, Table No. 180-0003



For non-financial businesses, average collection periods increased from approximately 43.9 days in 2005 to 48.5 days in 2010 and then fell back to 48.0 in 2011. *In the construction industry, however, the average collection period is both longer and increased more sharply – from 57.3 days in 2002 to 69.2 days in 2011.*

The essence of the late payment risk is not wholly captured by changes in the average collection period. The core of the late payment risk is what financial analysts call ‘tail risk’, namely the risk that a few receivables will be subject to *significant and uncertain delay*. The nature of ‘tail risk’ is illustrated in Figure No. 3.

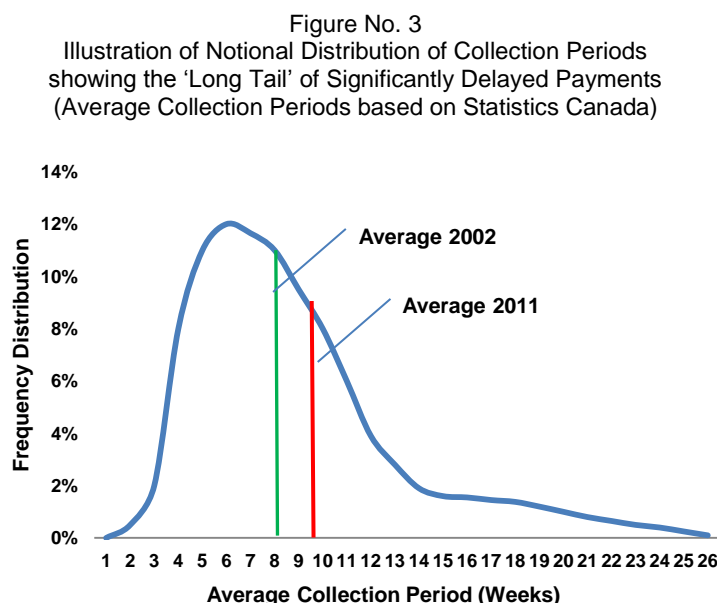
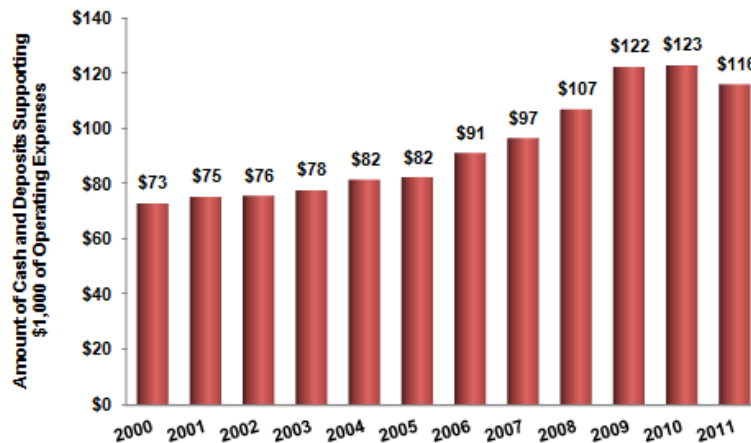


Figure No. 3 depicts a notional distribution of payment periods, although the averages for 2002 and 2011 reflect the estimates derived from Statistics Canada data. Based on Statistics Canada data, we know that the ‘average collection period’ increased from 57.3 days in 2002 to 69.2 days in 2011. If the cause of this were simply an eleven day increase in the collection period for a typical payment, it might be inferred that the increase in late payment risk was comparatively moderate. However, trade contractors tell a quite different story. Their experience is that the increase in the average collection period was actually caused by an increase in the proportion of payments that fell into the significantly delayed category, *i.e.*, the portion of the graph to the far right of the average. This is the ‘tail risk’. Although ‘tail risk’ probably affected fewer than 10% of invoices, the effect was to increase the average, but more importantly to introduce a much higher degree of uncertainty into overall cash-flow. For contractors who had committed all or a large proportion of their resources to a single project, the seriousness of the increase in cash-flow risk was considerable.

### Cash Requirements

All businesses require a certain amount of cash to finance their ongoing operations. Figure No. 4 shows the amount of cash and short-term deposits needed to support \$1,000 of operating expenses in the construction industry from 1999 to 2009.

Figure No. 4  
Amount of Cash and Deposits Supporting \$1,000 of Operating Expenses  
in the Construction Industry, Canada, 1999-2011  
Calculations based on Statistics Canada, CANSIM Table No. 180-0003



As can be seen from Figure No. 4, the amount of cash needed to support \$1,000 of operating expenses increased from \$73 in 2000 to \$123 in 2010 and then fell back to \$116 in 2011. This was an increase of almost 59% in the amount of cash that a construction company needs to finance a \$1,000 of operating expenses. The increase arose from two factors. The first was stricter borrowing conditions which caused companies to rely on self-financing to a greater degree. The second was increased caution on the part of construction business related to the increase in payment risk that was evident from Figure No. 2.

#### *The Consequences of Late Payments Increase in 'Lean Times':*

Writing in the *Journal of Commerce*, one legal commentator observed that a contingent payment clause “gives rise to special problems in times of recession”.<sup>19</sup> The experience of many Contractors is that in ‘lean times’ there is an increase in both the frequency and the risk of late payment. The consequences for Contractors are serious. In ‘lean times’, banks are more stringent in their credit requirements, especially for small and medium sized businesses. Typically banks reduce the amount of credit they will make available for a given amount of receivables. The result is that Contractors need more cash at the same time that those higher up on the pyramid are slowing down the flow of funds. Those Contractors that are unable to marshal additional cash resources have no choice but to cut back on the amount of work they undertake. The overall result is that, *in ‘lean times’, late payments magnify job losses in the construction industry at precisely the time when public policy is striving to minimize job losses.*

#### *The Financing Costs of one Contractor are the Financing Gains of Another:*

In construction, as in other industries, time is money. Materials and wages must be paid as the work is performed. Whenever the flow of that money down the construction pyramid is interrupted, *additional* financing costs are imposed on those Sub-Contractors who are forced to wait for payment *beyond* the normal invoicing period.

<sup>19</sup> MacEwing, J. Marc, “Navigating the perils of ‘pay when paid’”, *Journal of Commerce*, September 23, 2009

However, the entity that is holding back the monies is enjoying a commensurate financing gain. Either that entity can earn interest on the idle funds or (more likely) it can avoid bank borrowing. *Late payments impose financing costs on those further down the construction pyramid while at the same time providing an unwarranted financing gain to those higher up the pyramid.* This is not only unfair. Late payment practices also impose additional costs on the construction industry and have negative consequences for the economy as a whole. To see how these negative consequences arise, it is important to understand how Contractors respond to the risk of late payment.

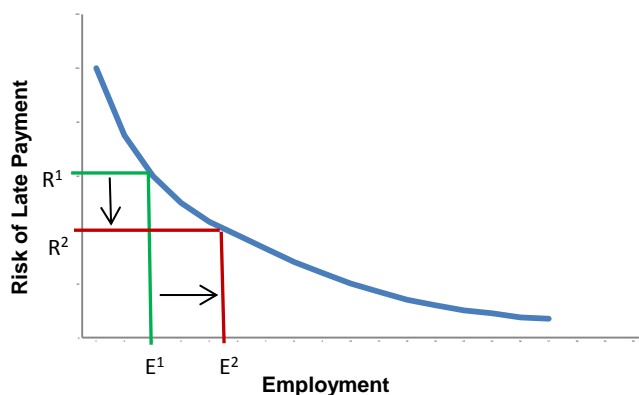
### Managing Late Payment Risk

Managing late payment risk is critically important to the survival of a construction business. There are six ways that Contractors manage the risk of late payment. *All* of these have negative implications for the economy.

#### 1. *Holding Down Payroll Commitments:*

For a given amount of working capital, there is an inverse relationship between the level of payment risk and employment. Figure No. 5 illustrates the inverse relationship between payment risk and employment.

Figure No. 5  
Relationship between Trade Contractors' Risk of Late Payment and Capacity to Carry Employment



In this illustration a reduction of late payment risk from  $R^1$  to  $R^2$  leads to an increase in a Contractor's capacity to take on additional work. This is shown by the movement along the employment line from  $E^1$  and  $E^2$ . Conversely, an increase in the level of late payment risk, as happened over the past several years, *reduces* the amount of work that a Contractor will take on. One of the most important and adverse economic consequences of increased payment risk is that it leads to *less* employment than would otherwise be the case.

#### 2. *Ratcheting Up the Number of 'Independent Operators':*

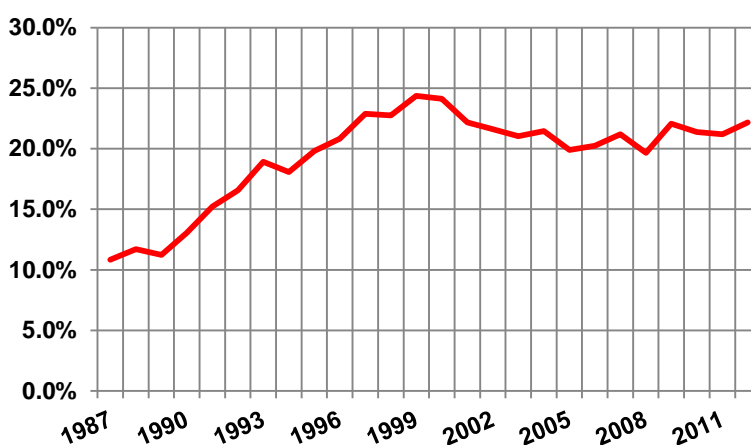
Late payment risk encourages Contractors to restructure their work force to utilize a greater number of 'independent operators'. The reason for this is that 'independent operators' can be treated as sub-contractors for



purposes of off-loading payroll risk.<sup>20</sup> This practice fosters the ‘underground economy’ by eliminating deductions-at-source for income tax, complicating coverage under workers’ compensation and creating ambiguities about whether workers enjoy the protection of labour standards and are entitled to EI benefits.

Figure No. 6 shows the growth of ‘independent operators’ as a share of the construction work force in Ontario. As can be seen, the independent operator share of construction employment is roughly double what it was in the late 1980s.

Figure No. 6  
‘Independent Operators’ as a Percent of Total Employment  
in the Construction Industry  
Ontario, 1987-2012  
(‘Independent Operator = Self-Employed and Not Employing Other Help)  
Statistics Canada, CANSIM Table 282-0012



It is not the argument of this report that payment risk is the sole driver behind the increase in the number of ‘independent operators’. However, the risk management benefit of employing ‘independent operators’ rather than regular employees, will not be lost on a Contractor. Payment risk adds to the other incentives to restructure employment in favour of ‘independent operators’. The implications of this trend for ‘underground practices’ in the construction industry have been described elsewhere.<sup>21</sup> Among the most important of these are evasion of income tax and premiums for workers’ compensation coverage.

### 3. Reducing Investment in Apprenticeship:

New apprentices are a net cost to an employer, at least during the first year of training and sometimes longer. This net cost is the employer’s investment in the apprentice. In most trades, the investment is recouped in the latter

<sup>20</sup> The term ‘independent operator’ originates in workers’ compensation legislation. The term connotes a worker who is self-employed and who does not employ any other workers. It is not relevant to this definition whether the individual is incorporated or unincorporated.

<sup>21</sup> The Ontario Construction Secretariat has published a number of studies that highlight the role of ‘independent operators’ in the growth of the ‘underground economy’. Among these are:

- Ontario Construction Secretariat, *Underground Economy in Construction – It Costs Us All* (July 2010)
- Ontario Construction Secretariat, *Attacking the Underground Economy in the ICI Sector of Ontario's Construction Industry* (April 2004)

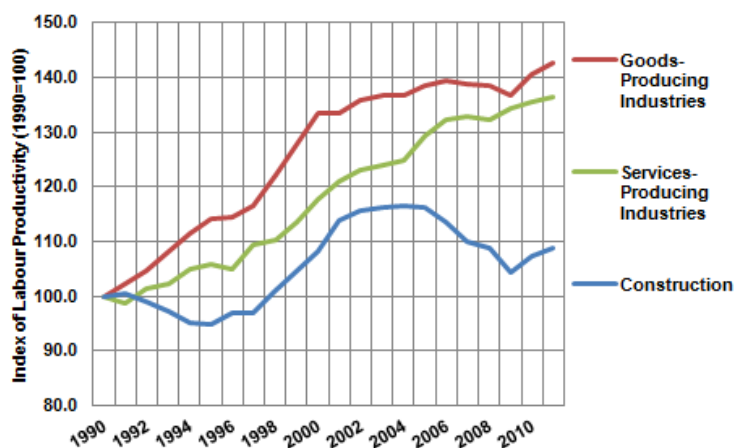
half of the apprenticeship period. Consequently, to benefit from this investment, an employer must plan on retaining an apprentice. Taking on an apprentice therefore entails a long-term employment. The willingness of an employer to take on employment commitment is reduced by an increase in payment risk. This is because an increase in payment risk reduces the willingness of employers to take on long-term, fixed payroll costs.

The construction industry's investment in apprenticeship is important. Roughly 40% of all apprenticeships originate in the construction industry.

#### 4. Reducing Productivity

An increase in payment risk reduces that amount of fixed costs that a Contractor will take on. This implies limiting lease or purchase commitments for new machinery and equipment. The impact of this is to hold down productivity growth. Figure No. 7 shows trends in labour productivity for the construction industry, compared with all goods-producing industries and all services-producing industries.

Figure No. 7  
Index of Labour Productivity – Canada, 1990-2010  
Index: 1990 = 100  
Construction, Goods-Producing Industries and Services-Producing Industries  
Statistics Canada, CANSIM Table 383-0021 (Re-based to 1990)



As can be seen in Figure No. 7, since 1990, labour productivity in both the goods-producing and the services-producing industries increased by approximately 35%. By contrast, labour productivity in the construction industry did not show any similar trend to sustained productivity growth.

#### 5. Factoring Late Payment Risk into Bids

Financing late payments and bearing the risk of late payments entail real, financial costs for both Trade Contractors and General Contractors. This cost was described in a study for the Irish government:

“...bad payment practices in the construction industry can give rise to *substantial additional financing and transaction costs* as well as consuming considerable skilled resources in dealing with disputes over payment that could otherwise be put to productive use.”<sup>22</sup>

Faced with the risk of late payment contractors are obliged to factor into their bids a margin to compensate for this risk, *even when it does not materialize*. This point is emphasized by Hendrickson in *Project Management for Construction*:

“Since contractors do not have large capital assets, they typically do not have large amounts of credit available to cover payment delays. *Contractors are also perceived as credit risks in many cases, so loans often require a premium interest charge*. Contractors faced with large financing problems are likely to *add premiums to bids...*”<sup>23</sup>

A study of sub-contracting in the electrical contracting sector came to the same conclusion though stated its finding in the obverse, namely that when late payment risk is taken off the table, bids are lower than they otherwise would have been:

“...when specialty contractors do not bear the risks associated with the single prime contracting method (*i.e.*, bid shopping and payment delays) *they are willing to lower their bids and forgo the premium they would normally charge...*”<sup>24</sup>

Survey data reported by the *Engineering News Record* support the conclusion that late payment risk is factored into construction costs. When contractors were presented with ‘pay-when-paid’ clauses, 68% reported that they *increased* their bid prices. Half of these indicated that they increased their bid price by *more* than 5%. When trade contractors are unfamiliar with a General Contractor or an Owner/Developer (if they are in a direct contractual relationship), three-quarters report that they increase their bid price, with 40% saying that they do so by 5% to 10%. Fully 90% of survey respondents indicated that they ‘pad’ their bid in circumstances where there is a poor reputation for prompt payment.<sup>25</sup>

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<sup>22</sup> Eire, Government of, “Construction Contracts Bill, 2010: Summary of Regulatory Impact Analysis”, Department of Public Expenditure and Reform, September 2011 [www.per.gov.ie/wp-content/uploads/Regulatory-Impact-Analysis-of-the-Construction-Contract-Bill.pdf](http://www.per.gov.ie/wp-content/uploads/Regulatory-Impact-Analysis-of-the-Construction-Contract-Bill.pdf) [Emphasis added]

<sup>23</sup> Hendrickson, Chris and Tung Au, *Project Management for Construction*, 2<sup>nd</sup> ed., Version 2.2 (1<sup>st</sup> edition published by Prentice Hall) <http://pmbook.ce.cmu.edu/index.html> See Chapter 7. [Emphasis added]

<sup>24</sup> Rojas, Eddy M., *Single vs. Multiple Prime Contracting*, University of Washington for Electric International – Foundation for Electrical Construction Inc. (2007) [Emphasis added.]

<sup>25</sup> Meir, Jonathan, “Procurement Risk-Shifting Contracts Hurt”, *Engineering News Record* – “Viewpoint” web site, posted May 27, 2002. [www.enr.construction.com/opinions/viewPoint/archives/020527.asp](http://www.enr.construction.com/opinions/viewPoint/archives/020527.asp) The survey covered 512 contractors with a 20% response rate. Illustrative ‘pay-when-paid clauses’ used in the survey were taken from standard clauses appearing in contracts issued by the New York City Metropolitan Transit Authority.

In his review of the factors leading to the adoption of prompt payment legislation in the U.S. federal jurisdiction, William Arnold comments that public sector construction costs were higher than necessary because both General Contractors and Trade Contractors were factoring in the financing costs and risk costs of dealing with late payments.<sup>26</sup>

The foregoing discussion leads to a straight forward conclusion: *costs are higher than they need to be even on projects that maintain a prompt payment cycle.* The reason for this is that the risk of late payment causes Contractors to add a margin to their bids to compensate for the *potential* financial costs. A contractor cannot know in advance whether payment will be received in accordance with the invoicing cycle. Consequently, projects that adhere to a prompt payment policy will still have construction costs that are higher than they need be. *In effect, those projects are paying for the poor payment practices on other projects.*

#### 6. Reducing the Bidding Pool:

Contractors also respond to the risk of late payment by declining to submit bids. This can arise for two reasons. The first is that late payment risk reduces the amount of work that a Contractor can take on with a given amount of working capital. A contractor may have the organizational resources to take on additional work, but will be constrained from doing so because their business has hit the limit on the amount of payment risk it can carry. A second and related cause of passing on bidding opportunities may be the reputation of those higher up on the construction pyramid for imposing payment delays. Prudent contractors will demur when presented with the opportunity to bid on such work. Less cautious, and often less diligent contractors, may pursue the work, but usually at a cost to quality and performance. *The result of few bidders is less competition and a tendency to higher construction costs.*

#### 7. Undermining the Level Playing Field:

Competitive neutrality, or a ‘level playing field’, means that no entity enjoys an undeserved advantage or suffers from an unwarranted disadvantage in competing for business. There are both ethical and economic reasons to value competitive neutrality. The ethical case for a ‘level playing field’ is self-evident in any society that values fair play. The economic case is more subtle. Competitive neutrality ensures that resources are allocated to entities that will use them in the most efficient manner. By contrast, a tilted playing field gives preference to entities that secure their competitive advantage by ‘gaming the system’. As described in this report, late payment risks cascades down the construction pyramid. The further down the pyramid a party operates, the greater is that party’s exposure to payment risk. Those at the bottom of the pyramid have little or no capacity to off-load payment risk. Those Owner-Developers and Contractors that abide by prompt payment norms are at a competitive disadvantage compared to those who engage in late payment practices to economize on their financing costs. In the long run, the pressure is on others to engage in the same late payment practices. The ‘level playing field’ is not self-supporting. A ‘level playing field’ requires a statutory framework.

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<sup>26</sup> Arnold, William G., *The Prompt Pay Act Answer Book*, 2009, Management Concepts

Payment risk causes construction businesses to operate in ways that have negative consequences for the economy:

1. Employment is lower because the amount of operational spending that can be supported by a given amount of working capital is reduced when payment risk increases.
2. Off-loading payroll risk by increasing the number of 'independent operators' increases the scope for 'underground practices', notably evading income tax and workers' compensation premiums.
3. Increased payment risk leads to fewer apprenticeships because employers are less willing to make the long-term employment commitments that are required for an investment in apprentice training to be recouped.
4. Increased payment risk leads to avoiding fixed costs and therefore to less investment in new machinery and equipment. In turn, this levers down the long-term productivity trend.
5. Construction costs are higher because contractors must factor into their bids the financing costs and the risk costs associated with late payments.
6. Construction costs are also higher because late payment risk reduces the size of the bidding pool.
7. Late payment practices put competitive pressure on others to adopt the same opportunistic conduct. The result is an erosion of standards and an undermining of the level playing field which is essential for a healthy market.

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## 5. Other Jurisdictions

Prompt payment legislation overrides or restricts the use of contingent payment clauses. In place of those clauses prompt payment legislation introduces a simple model that comprises four elements:

1. a specified invoicing and payment cycle for construction projects,
2. specifying the circumstances in which payment can be delayed and the maximum duration of delay,
3. an obligation to pay interest on late payments, and
4. a right to cease work when payment is not received.

In some jurisdictions, there is also an expedited procedure to resolve performance disputes. Other jurisdictions leave the resolution of performance disputes to private contractual arrangements.

*The majority of comparable jurisdictions outside of Canada have adopted some form of Prompt Payment legislation.* In 49 of the 50 U.S. states and in the federal jurisdiction, Prompt Payment legislation applies to public sector work. In 31 states – including most of the largest states – Prompt Payment legislation also applies to private sector contracts.

In the United Kingdom, Ireland, Australia and New Zealand, Prompt Payment legislation applies to both public and private construction. The European Union has adopted a Prompt Payment directive which applies to *all* commercial transactions (*i.e.*, including non-construction contracts) in both the public and the private sector. Member states in the EU are required to translate this directive into domestic law no later than March of 2013.

### *United States:*

In 1982, the U.S. federal government adopted the *Prompt Payment Act*. The initial version of the *Act* required that the federal government and its agencies pay contractors within 30 days of receipt of a valid invoice. The *Act* also provided for interest on late payments. In 1988 the *Prompt Payment Act* was amended to require General Contractors to pay Sub-Contractors and Sub-Contractors to pay Sub-Sub-Contractors within the same specified time frame. Interest penalties also apply. Both the prompt payment obligations and the interest penalty flow down to all tiers of Sub-Contractors.<sup>27</sup>

The payment cycle set out in the *Prompt Payment Act* is as follows:

- the U.S. government or federal agency is obliged to make a progress payment to the General Contractor no later than 14 days after receipt of a proper invoice. The final payment is due no less than 30 days after receipt of the invoice and final acceptance of the work;

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<sup>27</sup> *Prompt Payment Act*, 31 U.S.C. §§ 3901 *et seq.* - <http://uscode.house.gov/download/pls/31C39.txt>

- the General Contractor is obliged to pay Sub-Contractors no later than 7 days after receipt of a proper invoice and acceptance of the work;
- the 7 day obligation extends down the contracting chain; and
- the interest rate on late payments is prescribed by regulation.

Similar legislation applying to public sector construction has been adopted by *every* state, except New Hampshire. The regulation of private contracts for construction falls within state jurisdiction. *At present, 31 states have legislation requiring General Contractors to pay Sub-Contractors within a specified time.*<sup>28</sup>

#### *United Kingdom:*

A 1994 report on the construction industry commissioned by the U.K. government drew attention to the damage to the industry caused by payment delay. The report recommended that “any attempt by a contractor to include a clause in a bespoke form with the effect of introducing ‘pay-when-paid’ conditions should be explicitly declared unfair and invalid.”<sup>29</sup> Subsequently the government prohibited ‘pay-when-paid’ clauses in sec. 113 of the *Housing Grants, Construction and Regeneration Act, 1996* (commonly known as the ‘*Construction Act*’). Sec. 113 provides that ‘pay-when-paid’ clauses are void, except in conditions of an insolvency. Sect. 114 empowers the Minister to establish by regulation a ‘Scheme for Construction Contracts’ which constitutes a ‘default’ contract. The *Construction Act* applies equally in the public and private sector.

Under the *Construction Act*, if a ‘pay-when-paid’ clause is included in a construction contract, then not only is that clause ineffective, but *all* of the payment provisions in the contract are replaced by the default provisions contained in the “Scheme for Construction Contracts”.<sup>30</sup> The default payment requirement under the “Scheme for Construction Contracts” is seven days. This default applies if the parties to a construction contract are unable to agree on a different payment schedule. The *Construction Act* also provides for an expedited adjudication system to settle performance disputes. The procedure provides for a decision within 28 days or, with the agreement of the referring party, 42 days.

The prompt payment provisions of the original 1996 *Act* were subsequently strengthened by the *Local Democracy, Economic Development and Construction Act 2009, Part 8* (“*Construction Contracts*”).

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<sup>28</sup> The 31 U.S. states with Prompt Payment statutes protecting sub-contractors on private construction projects are: Alabama, Arizona, California, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Montana, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, and Vermont.

<sup>29</sup> Latham, M., *Constructing the Team: Final Report of the Government/Industry Review of Procurement and Contractual Arrangements in the UK Construction Industry* (United Kingdom: Her Majesty’s Stationary Office, 1994) p 84 (part of Recommendation No. 25)

<sup>30</sup> United Kingdom, *Housing Grants, Construction and Regeneration Act, 1996* <http://www.legislation.gov.uk/ukpga/1996/53/contents>

#### *Eire (Republic of Ireland):*

In 1997, the Republic of Ireland adopted the *Prompt Payment of Accounts Act* which requires public agencies to pay their accounts within 45 days. This applies to construction undertaken by the public sector. Interest charges apply to late payments. In the private sector, the predominant view is that the principal cause of late payment in the construction is disputes over performance, sometimes with a meagre basis in fact.

In 2011, the Republic of Ireland adopted the *Construction Contracts Act* which is modelled in key respects on the U.K.'s *Construction Act*. The *Construction Contract Act* applies to both the public sector and the private sector. By incorporating a reference to the European Union's Regulation on Late Payments in Commercial Transactions, the Irish *Act* effectively prohibits 'pay-if-paid' and 'pay-when-paid' clauses. *Per* the E.U. regulation, the payment period is 30 days and late payments are subject to interest charges. Like the U.K. *Act*, the Irish statute also introduces a system of rapid and expedited adjudication to resolve payments delayed on the basis of a dispute over performance. Similarly, like the U.K. *Act*, Ireland's *Construction Contracts Act* empowers the Minister to establish a Schedule of default contract terms that apply in the absence of an agreement between a General Contractor and a Sub-Contractor or between a Sub-Contractor and a Sub-Sub-Contractor.

#### *Australia:*

Prompt payment legislation in Australia operates at both the Commonwealth (*i.e.*, federal) level and at the state level. The process of payment reform began in New South Wales which accounts for approximately one-third of construction activity in Australia. In 1997, the government of New South Wales enacted the *Building and Construction Industry Security of Payment Act 1999*. The *Act* was subsequently amended to close loop-holes in the original version.<sup>31</sup> The New South Wales statute expressly nullifies 'pay-when-paid' clauses. Payments under construction contracts are due within 10 days following the submission of a valid invoice. Interest charges are applicable on late payments. Similar to the U.K. statute, the New South Wales *Act* also provides for an expedited adjudication system to resolve payments withheld on the grounds of performance. Similar statutes were adopted by most other Australian states and by the Commonwealth legislature.

#### *New Zealand:*

In 2002, New Zealand enacted the *Construction Contracts Act, 2002*.<sup>32</sup> The New Zealand *Act* is modelled on the Australian and U.K. bills. The *Construction Contracts Act* voids conditional payments clauses in contracts (*i.e.*, 'pay-if-paid' and 'pay-when-paid') and prohibits contracting out of the *Act*. Payment is due within 20 days of a proper invoice being submitted. The *Act* provides for expedited adjudication of disputes where a payment is withheld for reasons of alleged deficiency in performance.

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<sup>31</sup> New South Wales, *Building and Construction Industry Security of Payment Act 2002*  
<http://www.legislation.nsw.gov.au/maintop/view/inforce/act+46+1999+cd+0+N>

<sup>32</sup> New Zealand enacted the *Construction Contracts Act, 2002* <http://www.nadr.co.uk/articles/published/AdjudicationNewZealand/ConstructionContractsAct2002NZ.pdf>



### *European Union:*

In 2000, the European Union adopted Directive 2000/35/EC on *Combating Late Payment in Commercial Transactions*. The Directive required individual E.U. members to adopt by August of 2002 enabling statutes or regulations consistent with the intent and framework of the E.U. Directive. The E.U. Directive does not set a payment period, but provides for a significant interest charge 30 days after submission of a proper invoice. Unless otherwise specified in an agreement, the applicable interest rate is the European Central Bank's main refinancing rate *plus* 7 percentage points, charged on a daily basis. The E.U. Directive is applicable equally to public and private sector transactions.

In 2011, the E.U. revisited the late payment directive. The interest charges were increased to the reference rate of the relevant central bank plus 8 percentage points. Creditors will also be entitled to obtain from debtors, as a minimum, a fixed sum of EUR 40 as compensation for the creditor's own internal recovery costs, such as the time spent by employees in chasing up late payments. The E.U. Directive establishes payment periods of 30 days for the public sector and 60 days for the private sector. Member states must implement the Directive no later than March of 2013.

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It is apparent from the foregoing discussion that *most jurisdictions in the OECD region have come to the conclusion that the problem of late payments in the construction industry can only be addressed by adopting statutory remedies.*<sup>33</sup> By adopting prompt payment legislation, Ontario will not be breaking new ground. On the contrary, Ontario will be building on more than two decades of diverse experience with legislated norms for prompt payment.

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<sup>33</sup> The OECD region comprises countries that are members of the Paris-based Organization for International Cooperation and Economic Development (OECD). The 34 member states of the OECD are: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Eire (Ireland) Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherland, New Zealand, Norway, Poland, Portugal, Slovak Republic, Sweden, Switzerland, Turkey, United Kingdom, and United States.

## 6. How Prompt Payment Would Work

This chapter summarizes the operation of the proposed *Prompt Payment Act* which is reproduced at Appendix B. Additional explanatory information is provided in Appendices C and D.

The proposed *Prompt Payment Act* reflects an industry consensus and is endorsed by both the National Trade Contractors Coalition of Canada (Ontario) and the Ontario General Contractors Association. Appendix E reproduces a report from the *Daily Commercial News* describing this joint endorsement. Appendix A lists all of the individual Associations that support Prompt Payment Legislation.

The objective of prompt payment legislation is to ensure a predictable flow of funds for satisfactorily performed work on a construction project. Prompt payment legislation imposes the same obligations on all parties in the construction supply chain. Prompt payment therefore benefits General Contractors, Trade Contractors and Suppliers. Additionally, by removing the need to factor the risk of late or uncertain payment into bids, prompt payment will reduce the cost of construction to Owner-Developers.

### *Proposed Scope:*

The proposed *Prompt Payment Act* would apply to all construction work undertaken as a result of a contract, either oral or written, whether in the public sector or the private sector. However, by regulation, certain types of construction work could be excluded from coverage.

The proposed *Act* would bar parties to a construction contract from contracting out of the protections and obligations set out in the *Act*.

### *Entities Defined by the Proposed Act:*

The proposed *Act* defines three ‘actors’ or ‘entities’:

- An Owner,
- A Contractor who enters into a contract for construction work with an Owner,
- A Sub-Contractor who enters into a contract for construction with a Contractor or with another Sub-Contractor.

For purposes of this proposed *Act*, a supplier is deemed to be a Sub-Contractor and therefore has the rights conferred on a Sub-Contractor by the proposed *Act*.

The proposed *Act* establishes payment and other rights for a Contractor vis à vis an Owner and mirrors those payment and other rights for a Sub-Contractor vis à vis a Contractor.

The terms ‘payer’ and ‘payee’ refer respectively to an entity that owes a payment and an entity that is entitled to a payment for work performed or goods and services provided.

*Rights and Obligations Established by the Proposed Act:*

The proposed *Act* establishes the following rights and obligations which supersede any contractual provisions between the parties that provide a payee with lesser rights or establish lesser obligations on the part of a payer:

- a right to receive / obligation to make *progress payments* at a minimum on a monthly basis;
- a right to receive / obligation to make a *final payment* no less than 30 days after application for payment has been made;
- a right to *withhold payment* for work that is deficient or incomplete or which caused loss or damage subject to the limitation that the amount withheld cannot exceed a reasonable estimate of the cost of correcting, completing or remedying;
- a right of a payee to *suspend work and enforce lien rights* if a payer is more than 7 days late, subject to a notice of default being made to the payer that it is in default and notice of this default also being provided to all sub-contractors in contractual relationship with the payee;
- a payee’s *right to information* on the schedule of pertinent due dates for progress payments to a payer and the payer’s receipt of those payments;
- a Contractor and Sub-Contractor’s right to *reasonable financial information* pertinent to the Owner’s financial arrangements to meet its payment obligations;
- a payee’s *right to interest* on late payments;
- *a payer’s right to delay payment* if payment to it has been delayed, subject to that payer taking steps to enforce its lien rights. This right to delay payment expires when these lien rights have expired, the default is corrected or otherwise resolved by agreement.

*Progress and Final Payments:*

The proposed *Act* would require progress payments to be made, at a minimum, on a monthly basis. The amount of progress payments would be the negotiated amount set out in a contract or, in the absence of specified progress payment, an amount commensurate with the value of the construction work performed, taking account of the total value of the contract. Final payments would be due within 30 days of completion of the work.

*Withholding Payment for Unsatisfactory Performance, Direct Loss or Damage:*

Any payment may be withheld, if within 10 days, the payer states in writing the reasons for withholding payment. Those reasons may include deficiencies in the work performed or in the goods supplied, incompleteness, or direct loss or damage. The amount withheld must be commensurate with the approximate cost of correcting or completing the work or remedying the damage or direct loss. The resolution of such disputes would be *per* the contract between the parties. In the event that a statement setting out the reasons for withholding payment is not provided within the required 10 day period, an invoice will be deemed approved and will be fully payable within the specified time.

*Suspending Construction Work for Non-Payment:*

All payees would all have the right to suspend construction work if a default has not been rectified within 7 days after notice has been given of the intention to suspend work for reason of non-payment. If work is subsequently resumed, the payees would be entitled to reasonable remobilization costs.

*Right to Information:*

All payees would have three information rights:

- 1) the right to know the payer's schedule for receipt of the progress payments that are due to it;
- 2) the right to know when the payer has received the progress payments that are to due to it; and
- 3) the right to reasonable information as to the Owner's financial arrangements to meet its payment obligations.

*Interest on Overdue Payments:*

Interest would accumulate on all overdue payments at a rate that is not less than the rate prescribed under the *Courts of Justice Act*.

*Delay Right in the Event of a Default on Payment:*

In the event that one payer fails to make a required payment to another payer, the payer that has not received a payment which is due has the right to delay payments to payees subject to certain conditions. First, the payer that

has not received payment must file notice of default with the delinquent payer. Second, the payer that has not received payment must provide that notice of default to all of its payees. Third, the payer that has not received payment must undertake to the fullest such remedies as are provided under the *Construction Lien Act*. The right to delay payment in the event of a default ends at the earliest of when (1) the default is remedied, (2) a settlement is reached with the defaulting payer, or (3) all lien rights have expired. The right to delay payment in the event of default does not extinguish the obligation to pay interest on late payments to payees.

*Limit on Holdbacks:*

The amount of any holdback on a progress or final payment would be limited to the amounts prescribed by the *Construction Lien Act*.

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The obligations required in the proposed *Prompt Payment Act* substantially mirror the obligations that are set out in the Canadian Construction Association's *Stipulated Price Subcontract, CCA 1- 200*, with the following comparatively modest exceptions:

1. The interest rate on overdue payments is tied to the *Courts of Justice Act* whereas the CCA's *Stipulated Price Subcontract* sets the interest rate at prime + 2% for the first 60 days and prime +4% thereafter.
2. The proposed *Prompt Payment Act* specifies a maximum time period for delay of payment. The maximum permissible period for delaying payment is the *earliest* of: (1) the date of final determination of the payee's lien rights, (2) the date of the expiry of the payee's lien rights, (3) the date on which the default is corrected, or (4) the date on which the default is resolved.
3. The time allowed for an Owner to rectify a default before work is suspended is 7 days in the proposed *Act*, whereas the CCA's *Stipulated Price Subcontract* leaves this to whatever provisions apply in the contract between the Owner and the General Contractor.
4. Sub-Contractors to a General Contractor are entitled to obtain, if they request, information as to the agreed time schedule of progress payments by the Owner to the General Contractor.
5. All Sub-Contractors are entitled to be informed as to the financial arrangements of the Owner to meet its payment obligations.

It is important to stress, therefore, that the proposed *Prompt Payment Act* does not significantly alter the Canadian Construction Association's recommended terms of agreement between General Contractors and Sub-Contractors. What the proposed *Prompt Payment Act* would do is require all Contractors (whether General Contractors or Trade Contractors) to abide by the principles recommended by the Canadian Construction Association and applied by many, though not all, General Contractors and Trade Contractors. In other words, the proposed *Prompt Payment Act* would level the playing field by ensuring that General Contractors and Trade Contractors that operate with integrity and due regard for their Sub-Contractors are not placed at a competitive disadvantage by the opportunism of the minority who may use an imbalance of bargaining power to impose inferior payment terms on Sub-Contractors.

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## 7. Prompt Payment and Ontario's Strategy for Renewed Growth

The current payment system in the construction industry is seriously flawed. As a result of these flaws, employment in the construction industry is lower, investment in apprenticeship is reduced, costs are higher, productivity is diminished, and the principle of a level playing field is undermined. Quite simply, the *status quo* is not working:

- The *status quo* unfairly burdens the many thousands of Trade Contractors who perform most of the construction in this province and who employ the overwhelming majority of construction workers.
- The *status quo* is flawed from the perspective of General Contractors who also support the enactment of prompt payment legislation and who would also benefit from curtailing late payment risk.
- The *status quo* adversely impacts the suppliers of materials and equipment who risk late or defaulted payment when the Contractor to whom they supplied materials or equipment is not paid.
- The *status quo* should not be acceptable to the provincial government which sees less employment and training than would otherwise be achieved, less investment in productivity-enhancing machinery and equipment, and higher costs on its own construction work as well as on privately financed projects.
- Equally, the *status quo* cannot be acceptable to the many hundreds of Owner-Developers in both the public and private sectors who adhere to prompt payment norms, but who nevertheless pay construction costs that factor in the risk of payment delay because of the opportunistic conduct of others.

*Ontario needs to follow the example of other jurisdictions in the United States, Europe and Australia by adopting statutory norms to govern the payment process in the construction industry.*

Ontario should make the enactment of prompt pay legislation for the construction industry an integral part of the province's strategy for renewed growth.

While the majority of the industry favours prompt payment, it will never be feasible to achieve unanimous, voluntary adherence. The opportunism of the minority will drive the entire industry's practices down. *Left to its own devices the construction industry will not abandon the use of contingent payment clauses.* In the absence of prompt payment legislation, the situation will worsen, rather than improve.

### *The Case for Prompt Payment Legislation in Ontario:*

1. Prompt payment legislation will ensure a level playing field.

A great many Contractors and Owner-Developers adhere to prompt payment policies. Yet they nonetheless must pay bid costs that factor in a risk of late payment. The opportunistic business conduct of the minority shapes the cost environment of the majority.

2. Prompt payment legislation will increase employment in the construction industry.

Contractors must meet weekly payrolls as well as pay promptly for materials and meet their obligations to CRA and the workers' compensation system. As a result, Contractors depend on cash-flow. The risk that cash-flow will be interrupted limits the amount of payroll risk that a Contractor can take on. A reduction in late payment risk will increase the capacity of Contractors to take on a larger volume of work and thereby increase employment in the construction industry.

3. Prompt payment legislation will increase the construction industry's investment in apprenticeship.

Employers recoup their investment in apprenticeship training during the latter half of the apprenticeship period. Consequently, taking on an apprentice entails a long-term commitment. The willingness of a Contractor to make that commitment is reduced when payment risk increases. Conversely a reduction in payment risk will encourage more contractors to make apprenticeship investments. Roughly 40% of all apprentices are trained by the construction industry. Reducing payment risk in the construction industry will directly encourage an increase in the number of apprentices, to the benefit of both the construction industry and the overall economy.

4. Prompt payment legislation will increase investment in productivity-enhancing machinery and equipment.

The risk of late or uncertain payment limits the amount of overhead that a Contractor can take on. Part of this overhead is the cost of leasing or purchasing machinery and equipment. A reduction in payment risk means that Contractors will be more willing to take on the additional overhead associated with increased investment in machinery and equipment. This, in turn, will increase productivity in the construction industry.

5. Prompt payment legislation will reduce construction costs.

Prompt payment legislation will remove the need for Contractors to 'factor in' compensation for payment risk. The result will be lower bids.

6. Prompt payment legislation will increase the size of the bidding pool.

Payment risk limits the amount of work that Contractors can undertake with a given amount of working capital. By reducing payment risk, prompt payment legislation will enable more contractors to bid on more



work. This will make the industry more competitive to the benefit of both private and public sector Owner-Developers.

7. Prompt payment legislation will remove one of the incentives to replace hourly-paid workers with 'independent operators' and by so doing will curtail a major driver of underground practices in the construction industry.

Payment risk encourages contractors to off-load their payroll risk by replacing regular workers with self-employed 'independent operators'. This practice fosters the 'underground economy' by eliminating deductions-at-source.

8. Prompt payment legislation will make the construction industry less litigious.

The current payment system invites conflict over performance by rewarding delay. The only remedy open to a Contractor is a lien action. Prompt payment legislation will remove the incentive to delay payment and thereby eliminate a major source of payment conflict in the construction industry.

9. Prompt payment legislation will ensure that public monies spent on construction are used as they were intended to be used, namely to remunerate the people who did the work.

Taxpayer money should not go to Contractors who attest to the progress on a project to support a claim for payment and then hold back those funds from the other Contractors who actually performed the work. Especially on public projects, government has a duty to ensure monies that are used as they are intended to be used.

10. Prompt payment legislation will make the system of competitive tendering both fairer and more efficient and thereby ensure that its benefits are widely shared.

In almost every area of construction, there are a large number of Contractors competing for work that is put out to tender. This process ensures high quality construction at the lowest cost. However, competitive tendering also enables some in the industry to require contingent payment clauses in their contracts which then enables them to engage in late payment practices for which there is no effective remedy. This is the downside in a system of competitive tendering that has otherwise served Ontario well. Prompt payment legislation will correct the late payment problem without diminishing any of the advantages that arise from the system of competitive tendering.

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# Appendices

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- A: Associations supporting Prompt Payment Legislation in Ontario**
- B: Proposed *Prompt Payment Act***
- C: Summary of Key Points in Proposed *Prompt Payment Act***
- D: High-Level Summary of Key Principles in Proposed *Prompt Payment Act***
- E: *Daily Commercial News*, “Ontario Prompt Payment Blueprint Reached” (February 19, 2013)**

## **Associations Endorsing the Adoption of Prompt Payment Legislation in Ontario (April 16, 2013)**

### **National Trade Contractors Coalition of Canada (Ontario)**

- **Mechanical Contractors Association of Canada**
- **Canadian Electrical Contractors Association**
- **Canadian Masonry Contractors Association**
- **Canadian Automatic Sprinkler Association**
- **Canadian Roofing Contractors Association**
- **Contractors Division of the Heating, Refrigeration and Air Conditioning Contractors of Canada**
- **Ontario Sheet Metal Contractors Association**
- **Thermal Insulation Association of Canada**
- **Interior Systems Contractors Association**
- **Canadian Institute of Steel Construction**
- **Canadian Precast/Prestressed Concrete Institute**

### **Ontario General Contractors Association**

### **Mechanical Contractors Association of Ontario**

### **Council of Ontario Construction Associations**

- **Acoustical Association Ontario**
- **Architectural Glass & Metal Contractors Association**

- Association of Millwrighting Contractors of Ontario
- Barrie Construction Association
- Canadian Farm Builders Association
- Construction Association of Thunder Bay
- Electrical Contractors Association of Ontario
- Grand Valley Construction Association
- Hamilton-Halton Construction Association
- Interior Systems Contractors Association of Ontario
- London & District Construction Association
- Merit OpenShop Contractors Association of Ontario
- Ontario Association of Demolition Contractors
- Ontario Industrial Roofing Contractors Association
- Ontario Masonry Contractors' Association
- Ontario Painting Contractors Association
- Pipe Line Contractors Association of Canada
- Progressive Contractors Association of Canada
- Reinforcing Steel Institute of Ontario
- Resilient Flooring Contractors Association
- Sarnia Construction Association
- Sault Ste. Marie Construction Association
- Sudbury Construction Association
- Terrazzo, Tile & Marble Guild of Ontario
- Toronto & Area Road Builders Association
- Toronto Construction Association
- Utility Contractors' Association of Ontario
- Windsor Construction Association

### **Proposed** ***Prompt Payment Act***

# **AN ACT RESPECTING THE PROTECTION AND VIABILITY OF CONSTRUCTION CONTRACTORS**

**[Consensus Draft 3]**

## **PREAMBLE**

People of Ontario and their Government:

Recognize the importance of the construction industry to the financial health of the Province of Ontario;

Recognize the contribution to that industry made by contractors and subcontractors;

Believe that contractors and subcontractors are particularly vulnerable as they must carry substantial upfront costs, including equipment, materials and employee salaries;

Recognize that carrying these costs have an obvious impact on all areas of a contractor's and subcontractor's business when payment is not forthcoming within a reasonable timeframe;

Recognize that payment for goods or services delivered in a prompt and efficient manner is necessary to ensure the success of contractors and subcontractors who operate important small businesses in the Province of Ontario; and

Believe it is important to facilitate regular and timely payments between the parties to a construction contract.

## **DEFINITIONS**

1. In this Act,

**“change” or “changes”** means any variation to a construction contract which varies the price or the method of calculation of the price, adds to or deletes from the amount of construction work supplied or to be supplied, varies the method of performance, or varies the schedule for performance of construction work.

**“construction contract”** means a contract or agreement made between an owner or an agent of the owner, and a contractor, or a contract or agreement between a contractor and a subcontractor, or a contract or agreement between a subcontractor and another subcontractor, under any of which one party undertakes with the other party to provide construction work in connection with an improvement;

**“construction work”** means the supply of labour, services and materials, or any combination thereof, in connection with an improvement;

**“contractor”** means any person performing construction work under a construction contract with the owner or an agent of the owner, and may include a material supplier;

**“Crown”** includes a Crown agency to which the *Crown Agency Act* applies;

**“day”** or **“days”** means calendar day or calendar days, as the context requires;

**“final payment”** means the payment to which a person is entitled under sections 5 or 6 of this Act, and includes payment or credit for any change. Any single or one-time payment for carrying out construction work under a construction contract shall be deemed to be a final payment;

**“holdback”** means the holdback prescribed by Part IV of the Construction Lien Act;

**“improvement”** means, in respect of any land,

- (a) any alteration, addition or repair to the land;
- (b) any construction, alteration, repair, restoration, maintenance, erection or installation on the land, including any temporary work, and also including the installation of industrial, mechanical, electrical or other equipment on the land or on any building, structure or works on the land that is essential to the normal or intended use of the land, building, structure or works; or
- (c) the complete or partial demolition or removal of any building, structure or works on the land;

**“material supplier”** means a contractor or subcontractor who supplies every kind of movable property,

- (a) that becomes, or is intended to become, part of the improvement, or that is used directly in the making of the improvement, or that is used to facilitate directly the making of the improvement;  
or
- (b) that is equipment rented without an operator for use in the making of the improvement;

**“owner”** means any person, including the Crown, having an interest in real property at whose request and,

- (a) upon whose credit, or
- (b) on whose behalf, or
- (c) with whose privity or consent, or
- (d) for whose direct benefit,

an improvement is made to the real property.

**“payee”** means any contractor or subcontractor entitled to receive payments directly from a payer under a construction contract;

**“payer”** means any owner, contractor or subcontractor obligated to make payments directly to a payee under a construction contract;

**“payment application”** means any invoice, bill or other request for periodic payment, payment upon any change, final payment or release of holdback in relation to and in accordance with the terms of the applicable construction contract;

**“payment certifier”** means the person or entity identified in a construction contract responsible for the issuance of certificates for payment;

**“progress payment”** means a payment to which a person is entitled under sections 5 or 6 of this Act, and includes payment or credit for any change;

**“regulations”** means regulations made under this Act;

**“reasonable evidence of financial arrangements”** means evidence reasonably and accurately verifying the owner’s ability to perform its financial obligations under a contract, and may include, as the circumstances require, commitment letters or credit agreements from lenders, bank verification letters, financial statements and verification of budgetary allocations or commitments.

**“subcontractor”** means any person performing construction work under a construction contract with a contractor or with another subcontractor, but not with the owner, and may include a material supplier;

**“temporary work”** means temporary supports, structures, facilities, services and other temporary items required for the execution of an improvement but not incorporated into the improvement.

## **APPLICATION**

2. This Act applies to every construction contract entered into for construction work undertaken in Ontario after the effective date of this Act irrespective of whether or not the governing law of the contract is expressed as being the law of Ontario.

## **EXCLUSIONS**

3. This Act does not apply to:

(a) a construction contract under which a party undertakes to carry out construction work as an employee of the party for whom the work is to be carried out; and



(b) any construction contract or class of construction contracts prescribed by the regulations for the purposes of this section.

#### **NO CONTRACTING OUT**

4. Any agreement by any person that this Act, or any portion thereof, does not apply to the person or that the remedies provided by it are not available for the benefit of the person is void.

#### **OBLIGATION TO PAY CONTRACTOR**

5. (a) The owner shall pay to a contractor progress payments and final payment for construction work in accordance with the terms of the construction contract between them on the dates provided for such payments in the construction contract, but no less frequently than monthly.

(b) Should no date for progress payments be provided in the construction contract, progress payments shall be made monthly. The contractor shall submit a payment application dated the last day of the first and each subsequent month, and each payment application shall claim for the value of construction work performed as at the date of the application. Payment upon each such payment application shall be made on or before 20 days following the later of the receipt by the owner, or the payment certifier on behalf of the owner, of the payment application or the last day of the monthly payment period for which the payment application is made.

(c) Should no date for final payment be provided in the construction contract, final payment shall be made 5 days following the issuance of any certificate for final payment issued by the payment certifier, or if there is no payment certifier or the payment certifier fails without sufficient cause to issue a certificate for final payment within 10 days of a request to do so, within 15 days after submission of the payment application for final payment.

(d) Notwithstanding subsections (b) and (c) hereof, if any progress payment or final payment includes payment of any holdback prescribed by the *Construction Lien Act*, such payment of holdback shall only be made one day after the expiration of the holdback period prescribed by the *Construction Lien Act*, provided that there are no preserved or perfected liens then registered on title to the lands and premises upon which the improvement was undertaken under which claims against the holdback may be made.

#### **OBLIGATION TO PAY SUBCONTRACTOR**

6. (a) A contractor shall pay to the subcontractor, and a subcontractor shall pay to another subcontractor, progress payments and final payment for construction work in accordance with the terms of the construction contract between them on the dates provided for such payments in the construction contract, but no less frequently than monthly.

(b) Should no date for progress payments be provided in the construction contract, progress payments shall be made monthly. The subcontractor shall submit a payment application dated the 25th day of the first and each subsequent month, and each payment application shall claim for the value of construction work performed as at the date of the application. Payment upon each such payment application shall be made on or before 30 days following the receipt of the payment application, or 10 days after the date of a certificate for such payment issued by the payment certifier, whichever is the later.

(c) Should no date for final payment be provided in the construction contract, final payment shall be made on or before 30 days following the receipt of the final payment application, or 10 days after the date of a certificate for payment issued by the payment certifier, whichever is the later.

(d) Notwithstanding subsections (b) and (c) hereof, if any progress payment or final payment includes payment of any holdback prescribed by the *Construction Lien Act*, such payment of holdback shall only be made one day after the expiration of the holdback period prescribed by the *Construction Lien Act*, provided that there are no preserved or perfected liens then registered on title to the lands and premises upon which the improvement was undertaken under which claims against the holdback may be made.

#### **AMOUNT OF PROGRESS PAYMENT**

7. The amount of the progress payment to which a person is entitled under a construction contract shall be:

(a) the amount provided for payment for construction work under the construction contract, including the payment or credit provided for any changes; or

(b) if the construction contract does not provide for payment of a specified amount, the actual value of the construction work performed, or related goods or services supplied, immediately prior to the date of payment for the particular payment period, relative to the value of the entire construction contract including the actual value of all changes.

#### **DEEMED APPROVAL OF PAYMENT APPLICATION**

8. (a) A payment application shall be deemed approved or certified for payment unless the party liable for payment, or the payment certifier on its behalf, within 10 days after receipt, provides a written statement to the party delivering such payment application describing the reasons for any disapproval or amendment of such payment application.

(b) Receipt of the payment application by the payment certifier or agent of the owner shall be deemed to be sufficient for the purposes of establishing the date of receipt under subsection (a) hereof.

(c) The written statement prescribed by subsection (a) hereof shall contain full particulars of the reasons for any disapproval or amendment of such payment application, including relevant provisions of the construction

contract being relied upon, and shall further contain a statement of the amount of such payment application for which payment is disapproved or amended.

- (d) The portion of any payment application for which payment is disapproved or amended,
  - (i) shall be limited to a reasonable estimate of the direct loss, damage or cost of completion or correction of construction work for which payment is being disapproved or amended and which direct loss, damage or cost of completion or correction of construction work is otherwise recoverable under the construction contract; and
  - (ii) to the extent the disapproval of a payment application, or portion thereof, is limited to the valuation or method of valuation of any change, shall be further limited to the reasonable estimate of only such portion of the value of such change as is in dispute.
- (e) Provided the party liable for payment provides the written statement as provided in subsection (a) hereof, that party may only withhold such amount from the progress payment as may represent the reasonable value of the disputed portion of the construction work.
- (f) Payment shall be made upon any payment application:
  - (i) in respect of which the written statement prescribed by this section 8 is not given, or is not given in accordance with the provisions of this section 8; and
  - (ii) for the amount of any payment application for which payment is not disapproved or amended, as verified by the statement prescribed in subsection (c) hereof.

#### **RIGHT TO SUSPEND PAYMENT**

9. In the event a payer fails to make payment to a payee as prescribed by this Act:
- (a) written notice of default shall immediately be provided as follows:
    - (i) if the payee is a contractor, the contractor shall provide written notice of default to the owner, and shall provide a copy of such written notice of default to all subcontractors with whom the contractor has entered into a construction contract for that portion of the improvement under which subcontract payments are due or will become due;
    - (ii) if the payee is a subcontractor, the payee shall provide written notice of default to the payer, and a copy of such written notice of default shall be given to the owner, to all subcontractors with whom the payee has entered into a construction contract for that portion of the improvement under which subcontract payments are due or will become due, and provided the payer is not otherwise the contractor, to the contractor;

(b) should the payer not remedy the default within the time prescribed in the contract between the payer and the payee, or if such contract does not provide for a time to remedy the default, within 7 days of the date of delivery of the written notice of default, the payee may suspend performance of construction work and may also take such steps as are required to enforce the lien rights of the payee under the *Construction Lien Act*. If the payee suspends performance or takes steps to enforce lien rights, the payee shall provide to those persons to whom the payee provided the written notice stipulated by subsection (a) hereof a written notice of all such steps taken to enforce payment;

(c) provided the written notice of default has been given in accordance with subsection (a) hereof and provided the written notice of steps taken to enforce payment has been given in accordance with subsection (b) hereof, the time for payment prescribed by this Act to which the payee who provided such written notices is otherwise subject shall be extended to the earlier of:

- (i) the date of final determination of the lien rights of such payee;
- (ii) the date of expiry of the lien rights of such payee;
- (iii) the date on which the default which is the subject of the written notice of default prescribed by subsection (a) hereof is corrected; or
- (iv) the date on which the default which is the subject of the written notice of default prescribed by subsection (a) hereof is resolved by settlement or agreement.

and the amount of payment so suspended shall be then deemed payable as a progress payment or a final payment pursuant to this Act; and

(d) notwithstanding any suspension of the obligation to make payment under any subcontract, the contractor or subcontractor whose payment obligation is suspended shall be obliged to pay interest on the amount of payment so suspended from the date the payment was due but for the suspension to the date the payment finally becomes due pursuant to subsection (c) hereof, at the rate of interest prescribed in section 10.

## **INTEREST ON OVERDUE PAYMENTS**

10. Interest is payable on the unpaid amount of any progress payment or final payment that becomes due and payable in accordance with this Act, calculated at the rate prescribed by the *Courts of Justice Act* for prejudgment interest, or at the rate prescribed by the construction contract, whichever is the greater.

## **RIGHT TO SUSPEND CONSTRUCTION WORK AND TERMINATE A CONSTRUCTION CONTRACT UPON NON-PAYMENT**

11. (a) If a contractor or subcontractor undertaking construction work does not receive payment to which such person is otherwise entitled pursuant to this Act, that contractor or subcontractor may suspend performance of construction work or terminate the construction contract, in accordance with the provisions of the construction contract.
- (b) Should the construction contract contain no provisions for, or prohibit, the suspension of performance of construction work or termination of the contract for failure to make payments, the contractor or subcontractor who does not receive payment to which such person is otherwise entitled pursuant to this Act may, notwithstanding such construction contract, suspend performance or terminate the construction contract in accordance with the provisions of subsections (c) to (f) inclusive of this section 11.
- (c) No suspension of construction work or termination of the construction contract pursuant to subsection (b) hereof shall be effective unless the contractor or subcontractor intending to suspend or terminate,
- (i) provides written notice to its payer of such intention to suspend construction work or terminate the construction contract, which written notice shall provide that if the default is not corrected within 7 days following receipt of such written notice, the contractor or subcontractor shall suspend construction work or terminate the construction contract; and
  - (ii) the party receiving such notice fails to correct the default within such 7 days following receipt of notice.
- (d) Without affecting any right to receive any payment otherwise due upon the construction contract, a construction contract upon which construction work has been suspended in accordance with the provisions of subsection (b) hereof may be terminated following 7 days written notice of termination provided by the contractor or subcontractor to its payer.
- (e) No suspension or termination in accordance with the provisions of subsection (b) hereof shall be deemed to be a breach of the construction contract.
- (f) Upon any resumption of construction work following a suspension thereof in accordance with subsection (b) hereof, the party resuming construction work shall be entitled to the payment of reasonable remobilization costs, in addition to such other amounts to which such party is otherwise entitled under the construction contract or under this Act.
- (g) The rights and remedies prescribed by this section 11 shall in addition to those rights and remedies prescribed by section 9.

## **RIGHTS TO INFORMATION**

12. (a) The owner, before entering into a construction contract, shall provide to the contractor reasonable evidence of financial arrangements to fulfill the owner's obligations under the construction contract.

(b) The owner shall further provide such updated reasonable evidence of financial arrangements at any time after entering a construction contract, forthwith upon written request of the contractor.

(c) Upon receipt from the owner of the reasonable evidence of financial arrangements provided under subsection (a) hereof, and upon receipt of any updated reasonable evidence of financial arrangements obtained upon written request pursuant to subsection (b) hereof, the contractor shall provide a copy thereof to any subcontractor forthwith upon written request of such subcontractor. .

(d) All reasonable evidence of financial arrangements required by this section 12 shall be provided by the owner and received by the contractor, and copies thereof shall be provided by the contractor and received by any subcontractor, in strict confidence, solely for the use by the contractor and any subcontractor to satisfy themselves as to the ability of the owner to fulfill the owner's financial obligations under the contract, and for no other purpose whatsoever.

(e) A subcontractor may, at any time, by written request, require its payer under a construction contract to disclose the due dates for payment of progress payments and final payment to such payer under a construction contract.

(f) Every payer under a construction contract shall provide notification to its payees of the date or dates of all monies or payments received by such payer on account of the construction work.

(g) The notification of payment received stipulated in subparagraph (f) hereof shall be made forthwith upon receipt of payment, and may be made in writing, posting on a website, or in any other manner as will reasonably allow access to such payees to the information contained in such notification.

(h) If the owner or contractor, as the case may be, fails or refuses to comply with the obligations prescribed in subsections (a) or (c) hereof, or if the payer fails or refuses to comply with the obligations in subsection (e), (f) or (g) hereof, or if any person knowingly or negligently mis-states the information provided, such person shall be liable to the person entitled to receive such information for any damages sustained by reason thereof.

(i) Upon application, the court may at any time order a person to comply with the obligations prescribed in subsections (b), (c), (e), (f) and (g) hereof, and, when making the order, the court may make any order as to costs as it considers appropriate, including an order for costs on a substantial indemnity basis.

(j) If a person receiving the reasonable evidence of financial arrangements stipulated herein fails or refuses to comply with the obligations of confidentiality stipulated in subsection (c) hereof, such person shall be liable to the owner for any damages sustained by reason thereof, and in addition the owner shall be entitled to injunctive relief upon such terms as the court considers just in order to remedy the consequences of any such breach of confidentiality.

#### **LIMITATION ON HOLDBACKS**

13. No construction contract shall provide any right to maintain any holdback or other withholding of funds other than such holdbacks as are prescribed by the *Construction Lien Act*.

#### **ACT BINDS CROWN**

14. This Act binds the Crown.

#### **REGULATIONS**

15. The Lieutenant Governor in Council may make regulations under this Act.

#### **COMMENCEMENT**

16. This Act comes into force on the day it receives Royal Assent.

#### **SHORT TITLE**

17. The short title of this Act is the Prompt Payment Act.

### **Summary of Key Points in Proposed *Prompt Payment Act***

***Prepared by  
Geza Banfai,  
Heenan Blaikie***



## **An Act Respecting the Protection and Viability of Construction Contractors**

### Generally

- This Act is intended to apply essentially to every construction contract entered into for construction work undertaken in Ontario whether or not the governing law of the contract is expressed as being the law of Ontario.
- It does not apply to construction contracts where one party is an employee of the other party, or where a Regulation exempts any construction contract or class of construction contracts.
- Contracting out of the operation of the Act is prohibited.

### The Payment Obligation: Generally

- The default rule is that owners, contractors and subcontractors are obligated to make payments under their respective construction contracts in accordance with the terms of those contracts, provided that payments be made no less frequently than monthly.

### The Payment Obligation: If Not Covered by the Contract

- If the construction contract between owner and contractor does not provide a date when progress payments are to be made, payment shall be made monthly. Payments are due on or before 20 days following the later of the receipt of a payment application or the last day of the monthly payment period for which application is made.
- If the construction contract between contractor and subcontractor, or between two subcontractors, does not provide a date when progress payments are to be made, payments are also required monthly. The subcontractor must submit a payment application dated the 25th day of the month, claiming for the value of construction work performed as at the date of the application. Payment shall be made 30 days following the receipt of the payment application, or 10 days after the date of a certificate for such payment issued by the payment certifier, whichever is the later.
- If the construction contract between owner and contractor does not provide a date for final payment, final payment shall be made 5 days following the issuance of any certificate for final payment. If there is no payment certifier or the payment certifier fails without sufficient cause to issue a certificate for final payment within 10 days of a request to do so, final payment shall be made within 15 days after submission of the payment application for final payment.
- If the construction contract between contractor and subcontractor, or between two subcontractors, does not provide a date for final payment, final payment shall be made on or before 30 days following the receipt of the final payment application, or 10 days after the date of a certificate for payment issued by the payment certifier, whichever is the later.

- Payments of lien holdbacks are due one day after the expiration of the holdback period prescribed, provided there are no liens

#### How Much Is To Be Paid

- The default rule is that amount of the progress payment to which a person is entitled is the amount provided for under the construction contract.
- If the construction contract does not provide for payment of a specified amount, the payee is entitled to the actual value of the work performed immediately prior to the date of payment for the particular payment period, relative to the value of the entire construction contract including changes.

#### Deemed Approval of Payment Applications

- Payment applications are deemed approved unless the party liable for payment takes the affirmative step of providing a written statement to the payee describing the reasons for any disapproval or amendment of such payment application within 10 days.
- Any such written statement must contain full particulars of the reasons for any disapproval or amendment of a payment application, including relevant provisions of the construction contract being relied upon, and must further state the amount for which payment is disapproved or amended.
- The portion of any payment application for which payment is disapproved or amended must be limited to a reasonable estimate of the direct loss, damage or cost of completion or correction of construction work for which payment is being disapproved or amended and which direct loss, damage or cost of completion or correction of construction work is otherwise recoverable under the construction contract.
- Provided the payer provides the written statement aforementioned, that payer may only withhold such amount from the progress payment as may represent the reasonable value of the disputed portion of the construction work. Undisputed amounts shall be paid in any event.

#### Obligations in the Event of Non-Payment

- If a payer fails to make payment as prescribed by the Act, written notice of default must immediately be provided in the manner prescribed. If there is a cure period in the contract, the defaulting payer can remedy within that time, otherwise the default must be remedied with 7 days.
- If the payment default is not remedied, the payee may suspend performance of work and may also lien.
- If the payee suspends performance or liens, that payee's own payment obligations to its payees are extended to the earlier of four events: the date of final determination of lien rights; the date of expiry of lien rights; the date on which the default is corrected; or, the date on which the default is settled.
- Notwithstanding the suspension of the obligation to make payment, there remains the obligation to pay interest on the amount of payment so suspended.

### Interest on Overdue Payments

- Interest is payable on any unpaid progress or final payment at the rate prescribed by the Courts of Justice Act for prejudgment interest, or at the rate prescribed by the construction contract, whichever is the greater.

### Right to Suspend Construction Work and Terminate a Construction Contract Upon Non-Payment

- There is a general right of a contractor or subcontractor who does not receive payment to suspend performance or terminate the construction contract, in accordance with the provisions of the construction contract.
- If the construction contract is silent, or if it prohibits suspension or termination, the contractor or subcontractor who does not receive payment may still suspend performance or terminate the contract.
- 7 days' written notice of an intention to suspend work or terminate the contract must be given in order to exercise this right.
- No suspension or termination in accordance with the legislation hereof shall be deemed to be a breach of the construction contract.
- If work resumes following a suspension, the party resuming work is entitled to reasonable remobilization costs, in addition to such other amounts to which such party is otherwise entitled.

### Rights to Information: Owner's Ability to Pay

- The owner must provide the contractor with reasonable evidence of financial arrangements to fulfill the owner's obligations under the construction contract before entering into a construction contract. The owner must also update this information at any time after entering into a construction contract upon written request of the contractor. The contractor must pass this information along to any subcontractor forthwith upon written request of such subcontractor.
- This evidence of financial arrangements is provided in strict confidence, solely for the use by the contractor and any subcontractor to satisfy themselves as to the ability of the owner to fulfill the owner's financial obligations under the contract and for no other purpose whatsoever.

### Rights to Information: Due Dates for Payment

- A subcontractor may require its payer to disclose the due dates for payment of progress payments and final payment to such payer.

### Rights to Information: Payments Received

- Every payer under a construction contract must provide notification to its payees of the dates of payment received by such payer on account of the construction work.

- This notification of payment received must be made forthwith upon receipt of payment, and may be made in writing, posting on a website, or in any other manner as will reasonably allow access to such payees to the information contained in such notification.

#### Liabilities for Failure to Provide Information or for Providing Mis-stated Information

- If anyone with the obligation to provide the information aforementioned fails or refuses to comply with that obligation, or if any person knowingly or negligently mis-states the information provided, such person shall be liable to the person entitled to receive such information for any damages sustained.
- The court may at any time order a person to comply with the obligations set out above, with power to make any order as to costs as it considers appropriate, including an order for costs on a substantial indemnity basis.
- If a person receiving the reasonable evidence of financial arrangements fails or refuses to comply with the obligations of confidentiality, such person shall be liable to the owner for any damages sustained, and the owner shall be entitled to injunctive relief upon such terms as the court considers just in order to remedy the consequences of any such breach of confidentiality.

#### Limitation on Holdbacks

- No holdbacks other than those prescribed by the Construction Lien Act are permissible.

### **FAQ on the Proposed *Prompt Payment Act***

***Prepared by  
Geza Banfai,  
Heenan Blaikie***

# Proposed Ontario Prompt Payment Legislation

## Questions and Answers

### **1. Does the proposed legislation apply to both public sector projects and private sector projects?**

Yes. The proposed legislation applies to every construction contract entered into in Ontario, and applies to all owners, both private sector and the Crown, including Crown agencies.

### **2. We have the Ontario Construction Lien Act. How does prompt payment legislation differ?**

At the core, the proposed legislation prescribes certain *obligations to make payment* in timely fashion, and provides for certain rights if payment is not made.

On the other hand, the Construction Lien Act (CLA) prescribes a system for *securing those payment obligations* by means of lien rights and a holdback scheme. The CLA also prescribes a system of trusts, intended to ensure that money earmarked for a project is actually applied to that project and not diverted out of the project stream of funds.

The proposed legislation is intended to work in tandem with the CLA.

Both the CLA and the proposed legislation provide for certain rights to information. The proposed legislation expands those information rights in various ways, including an obligation on the part of owners to inform contractors concerning their ability to honour their financial obligations under the construction contract, and an obligation on the part of payers to notify payees concerning payments received from upstream in the contractual chain.

### **3. If a General Contractor (GC) does not get paid by an owner, what are the procedures the GC must follow?**

This question pertains to the procedures the GC must follow in order to get a deferral of the GC's payment obligation until such time as the payment issue between the GC and the owner is resolved.

Under the proposed legislation, the GC who does not get paid by the owner effectively has a choice: continue to pay its subs as due under its subcontract agreements, or defer those payments until the payment problem with the owner is dealt with.

To invoke the right to defer payment, the GC must do the following:

1. provide written notice of default to the owner, with a copy to all subcontractors involved in that portion of the work affected by the non-payment;
2. suspend performance of work and/or enforce the GC's lien rights; and
3. provide written notice of such suspension and/or enforcement of lien rights to the owner, with a copy to all subcontractors involved in that portion of the work affected by the non-payment.

It should be noted that these deferrals rights apply to both GCs and trade contractors who have their own payment obligations to sub-subs and suppliers.

#### **4. If the GC does not follow these procedures, what are my rights (as a subcontractor)?**

Under the proposed legislation, a subcontractor may suspend work and/or terminate the subcontract.

The subcontractor also retains all its rights otherwise available at law, including all rights under the CLA, as well as the right to sue the GC for payment in contract.

#### **5. If the GC does follow these procedures, and still doesn't get paid, what are my rights? Do I still get paid? When?**

Assuming the GC has followed the procedures set out above, the proposed legislation entitles the unpaid subcontractor to call for payment upon the earliest of the four events in section 9 (c) of the proposed legislation, being (a) the date of final determination of the GC's lien rights; (b) the date the GC's lien rights expire; (c) the date on which the owner's default in payment is corrected; and (d) the date on which that default in payment is resolved by settlement or agreement.

The subcontractor's rights under the CLA are not affected by the proposed legislation, and the subcontractor remains entitled to pursue those rights as it wishes. Also, the subcontractor's contractual rights to payment remain unaffected, although the timing of payment is subject to deferral provided the payer follows the process summarized in Question 3 above.

**6. Throughout the whole process, do I still maintain my lien rights?**

Yes. The proposed legislation does not affect lien rights.

**7. Does this legislation apply to the federal government? In other words, if there is a federal project being constructed in Ontario, is the legislation applicable in this case?**

No. Constitutionally, the proposed legislation falls under provincial jurisdiction

**8. If I am a prime trade contractor in a contractual relationship with the GC, and I get paid by the GC, do I have to notify my subs and/or sub-subs that I've been paid? What about my suppliers?**

Yes. There is an obligation on the part of all payers in the contractual chain to provide notification to their payees of the dates of all monies received by such payers on account of the construction work, whether those payers are GCs or trade contractors who have themselves retained sub-subs and suppliers.

**9. Notwithstanding the legislation, can I enter into a contract with a GC or owner with different contractual terms and conditions than the legislation? In other words, if I am comfortable with payment terms over 30 days, is that okay?**

No, that would not be permissible under the proposed legislation. The proposed legislation provides that payments shall be made in accordance with the terms of the construction contract between the parties but no less frequently than monthly. The proposed legislation also provides that any agreement that the Act, or any portion of it, does not apply or that the remedies provided by it are not available, is void.

**10. Under what terms can I lien a job and/or suspend performance of work according to the legislation?**

Lien rights are not affected by the proposed legislation and an unpaid payee can lien at any time to secure payment.



Regarding suspension rights, a contractor or subcontractor who does not get paid retains whatever suspension rights may be found within its contract. If the contract is silent, or if the contract prohibits suspension, the unpaid contractor or subcontractor may still suspend performance of work provided it gives 7 days' written notice of its intention to do so and the default in payment is not corrected within those 7 days.

**11. If I proceed to work on a project for which I bid on and was accepted, but for whatever reason did not sign a contract, does the provincial legislation take precedence particularly as it relates to payment?**

The proposed legislation applies to all contracts or agreements for construction work in Ontario. This includes oral as well as written contracts, and provided it was found that there otherwise existed an agreement between the parties notwithstanding the failure to execute a written contract following acceptance of a bid, the proposed legislation would apply to that agreement.

**12. What are the remedies for late or nonpayment? Does this legislation have “teeth”?**

The proposed legislation has a number of remedies, or “teeth”, designed to deal with late or non-payment:

- deemed approval of payment applications unless a written statement describing the reasons for any non-approval or amendment is delivered within 10 days of receipt of payment application;
- a prohibition against non-approval of payment applications beyond a reasonable estimate of the direct loss, damage or cost of completion or correction, coupled with an obligation to pay all amounts in excess of this reasonable estimate;
- confirmation of the right to suspend performance or terminate a contract in accordance with any such rights as may be found in the contract;
- if the contract is silent on suspension and/or termination rights, or if the contract otherwise prohibits such rights, a general right to nonetheless suspend performance and/or terminate upon 7 days written notice;
- a right to reasonable remobilization costs in the event work resumes following any suspension due to non-payment.

**13. Can contractors hold back monies other than those required by the lien act?**

No. Holdbacks other than those prescribed in the CLA are prohibited in the proposed legislation.

**14. Are material suppliers covered to the same degree as contractors?**

Yes. Material suppliers are covered within the definitions of both “contractor” and “subcontractor”, as applicable, and are subject to the same rights and remedies.

**15. How does this legislation impact upon owners and buyers of construction?**

The proposed legislation impacts owners and buyers of construction principally in the following ways:

- it supersedes any contractual terms that may conflict with the express provisions of the ppp;
- it imposes an obligation to make payment on the dates provided for such payments in any construction contract to which they are a party, but no less frequently than monthly;
- if a construction contract to which they are a party does not provide for progress or final payments, it prescribes a system of monthly payments;
- it provides a positive obligation to pay holdback prescribed by the CLA one day after expiration of the holdback period, provided there are no preserved or perfected liens claiming against that holdback;
- it provides an obligation to make progress payments in the amount provided for in the construction contract, and if the contract does not provide for payment of a specified amount, provides an obligation to pay the actual value of construction work performed;
- it deems approval or certification of payment applications unless a written statement describing the reasons for any non-approval or amendment is provided within 10 days;
- it restricts any non-approval or amendment of payment applications to the reasonable estimate of the direct loss, damage or cost of completion or correction of work;
- it provides an obligation to make payment of any undisputed portion of a payment application;
- it preserves any suspension and/or termination rights otherwise found within the contract;

- if the contract contains no suspension and/or termination rights, of if the contract prohibits suspension and/or termination, it nonetheless allows for suspension and/or termination;
- it prescribes a mandatory obligation to provide reasonable evidence, prior to entering into a construction contract, of financial arrangements to fulfill the owner's obligations under that contract, as well as an obligation to provide updated information after the contract is entered into, as well as remedies for any breach of this obligation;
- it provides for the confidentiality of such financial information, coupled with remedies for any failure to maintain that confidentiality.



*Daily Commercial News,*  
**“Ontario Prompt Payment  
Blueprint Reached”  
(February 19, 2013)**

February 19, 2013

## Ontario prompt payment blueprint reached

PATRICIA WILLIAMS  
staff writer

The Ontario caucus of the National Trade Contractors Coalition of Canada (NTCCC) and the Ontario General Contractors Association (OGCA) have reached agreement on a blueprint for what could ultimately become the basis for Canada's first legislation governing prompt payment.

"After more than a year of collaboration, we now have the groundwork for a workable piece of legislation that will see fairness from the sub-sub to the trade contractor and general contractor and right up to the owner," said OGCA president Clive Thurston.

He said the key to success was the fact that the parties involved in the negotiations "were actual general contractors and subcontractors who were willing to set aside their prejudices and beliefs and respect each other's points of view."

The draft legislation, called an act respecting the protection and viability of construction contractors, details in part the payment obligations of the respective parties.

"This is a total industry effort," said NTCCC director Richard McKeagan, president of the Mechanical Contractors Association of Canada.

"This is great for the relationship between the trades and generals with benefits for all concerned.

"Prompt payment legislation will help address problems in all sectors, and up and down the construction supply chain."

The proposed legislation was drafted by a joint task force of the OGCA and the national trade contractors' coalition.

"We had some real players at the table on both sides," said Eryl Roberts, executive vice-president of the Electrical Contractors Association of Ontario and one of the NTCCC representatives on the joint task force.

He said the most important structural aspect of the proposed legislation is that it is a consensus document.

“It includes all the parties in the construction chain from owners, generals and subs on down, each of which have the obligation to pay promptly and the right to be paid promptly. Unlike most other prompt payment legislation, this is more than just the subs versus the general contractors.”

The legislation has been drafted in accordance with the principles of CCDC2 and the Canadian Construction Association’s subcontract document.

From the perspective of the NTCCC, which represents 11 trade associations, Roberts said the most important provisions pertain to rights to information in the payment sphere.

“For the subtrades, it is the obligation of a general contractor to notify them of payment received from the owner,” he said. “This information is critical to managing prompt payment and agreement on it was key to reaching a deal.

“The discussions around this topic were most enlightening for both parties as it goes to the heart of the problem.”

Task force meetings were facilitated by Geza Banfai, a partner in Heenan Blaikie’s infrastructure and construction litigation practice group.

For its part, the OGCA said in a bulletin to its members that key benefits include the fact that:

- No owner would be able to contract out of the payment requirements in the proposed legislation, which are more balanced than those that many owners utilize.

- Payment certifiers would be held to the time limits proposed and face penalties if they do not process payments.

- If the payment certifier fails to issue certification within the time period, the submission would automatically be deemed certified and due.

- Only the actual value of a disputed amount or amounts involved with a deficiency could be held back. The value held back would be limited, no more 200 per cent of the value of the issue.

- The legislation still allows for deferral of payment to a trade if a contractor is not paid, but provides an incentive for generals to expeditiously pursue their claims. If the notification procedure and other processes are followed by the general contractor, he has the right to defer payment downstream.

- A CCDC clause allowing access to owners’ financial information would no longer be allowed to be deleted.

In addition, no holdbacks other than those prescribed under the Construction Lien Act are permissible.

OGCA chair David Blake said concerns over prompt payment are not new to the industry.

“Payment periods throughout the supply chain have been routinely getting longer, creating animosity and frustration on all sides,” he said. “This joint agreement will go a long way to address these concerns and ease tensions. It is a win for everyone involved.”

NTCCC Ontario caucus chair John Blair of the Canadian Masonry Contractors Association said research shows there is support from all three provincial parties for some sort of prompt payment legislation in the construction industry.

“Now that OGCA and NTCCC have agreed to what the proposed legislation could look like, relative to the terms and conditions, the Ontario industry has a good shot at being the first jurisdiction in Canada to introduce such legislation.”

The task force hopes to present its recommendations to the provincial government in early March.



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